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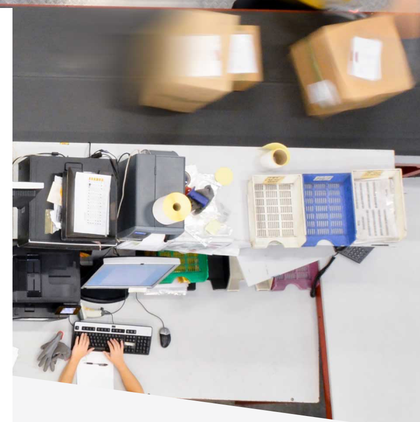
Gain clarity in 2022: A backdrop of changing monetary policy



December 20, 2021

Inflation and supply chain headwinds are expected to ease as the year progresses. And reopening trade will present select opportunities.

William Davies
Global CIO

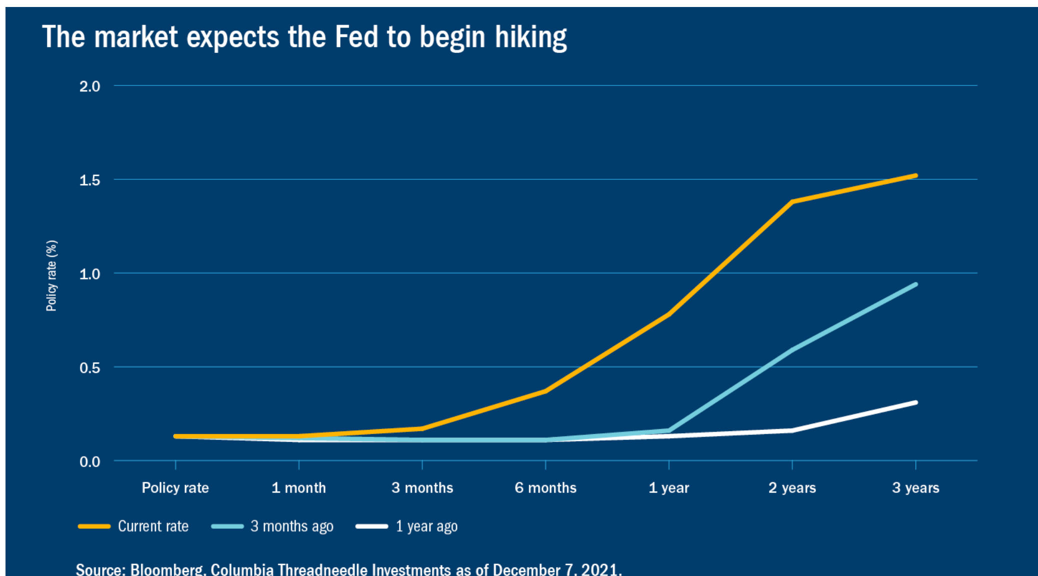
As economies transition to recovery from the onset of the pandemic, there will be changes and challenges. Without accommodative monetary policy to support asset prices broadly, investors must be more selective to find quality opportunities.

The monetary and fiscal backdrop change

Interest rates have been historically low for more than a decade, dampened by the flood of monetary stimulus introduced in the wake of the global financial crisis. In 2022, we expect this to change. As we move toward economic recovery from the COVID-19 pandemic, the new year will be marked by a reversal in monetary policy: Crisis support, stimulus and spending replaced by recovery, repair, reduced fiscal stimulus and a return toward "normal." Political compromise will be key, not least in the U.S., as governments tackle the transition. As the support for asset prices is withdrawn, active management — unearthing companies with the enduring qualities that will help them navigate volatility — will be essential to success in 2022.

Inflation: No time to panic

Transitory inflation is lasting longer than anticipated, but we believe that inflation will moderate through 2022. Helpfully, central banks continue to look through inflationary pressures. For example, the U.S. Federal Reserve has not appeared overly concerned by higher and persistent U.S. inflation, which in previous cycles would have been perceived as a major headwind. Investors and markets are also fairly sanguine. This is in stark contrast to previous shifts in monetary policy in 2013 and 2018, which induced negative market reactions, not least the taper tantrum. Now, the market feels more poised, having waited so long for clarity. This makes us more confident for 2022, albeit in a slowing growth environment.



Source: Bloomberg, Columbia Threadneedle Investments as of December 7, 2021.

One reason we believe inflation will fall in 2022 is improvements in the supply chain. Regardless of whether you believe COVID or other structural and political factors (in Europe especially) are to blame, many of us underestimated the degree to which the supply chain would impact the corporate backdrop. It is our belief that supply chain headwinds will continue to become less dominant in 2022, but it may well be toward the latter half of the year before the positive impacts are felt.

Quality will out

We've seen a good recovery in earnings this year — a reflection of relatively strong balance sheet management by corporates, with stricter cost controls and strong discipline around dividends and share buybacks. The reopening trade and enduring rebound in demand has resulted in heightened cash flows, which have boosted corporate coffers, giving companies the tools to reduce leverage.

But given those supply chain bottlenecks and the persistence of inflation, it will be harder for companies to beat forecasts in the way they have in 2021. At least in the short term. For companies, we anticipate next year will be a return to the familiar cycle of earnings disappointment as opposed to positive surprises.

In previous cycles, when the yield curve has flattened, the impact on equities has shown investors seeking quality companies that could survive any impending rates shock. As we near the end of 2021, we've seen the yield curve steepen, flatten and rise across the curve again. And that has led to a more mixed scenario in terms of what is leading the market. We don't see that changing in the short term, but some areas that outperformed more recently might struggle, such as "meme" stocks — those that become popular among retail investors through social media platforms. The companies we like — quality businesses with solid balance sheets and competitive advantages — stand a better chance of weathering volatility.

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Regions

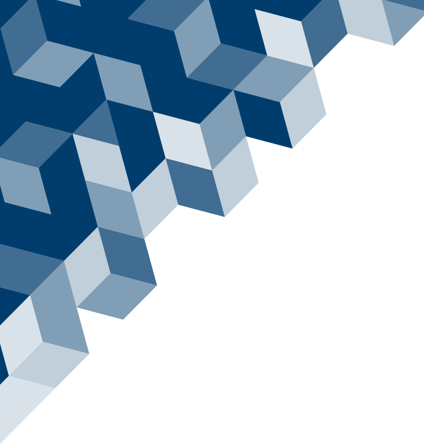
Looking regionally, many investors have turned away from China this year because of its well-publicized regulatory crackdown coupled with an imbalanced property market. We recognize the concerns about regulation, COVID outbreaks, extreme weather affecting food production and transportation, and slowing growth. But China recovered first from COVID and did so with a tighter policy framework than other regions. While growth in the country is a major concern, it increases the likelihood of Chinese authorities providing stimulus in 2022. There is opportunity in China (and the rest of the emerging markets universe), but it requires fundamental research and a bottom-up approach — building portfolios company-by-company — rather than a thematic approach.

In Japan, Prime Minister Fumio Kishida does not represent a positive catalyst in the way Shinzo Abe did. Without this political spark and the expectation of meaningful change, Japan has become a less exciting region for investors, notwithstanding improvements in supply chains that will help the country's industrial nature. That said, active investors are not devoid of opportunities and there is often more breadth in the Japanese market than we give it credit for, not least in the technology and service sectors. The latter is unusual given COVID, but there are ongoing initiatives designed to improve productivity that are unearthing opportunities.

Looking to Europe, we expect strong growth, albeit with the potential for supply chain shocks — already evident in the lack of truck drivers and the reduced labor pool. These factors will likely lead to higher than anticipated inflation and peak stimulus. There is also a theme of change in the region: Angela Merkel in Germany remains a strong presence but has stepped down. A Germany, led by the Socialist Democratic Party's Olaf Scholz along with the Greens and Federal Democratic Party, could see more volatility and a preponderance of stimulus. There will also be a presidential election in France in April, and French elections are notoriously difficult to predict. These events will be market influencers, but to what extent is difficult to estimate.

A year of change

2022 will be a year of change. We have had an environment of fiscal and monetary stimulus for some time. And when taps are kept open, investors do not mind how much governments and central banks spend or how big a national deficit is. But change is coming, however unwanted it might be, and we face a world of economic repair in which markets and investors must consider the impact of reduced fiscal stimulus.



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