The 9 things to watch in 2022

Key catalysts for the economy and markets

February 2022

Summary

When will we move on from the COVID-19 pandemic, from ultra-low interest rates, or from the holding pattern on climate change action? These are the key questions facing investors at the start of 2022.

The 9 things to watch in 2022 identifies what we think will be the crucial drivers for economic activity and market performance and provides our views on how they will evolve.

Globally, the speed of interest rate hikes and pace of inflation in major economies will likely have a significant hand in the outlook for growth. The overwhelming consensus is that elevated inflation will persist but we think price pressures could likely pull back further than the market expects. Nonetheless, the recent steep uptrend in prices does mean that major central banks, led by the US Federal Reserve, are set to hike rates in the coming quarters. One of the key implications will be rising real bond yields; these have been extremely depressed in recent years, and are poised to move higher. For asset markets, this is a significant step-change.

In Australia, the issue of rate hikes is very much front and centre of economic and growth outlooks for 2022. Market expectations for tightening are elevated, with 1 rate hike priced in by mid-year and 3-4 rate hikes by year's end. This looks aggressive as compared to the Reserve Bank of Australia's (RBA) own outlook, for tightening not to commence until late 2023 – a view we share. So, with inflation on the rise here at the turn of the new year, how the RBA reacts to these price pressures, and balances them against risks to growth, will be important. Recent data, encouragingly, shows the economy is weathering the most recent Omicron COVID-19 wave. Still, the current divergence in views indicates a volatile year could be ahead for Australian markets.

This year should also be where the "new normal" economy lands for Australia, the US, and other major economies. In particular, the US labour market, which has been choppy since the pandemic struck, looks set to settle at a lower level of participation, with many retirees exiting employment and unlikely to return. This has implications for inflation and wages which we will closely watch. It is also important for mobility. This changed dramatically earlier in the pandemic, including with relocations from large cities to smaller metros, and shifted our day-to-day movements in a big way. In our view, these big shifts have likely peaked, and the one-off structural changes we have seen are done for now. This matters for rents, spending and jobs. The one key exception to this outlook is China. Still in pursuit of COVID-zero, and with property activity on the decline, there are certainly downside risks here as this major economy finds its footing.

Finally, this year will also be an interesting one to watch for other markets – carbon and crypto. As the world recovers from the pandemic, countries are ramping up their Net Zero policies, and investors are increasingly focused on sustainability. Carbon pricing could then start to reflect, in a meaningful way, a push to carbon neutral economic activity. Crypto assets are another area garnering increased policy attention as we push on from COVID-19, with much tighter regulation set to come in 2022.

Table 1: The 9 things to watch in 2022

Item	Forecast
1. RBA doesn't tighten in 2022	Cash rate unchanged in 2022
2. US inflation falls towards 3%	End 2022 around 3%
3. Rising real yields deflate risk appetite	Ends 2022 around 0%, for 10-year US real yield
4. US mid-term elections trigger fiscal tightening	Republicans dominate US mid-terms
5. This is the new normal for labour force participation	US labour force participation maintains at ~62%
6. China slowdown deviates from its expected path	2022 GDP growth significantly undershoots, PMIs averages below 51.0
7. Pandemic-driven shifts in mobility have peaked	Rental vacancies trough in 22H1
8. The carbon price is a renewed catalyst for change	Carbon price sustains upward trend in 2022
9. Regulators target cryptocurrencies	International regulatory framework introduced, led by the Bank for International Settlements

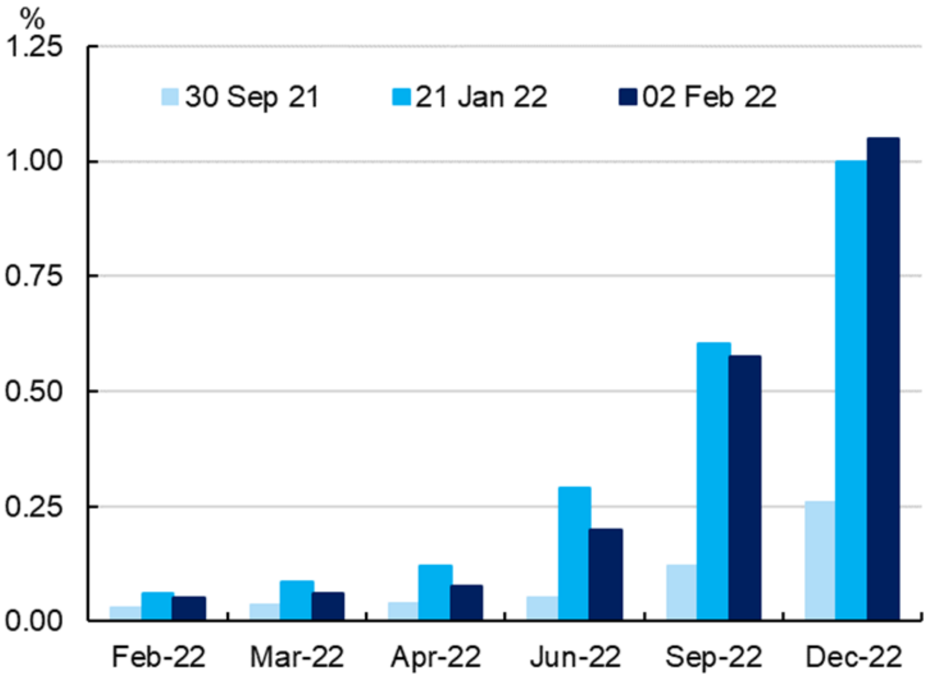
Source: TCorp

By listing these 9 things we think are most critical to the global economic outlook and expectations for how they may evolve, we can monitor how our views are tracking over time and whether (and in what direction) we need to revise our forecasts. We will revisit these forecasts regularly to see how they are performing and determine if the variables have diverged sufficiently from our baseline to warrant a shift in our overall view, or whether we can characterise this as “noise”.

1. Reserve Bank of Australia doesn't tighten in 2022

In December, the Governor of the Reserve Bank of Australia said that he thought it extremely unlikely that the conditions needed before the RBA would consider raising interest rates could be met in 2022. This position was reaffirmed in February, where the RBA indicated it would be "patient" while monitoring trends in inflation. Despite that, as shown in the chart below, markets became more confident that the RBA will raise interest rates and now have 1 rate hike priced in by mid-year and 3-4 rate hikes by the end of the year.

Chart 1: Market-implied RBA Cash Rate during 2022



Source: Bloomberg

The reason why investors are ignoring the RBA Governor likely relates to the backflips by global central banks in recent months. In the US, for example, policymakers in mid-2021 suggested that rate hikes were very unlikely in 2022 but are now happy to entertain raising rates 4 or 5 times while at the same time initiating "quantitative tightening" or selling their bond holdings.

Of course, US policymakers would argue that the change in their position reflects a change in the facts and, with inflation hitting 7%, it is prudent to remove some monetary stimulus. The situation in Australia is, however, very different with underlying inflation only recently sneaking back into the RBA's target band and wages growth still benign. That said, the RBA did quickly abandon its pledge to keep the April 2023 bond yield at 0.1% when markets challenged that policy. As such, they probably feel emboldened that the RBA will find it impossible to resist joining the global wave of tighter monetary policy this year.

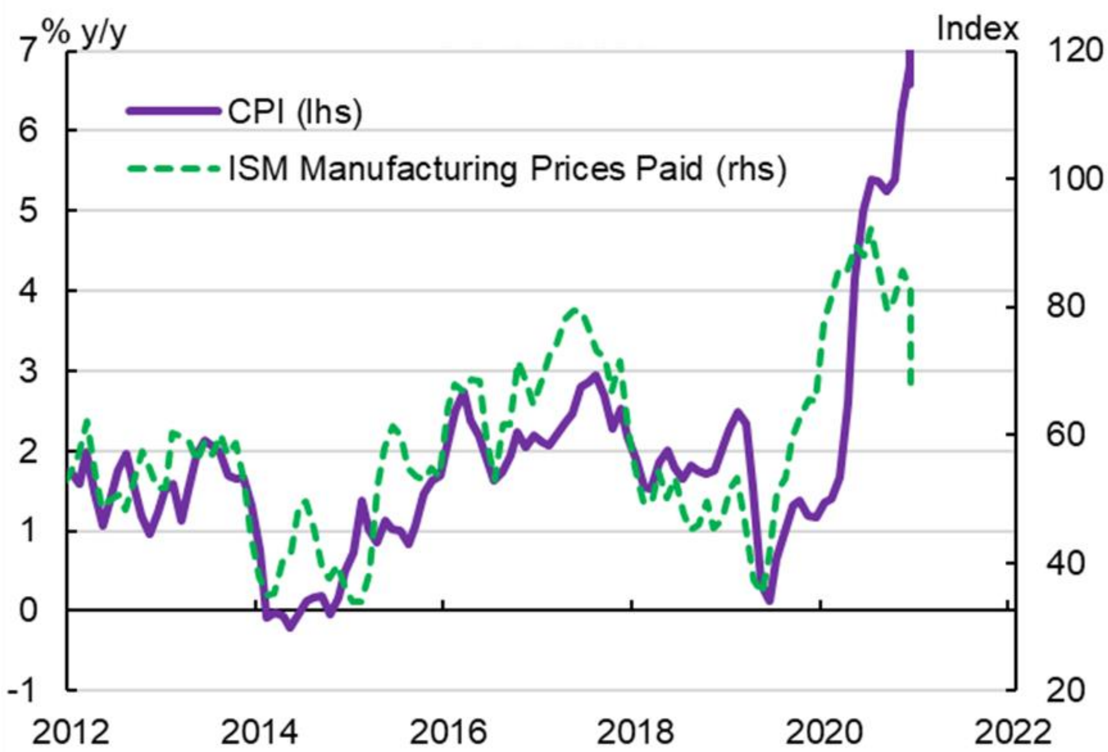
Our view is that the RBA is right to delay tightening until wages growth has risen well above 3% and that this is unlikely to happen in 2022. On the RBA's own estimates, this is only anticipated in 2023. If, however, the RBA does abandon its current framework, and capitulate to market pressure, then it would have profound implications for the housing market in particular, and the growth outlook for 2023.

2. US inflation falls towards 3%

Headline inflation in the US reached 7% during 2021, its highest level for 30 years. While the US central bank was initially relaxed about rising inflation with an expectation it would be transitory, policymakers shifted gear late in 2021 as they feared it may become entrenched.

While the description of inflation as "transitory" triggered a lot of debate as to whether that was the appropriate description, the real issue is whether inflation mainly results from unsustainably strong demand – in which case, raising interest rates to suppress demand is the appropriate response – or if it reflects supply chain issues resulting from the pandemic.

Chart 2: US consumer price inflation and ISM survey on producer prices, 2012-2022



Source: Bloomberg

Currently, market consensus forecasts suggest inflation will be 4.7% which is only a modest decline from its recent pace. Moreover, with aggressive monetary policy tightening expected by investors in 2022, it implies that they think inflation is essentially driven by too-strong demand and so requires a forceful response from the Fed.

We still believe, however, that most of the increase of inflation reflects supply problems and, as supply and demand patterns normalise over 2022, inflation will decline more quickly than the market expects, potentially falling to 3% later in the year. If this did occur, it could potentially have important implications for financial markets as it would raise questions over how aggressively monetary policy did need to be tightened.

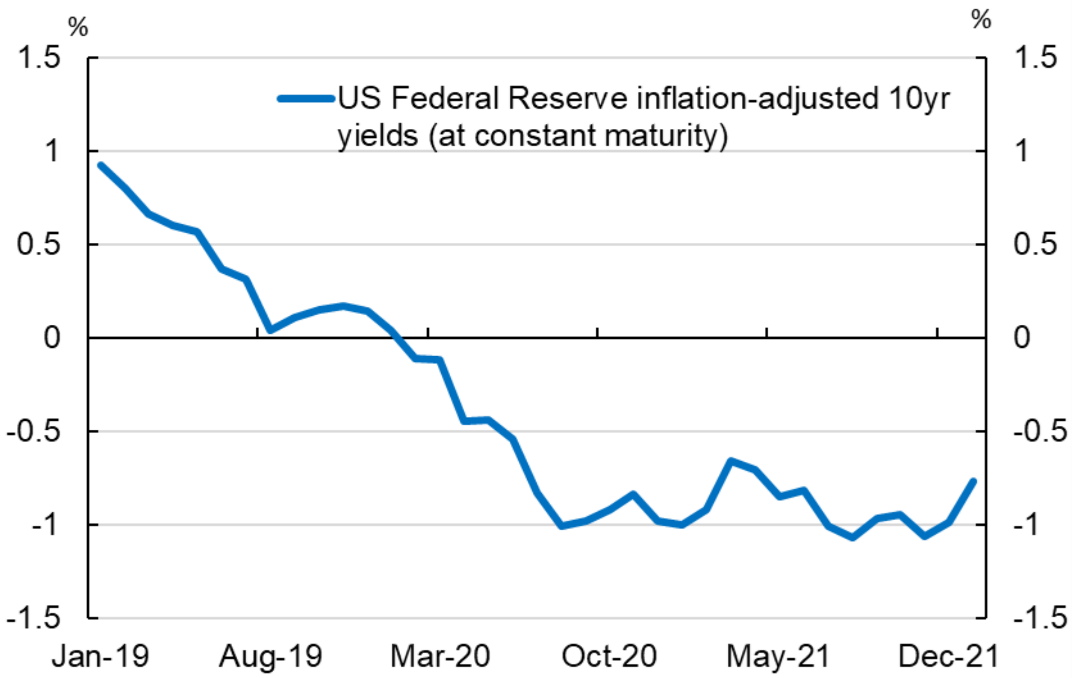
3. Rising real yields deflate risk appetite

The US Federal Reserve will start tightening monetary policy in 2022 in response to elevated inflationary pressures and resilient employment. Indeed, financial markets think the Fed could raise interest rates 5 times in 2022, and expect quantitative tightening to commence.

With a higher Fed fund rate comes higher longer-term bond yields, as the yield curve moves up. Consensus expectations currently put the US 10-year yield at 2.20% by year-end, which is around 50bps higher than average levels for January, and 75bps higher than average levels in Q4 of 2021.

Higher yields depend on inflation expectations and real yields. What matters in 2022 is that higher real yields are likely to do the work, in contrast to 2021, where rising longer-term yields predominantly reflected higher breakeven inflation expectations. That is, US 10-year breakeven inflation rates rose from 2.0% in January 2021 to more than 2.7% in November 2021. This year may be different, with real yields marching higher, albeit from an extraordinarily low base. Real US 10-year yields have already risen from -1.04% and end-2021 to -0.66%.

Chart 3: US 10-year real yields (constant maturity)



Source: Bloomberg, TCorp

The key issue for financial markets, and the economy, is how high these real yields will get. Risk appetite and asset prices can withstand some uplift in real rates but the unknown is what this threshold is. Rising rates are coming off a very low base. Indeed, even though real US yields have been increasing, they are still firmly in negative territory. Still, with rates expected to follow a steep upward trajectory from here, as Fed hiking commences and inflation peaks and declines, this then means that US 10-year real yields could touch 0% in 2022.

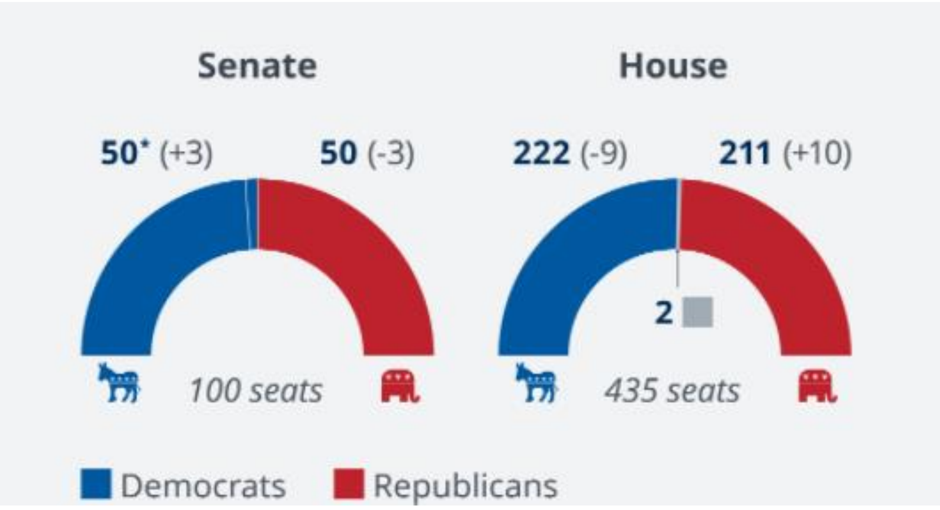
If that occurs, it would be the highest level since right before the COVID-19 pandemic. As a result, real yields at 0% could be an important benchmark for Fed policymakers, and markets, to look to in 2022. This can provide a gauge of the magnitude of impact Fed actions are having, as tightening through rate hikes, and quantitative tightening, begins.

4. US mid-term elections trigger fiscal tightening

The US will hold its mid-term election in November 2022. When President Biden took office at the 2020 election the Democrats also managed to gain control of both the Senate and House, although with narrow margins. In fact, the tightness of the Senate result has been problematic for the President as a couple of Democrat senators have been able to stymie some of his key fiscal programmes.

There is often a swing against the incumbent's party at the mid-term election, which means that the Democrats are likely to struggle to retain control of both houses. Throughout 2021, President Biden's popularity rating has also declined, which suggests that the Republicans are now clear favourites to win both chambers, which probably rules out the prospect of any further fiscal stimulus in the next couple of years. Rather, a return to fiscal tightening is now the base case.

Chart 4: The results for the US 2020 Congressional election by major party



Source: Associated Press

There is, however, another important aspect of the 2022 election cycle. Alongside the congressional results, are a number of state elections that will not only determine Governors and their legislatures, but also the Secretaries of State. This is potentially important because the states run the Presidential election and decide which people formally elect the President in the Electoral College. Until now, those electors have voted in line with the popular vote but following the 2020 election in which President Trump declared the result as fraudulent, a number of politicians have since advocated for a break from that tradition.

These issues are relevant in states such as Wisconsin, Nevada, Pennsylvania, Arizona, Michigan and Georgia. It raises the extraordinary possibility that a Democratic candidate could win a majority of states in the 2024 Presidential election, but if those states are run by Republican administrations they vote for the Republican alternative when sending their representatives to the Electoral College.

To be sure, this might be an extremely remote possibility but if Republicans in these states do very well in the mid-term elections, then momentum could build for the next Presidential election. It could have major implications for the US outlook in the next few years and may begin to affect markets as they consider the potential volatility.

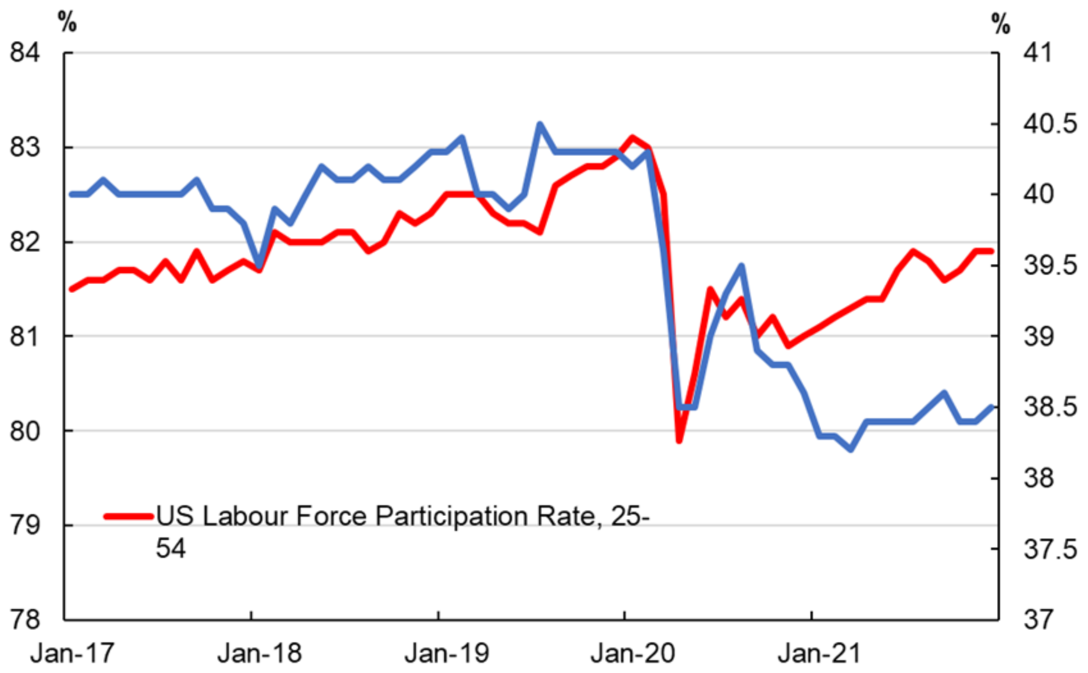
5. This is the "new normal" for labour force participation

The COVID-19 pandemic has disrupted labour markets, particularly in countries like the US and UK where the initial health response to the virus was poor. Participation rates and employment data have been very volatile which makes it difficult to discern whether a particular shift will be temporary or become a persistent feature of the labour market. This is important because if people have permanently left the labour market, then labour shortages will be more prevalent, and wages are more likely to rise.

In the US, the "new normal" appears to be characterised by lower labour force participation. The US labour force participation rate (which measures the proportion of the population that wants to work) stands at 61.9%, down from 63.2% pre-pandemic. In the initial stages of the pandemic, younger workers led the fall in participation. Prime-age (25-55) parents were part of this decline, as childcare demands forced some participants to remain home. However, participation for this group has now recovered back to 81.9%, roughly in line with 2017-18 levels.

This contrasts with older workers (those over 55), who have been leaving the labour force and have not yet returned. Labour force participation dropped from 40.3% pre-pandemic to 38.5% by end 2021 for this age group. Health concerns and access to retirement funds may have made early retirement more attractive and that suggests that this cohort will be less likely to return to the labour force.

Chart 5: US labour force participation rates, age 55+ vs age 25-54, 2017-2021



Source: Bloomberg

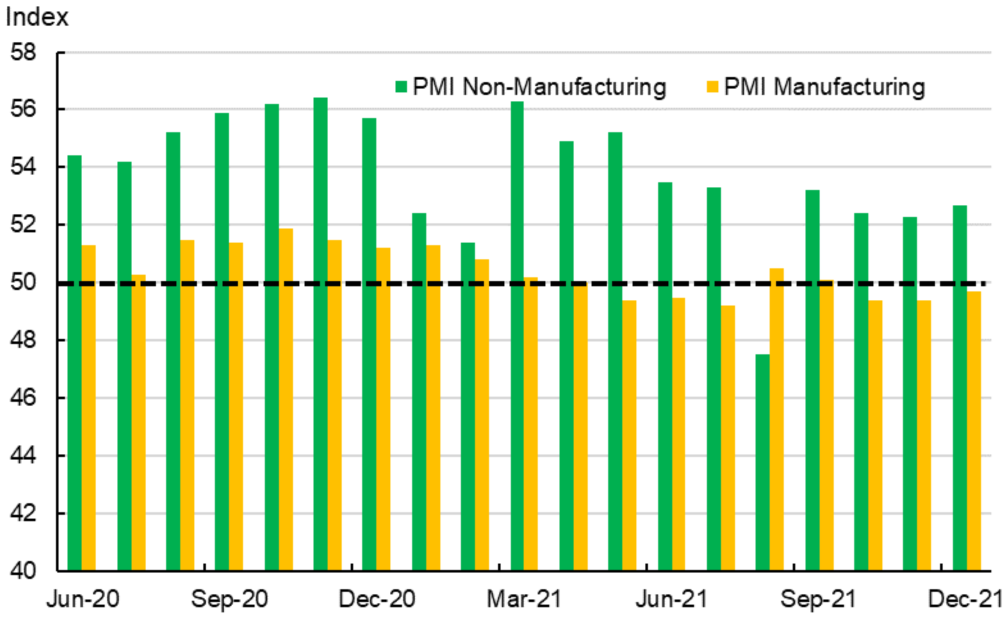
But while the vast majority of people who left the labour market as retirees are unlikely to return, now that they *have* left, the participation rate should stabilise. That is, this seems to be a one-off structural break rather than a change in trend. Thus, while the sharp fall in participation likely contributed to higher overall wages growth in 2021, wage pressures should ease in 2022 as participation stabilises and labour supply and demand come back into balance.

6. China slowdown deviates significantly from its expected moderate path

The Chinese economy is widely expected to grow more slowly in 2022. Purchasing Manager's Index (PMI) surveys weakened over 2021, which is consistent with moderating activity. But these PMI indicators appeared to stabilise at the end of 2021 and consensus forecasts point to GDP growth of around 5% for the year.

This outlook reflects significant weakness in real estate investment, which is expected to be offset by better manufacturing-related investment and activity. At the same time, macroeconomic policy settings in China will likely be loosened in 2022. The central bank, the PBOC, has already reduced interest rates and government spending is also expected to support activity.

Chart 6: China Purchasing Managers' Indexes 2018-2022



Source: Bloomberg

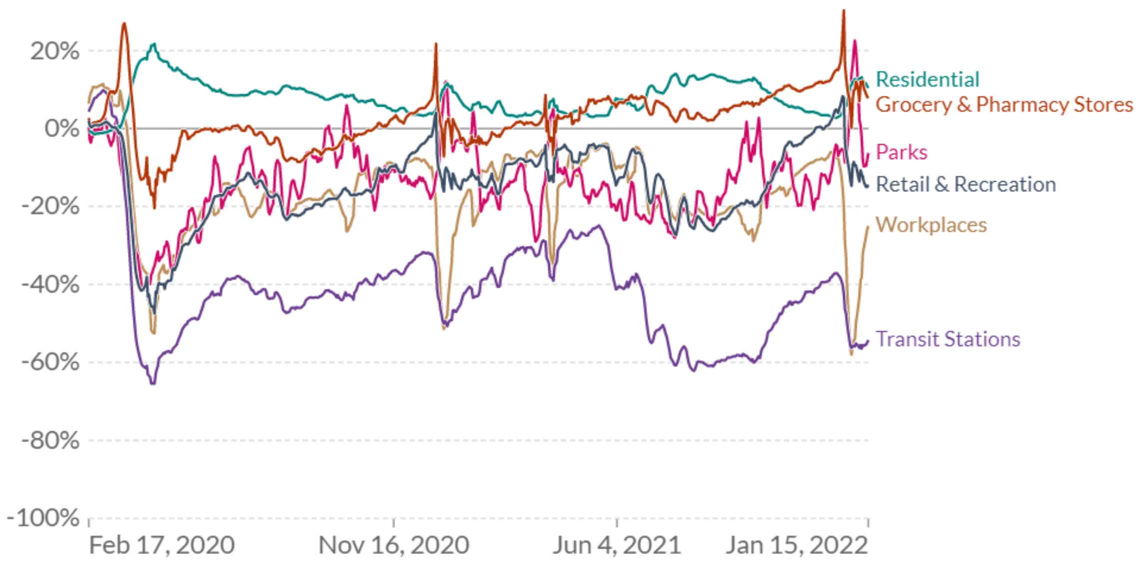
One of the key risks around this outlook is the way that Chinese authorities have chosen to manage COVID-19, namely, their decision to pursue "COVID zero". If this remains the policy stance in China in 2022, it is a significant risk to consumption and industrial activity, requiring the frequent use of lockdowns and economic restrictions whenever a case is found, and dampening consumer spending. It can also disrupt manufacturing, as workplaces with infections get closed down. On the flipside, a careful transition toward "living with" COVID and effectively ring-fencing property risks could mean a better year and earlier rebound in activity.

Risks to the outlook are global in their impact. For Australia, weaker Chinese growth – particularly if it is concentrated in construction – could dampen commodity prices. The terms of trade are expected to deteriorate in the coming quarters, a reflection of slowing demand from China's property sector. Supply chain disruptions from COVID zero could also mean that product shortages and price spikes persist in Australia, and other countries, in 2022.

7. Pandemic-driven shifts in mobility have peaked

Alongside the labour market, mobility is another area where the COVID-19 pandemic has generated significant shifts in activity. As shown in the chart below, Google mobility data reveal community movements in Australia to workplaces, transit, retail and recreation have been very volatile but on the whole are lower than where they were before the pandemic. People are also spending more time at home.

Chart 7: Community mobility by category in Australia, 2022-2022



Source: OurWorldInData

Part and parcel of this shift has been noticeable migration of some of the workforce from larger cities to smaller ones, or out of metro areas, enabled by working from home. This change has been substantial. For example in 2021, rents grew at a much quicker clip in Hobart, at around 13% yearly, compared to Sydney (around 6%), and Melbourne, where rents were near-flat. In NSW, the biggest annual growth rates in house prices in 2021 were in premium “lifestyle” markets, including the Southern Highlands and Central Coast regions. The same trends have been seen in other countries, including the US and UK.

At the outset of 2022, it looks possible that the COVID-19 pandemic progresses into an endemic phase, and with it, community behaviours may normalise. Whether mobility will snap back, or recent trends will continue, is important. This will affect the demand for public transport, office space, and shape the future of major CBDs and use of suburban and regional public areas. It is likely that the radical shift in households, from city to smaller city or town, is a one-off adjustment and as a result, the step-change in behaviours has peaked with remote or hybrid work arrangements already in place. Any affordability advantage to move to a smaller city or town has also been significantly eroded during the pandemic and could make this move less attractive going forward.

Two key indicators to watch in 2022, as a signal on the broader mobility picture, are rental vacancies, and rents. For example, at the same time rents could peak in second-tier locations, there are also signs that key urban housing markets, including New York and San Francisco, are recovering – vaccination rates are now high and offices are reopening. Such changes will be important to monitor in the rental market, insofar as they give ongoing updates on mobility overall.

8. The carbon price is a renewed catalyst for change

With governments working to mitigate climate change and get to net zero emissions, there is increasing adoption of "cap-and-trade" programmes, which typically work by allowing a reducing number of emissions allowances each year, capping the pollution that businesses can emit. Carbon prices have been on an upward trajectory in recent quarters, for example with the European Emissions Trading Scheme recording very strong growth in the price of its carbon allowances, from around EUR35 at the start of 2021 to more than EUR80 by year-end.

Chart 8: Carbon futures prices for European Emissions Trading Scheme 2017-2022

Source: Bloomberg

The key question is whether an uptrend in carbon prices will be sustained, as it would represent an important shift in incentives for those industries and businesses participating in the markets. With regulators setting the cap on emissions, the carbon price right now reflects demand stemming from mandates for some sectors, and voluntary net zero commitments from other firms. Firms that cannot deliver immediately on net zero, or mandated emissions reductions, participate in carbon markets to buy offsets and fill this gap. Price rises therefore reflect more interest from companies, and increasingly from institutional investors.

At some point, the relationship between buying offsets – and undertaking the real investment in technology and operational changes needed to achieve net zero operations – will start to shift. At this point, the carbon price would cease to be a cheap alternative, and firms would start to find it cheaper to reduce emissions directly. This is where the price of carbon could start to truly impact companies' bottom lines and investment decisions.

We don't know what this price will be, and it is unlikely to be uniform across sectors and jurisdictions. However, sustained carbon price appreciation in key markets in 2022 would be a sign that this push forward could be getting underway.

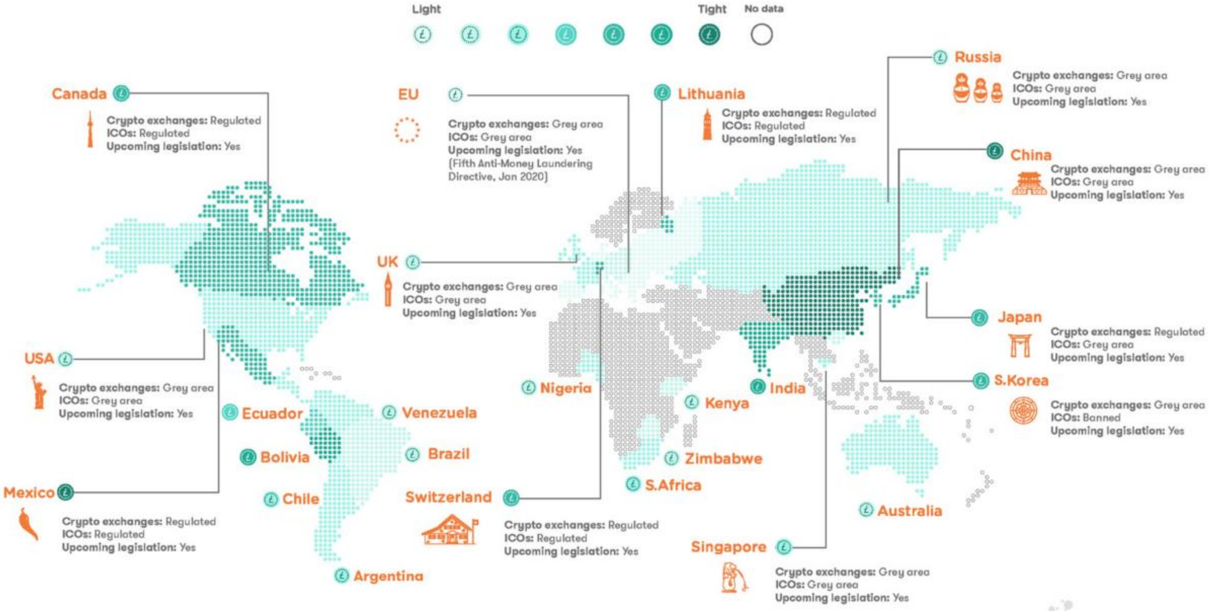
9. Regulators target cryptocurrencies

Cryptocurrencies such as Bitcoin, Ethereum and Tether have certainly grabbed the attention of many individual investors, as well as the financial press, for several years. More recently, some larger institutional investors, including hedge funds and fund managers have said that they consider cryptocurrencies to be a legitimate investment.

One of the impediments working against viewing cryptocurrencies as a legitimate financial asset has been the lack of regulation. If the exchange on which you are holding your crypto currency can simply disappear overnight (and with it your "investment") then this is a clear disincentive to invest, regardless of what other qualms an investor might have.

At present, there is a wide range of regulatory approaches towards cryptocurrencies around the world (see chart below). We suspect, however, that 2022 will be the year that global financial regulators finally develop rules around crypto assets.

Chart 9: Global crypto asset exchanges and regulations, January 2022



Source: Visual Capitalist

Of course, regulation can be designed to discourage or facilitate the use of cryptocurrencies. China, for example, is wary of their use, while other countries have been far more supportive. In our view, this divergence of views will remain. What may emerge, however, is an increased focus on consumer protection, which could affect the marketing and sales of cryptocurrencies, as well as increased scrutiny of crypto security and liquidity. The other area likely to receive attention surrounds transparency, such as the requirement to report crypto transactions to regulators.

The impact of increased regulation on cryptocurrencies is another question. While it might encourage more institutional investors to consider purchasing crypto assets, cryptocurrencies have also been widely used by criminals on the black web and used in cybercrime, extortion, and ransoms etc. Of course, this source of demand for crypto assets might wane, as long as the regulation is effective. Further, increased participation of institutional investors might make this space much more efficient. In a financial market sense, however, an efficient market is one in which there are no easy profits to be made. This could also remove one of the main reasons individual investors have flocked to these instruments.

Reflecting on 2021

Just as each year we peer towards the horizon to see what the next 12 months might deliver for investors, we also think it's worthwhile (if not always pleasant) to review last year's forecasts noting what we got right and wrong, and what lessons we can learn.

For our *9 things to watch in 2021*, this was a year of significant upside surprises to many of our forecasts. Overseas, US inflation and earnings growth were large outperformers compared to our expectations, and those of the market. In Australia, house prices were incredibly strong, again outpacing our estimates and analyst forecasts. At the same time, the RBA's ultimate decision to abandon its 3-year yield curve target and consequently see yields surge from 0.1% to more than 1.0%, was outside of our expectations and those of many analysts.

Perhaps it was the case that we, along with many others in the market, had been primed from 2020, when we were in the thick of the first wave of the COVID-19 pandemic. This recent experience – as well as other points in history – certainly fed into our forecasts for 2021, with an outlook for moderate-paced improvement seeming most plausible at the turn of the new year.

This sensible thinking was certainly tested, particularly when it came to price pressures. Inflation measures pushed boundaries in Australia and overseas, particularly in the US, where headline CPI hit 7.0% annual growth by December. Such eye-watering results are an important reminder of the magnitude, and duration, of supply chain problems and other disruptions from the pandemic. As a result, an understanding that these are still not normal times, with a normal business cycle, will be important to apply to interpreting data, and thinking about the outlook, in 2022.

Another key theme that stands out in our review of our 2021 predictions was the resilience of global economic growth. That the global PMIs rebounded, to continue to track at solid levels even with third, fourth and then the Omicron wave of COVID-19 infections, is a great result. It does suggest that other aspects of our *9 things to watch in 2021*, including a US minimum wage increase, normalisation in Australian household savings and a stronger Australian dollar, are in the pipeline, albeit more slowly.

While it was a volatile year with some key surprises, our 2021 list again captured the most impactful variables. Our *9 things to watch* undoubtedly reflected the hot button issues for investors and policymakers in Australia for 2021. In a period of great uncertainty and rapid change, identifying the key issues and providing a framework for thinking about them is arguably more important than specific forecasts. Staying focused on a select few issues is another key lesson to carry into 2022, where market nerves are likely to run high, and volatility with it.

Table 2: The nine things to watch in 2021 – forecast vs actual

Item	Forecast for 2021	Actual (year-end)	Outcomes
Global economic growth	Strong but slower than hoped	Improved	Global PMI rose from 53.8 to 54.2
US 10-year bond yields	End 2021 around 1%	1.51%	Rising rate hike expectations supported higher yields through the year, from 1.0% in January to1.2-1.5% in 2H21
US inflation	Ends 2021 around 2%	7.0%	Pandemic-driven supply chain and wage shocks drove extreme CPI
US minimum wage	Increased to $15 over time	Federal minimum wage held at $7.25 in 2021	Official minimum held, however low-wage sectors recorded significant increases
US earnings growth	Up 8% over the year	50% growth for all of 2021 for S&P500 companies	Huge profit gains supported by recovery from COVID-19 pandemic in 1H21
Australian household saving rate	Modest decline over the year	Averages 15.0% for 1Q-31, compared to 14.2% for 2020	Trended higher, with ongoing COVID-19 pandemic impacts
RBA 3-year bond yield target	Maintained	Abandoned in November 2021	Surprise move from the RBA to let yields run higher
A$	Ends 2021 at US$0.76	Ends 2021 at US$0.73	A$ trended lower through 2021, from a high of US$0.78 in February, to a low of US$0.70 in early December
Australian house prices	Up 5% over the year	Up 25.4% over the year	Massive surge in home prices fuelled by low borrowing costs, high employment and expectations for near-term rate hikes

Source: TCorp

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