Aviva Investors Q&A: House View 2022 Outlook

December 2021

Find out more about Aviva Investors' latest economic thinking and asset allocation views in the House View 2022 Outlook, with Michael Grady, head of investment strategy and chief economist, and Jennie Byun, multi- asset & macro investment director.

Jennie: The above consensus growth expectations we forecast at the start of 2021 broadly played out. What are your thoughts as we enter 2022?

Michael: Global growth is expected to be around six per cent for 2021. Looking ahead to 2022, we expect growth to moderate to around 4.25 per cent, broadly in line with consensus. Across all major economies, we expect a slowing from the rapid pace of recovery in 2021, but a still above-trend pace of growth, reflecting the expected full reopening of the service sector, pent-up demand, strong household and corporate balance sheets and easy (albeit less so than in 2020/21) monetary and fiscal policy.

Jennie: What are the main risks to this outlook?

Michael: The new Omicron variant of COVID-19 could present a challenge that may require - at least temporarily - the re-introduction of restrictions on economic activity. And it may not be the last variant that causes concern. However, we expect Omicron or other variants to defer growth rather than create a permanent loss, so long as income support measures are once again available. The risks around the growth outlook in China are also likely tilted to the downside, as the country continues to look to deleverage the property sector and pursue "common prosperity".

Jennie: How does inflation play into the equation – are we ready to retire the term "transitory"?

Michael: Yes, the transitory-permanent distinction is less helpful and relevant now but if we had to characterise it, persistent would be more appropriate. Although for less than a year, inflation has been high enough, for long enough, to matter in terms of influencing sentiment, behaviours and expectations. We believe inflation will remain high compared with the average since 2000, but it is not out of control and believe central banks can contain it satisfactorily. But the confluence of factors affecting inflation currently clearly point to upside risks due to the combination of continued strong demand, already tight labour market and supply-side constraints.

We, like many other forecasters, have significantly revised up both the peak in inflation and the time we expect it to take to ease back. But given the uncertainties around the inflation process and the unique nature of the recession and recovery, it is right to be humble about our ability to forecast the inflation outlook with any certainty.

Jennie: With that in mind, what are your projections for rate hikes across major developed central banks?

Michael: Starting in mid-2022, in the US we expect two to three rate increases by the end of next year, with another four to five in 2023. The Bank of England is expected to raise rates by a similar margin in 2022, although beginning that process sooner. Meanwhile, we now see the European Central Bank as potentially looking for the first rate increase in over a decade in early 2023. The Bank of Japan is not expected to raise rates in the next two years.

The special circumstances surrounding COVID-19 have complicated monetary policy decision-making considerably. In normal times, the combination of above-trend growth and above-target inflation would have led to at least some policy tightening, especially since current settings were effectively in maximum stimulus mode. But, as in the aftermath of the global financial crisis over a decade ago, a cautious approach to the withdrawal of support has been warranted.

Jennie: How does all this translate into asset allocation?

Michael: We retain a moderate overweight position to equities going into the new year, funded by an underweight position in credit. Equities typically fare better than credit during the middle stages of the business cycle; whilst valuations are high for both asset classes, the prospect of rising rates volatility raises disproportionate downside risks to credit.

While inferior to equities in the middle stages of the stylised business cycle, credit is likely to provide positive excess return thanks to the improved entry point, with better prospects in high yield, where we are cautiously constructive, versus investment-grade credit. In light of persistently high inflation and risks to the inflation outlook being tilted to the upside, we maintain a negative stance on government bonds. Emerging markets are expected to underperform developed markets in FX and equities.

Jennie: Wouldn't the rising rate environment pose a headwind for equities as well?

Michael: With the first rate hike by the Federal Reserve likely to occur by the middle of next year, it is worth noting that equities, on average, weather the beginning of well-telegraphed, rate-hiking cycles positively. Average inflation targeting has led the Fed to be significantly more patient in tightening monetary policy and, in turn, has led to unusually low real rates for this stage of the cycle. The risk to equities continues to be a swift re-setting in real rates that could lead to stock market volatility – however, we think real rates will remain negative for a while and would see selloffs as potential buying opportunities.

Equally important will be the type of company that outperforms. With end-demand growth rates normalising, and companies suddenly having to deal with significant input cost inflation for the first time in years, the performance gap between those with genuine pricing power and enduring cashflows and those without is likely to be stark. This is a key area where we are focusing our bottom-up analysis. We see further general potential for rotation from 'growth' to 'value' in 2022.

We reinstated our preference for US over EM equities based on the outlook for slowing global growth and higher real rates in light of stronger-than-expected inflation outcomes. At the same time, regulatory, re-distributional and de-leveraging policies in China are not met with adequate policy easing measures, resulting in downside risks to Chinese economic and earnings growth. China remains the key market to call for the EM asset class and confidence remains low.

Jennie: What about our currency outlook?

Michael: We expect 2022 to be a year where idiosyncratic stories drive currency returns, creating opportunities for macro investors who can correctly predict these differing paths. Currencies of economies where policy normalisation lags will prove to be good funders against more growth-sensitive crosses.

Both EUR and JPY could see their sensitivity to risk assets increase in 2022 if short market positioning becomes stretched. Higher commodity prices have led to significant terms of trade shocks; 2022 could see these pass through to currency pricing. With Omicron creating an uncertain environment, investors may be looking to traditional risk reducers such as JPY and CHF to help protect portfolios. Currently, the USD is more negatively correlated to global equities than any other G10 currency; hence, risk reducers are best played versus crosses other than the USD.

Jennie: With rising inflation reducing the dependable equity-bond correlation, what can investors do to build robust portfolios?

Michael: A major challenge for asset allocation is the instability of the bond yield-equity correlation, as we saw in early 2021 as a stronger recovery became consensus and again in Q4 after the Delta growth scare ebbed and inflation worries rose.

Duration will continue to be an important tool for most portfolio managers in managing broad risks, but understanding when this may not be as effective is crucial. In the face of a less dependable equity-bond correlation, investors can access direct and indirect exposure to help manage scenarios with rising inflation. Direct exposure can be achieved via inflation, rates and curve positioning, with second-order exposure achieved through commodities, currencies and equity sectors. For instance, physical securities, such as oil, should move with inflation and this in turn will move commodity producing countries' currencies and companies.

Jennie: What should we make of COP26? Did we see talk accompanied by action?

Michael: On the one hand, COP26 made it plainly clear there is little chance of achieving the long-stated goal of limiting global warming to 1.5 degrees agreed in COP21 in Paris. Essentially, the actions planned to achieve the Paris goals are simply insufficient and targets need to be reset.

But momentum from COP26 can help close the gaps. Another round of climate plans in 2022, the roll-out of targeted financing partnerships and renewed US-China collaboration all offer hope. Public interest and scrutiny have never been greater. Scepticism is understandable given the poor historic record, but if the mood and momentum do result in major changes to climate change policies, the economic consequences would be vast.

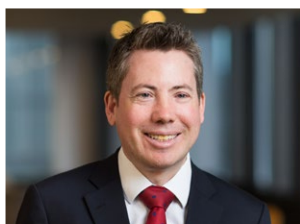
Jennie: What are the main takeaways for investors on the potential long term market impact?

Michael: Vaguely defined, longer-term threats like climate change are difficult for investors to price. But COP26 contained signals about where we should expect action and therefore how companies and countries might be affected. Already, the EU, a signatory to the deforestation pledge, has proposed banning products like beef and cocoa unless companies can prove supply chains are deforestation-free. The EU ETS carbon futures prices rose nearly ten per cent in the week following COP. Switzerland has signed a deal with Peru to purchase nearly a million tonnes of carbon offsets under the new rules.

More change is ahead. And because there is no one-industry or one-fuel response, transitions and sequencing will vary by sector and country. That will create opportunities as well as disorder, especially if Dornbusch's law applies, where things take longer than you think to happen, then occur far faster than you imagined.

Portugal's experience suggests it might. In 2017, with coal representing 25 per cent of the country's electricity generation, it proposed phasing out coal power by 2030. Shortly after COP, Portugal closed its last coal plant, nine years ahead of schedule. Investors cannot afford to miss the signals, as talk increasingly translates into action.

View the latest version of the House View here.



Michael Grady
Head of Investment Strategy and Chief Economist
Joined investment industry: 1999
Joined Aviva Investors: 2015

Main responsibilities

Michael is Head of Investment Strategy and Chief Economist and is responsible for formulating our macro 'House View' and the risks to that view, as well as overseeing investment strategy for the AIMS funds. Since joining Aviva Investors as Senior Economist and Strategist, Michael has been responsible for monitoring and analysing global macroeconomic, market and policy developments.

Experience and qualifications

Prior to joining Aviva Investors, Michael was senior economist at COMAC Capital Llp, a global macro hedge fund, where he was responsible for the economic and market analysis used to inform the investment process. Prior to this, he spent a decade at the Bank of England in a variety of senior roles, latterly as a Senior Manager in the Markets Directorate. He began his career at the Australian Treasury.

Michael holds a BEc (Hons) from Macquarie University, Australia.

Jennie Byun
Multi-asset and Macro Investment Director
Joined investment industry: 2000
Joined Aviva Investors: 2018

Main responsibilities

Jennie is an investment director focusing on our multi-strategy capabilities. Based in London, she works closely with our portfolio managers to articulate their investment process, portfolio positioning and investment performance to clients and consultants around the world.

Experience and qualifications

Jennie began her career in emerging markets fixed income index research with JPMorgan NY, before relocating to London to help build the company's commodity index business. She then moved to the investment side as strategist and execution trader for a long-only multi-asset fund, covering the fixed income and commodity portfolios.

Jennie holds a B.S. in Management Science from Massachusetts Institute of Technology and an executive MBA from London Business School.

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