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Can Central Banks Nail the Landing?

2022 is likely to be a year of transition as the market's focus shifts.

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We expect 2022 to be a year of transition, with the market's focus shifting from COVID-19 to the state of growth and inflation, and the response of central banks. Developed markets are close to moving from pandemic to endemic, with higher vaccination rates and better treatments reducing the risk of further lockdowns. Liquidity remains plentiful for consumers and companies. Consumers have bolstered their savings stockpiles significantly in recent quarters, wages should continue to increase, and spending should rise (**FIGURE 1**). Companies, for their part, are benefiting from ideal financing conditions, COVID-driven restructuring, and strong nominal growth, and we believe all of these things should continue and support earnings next year.

On the other hand, central banks now acknowledge that they underestimated inflation—both the level and persistence—and find themselves having to "nail the landing" by tightening policy just enough to tame inflation without derailing the cycle. In the end, we think the result will be reflation rather than stagflation, with the recovery from COVID-19 underpinning stronger demand, especially in the service economy.

FIGURE 1
Recent High Consumer Savings Imply Strong Consumption
US personal savings as a percent of disposable income, per quarter

Chart data: September 1999-September 2021. Source: Bloomberg.

While the economic backdrop may not be quite as supportive for the market in 2022 as it was in 2021, we maintain a pro-risk stance and prefer to be moderately overweight equities relative to bonds, moderately underweight EM equities, and overweight commodities. As the global cycle improves, we think regions that suffered more from deflationary forces before the pandemic will benefit more from higher inflation. Thus, within equities, we favor Japan

Key Points

- We expect COVID-19 concerns to fade, consumer spending to persist, and the economic recovery to continue but with higher inflation and less policy stimulus. On balance, we favor equities over bonds.
- Within equities, we prefer developed over emerging markets (EM) given China's slowdown and the hardships EM countries face post-pandemic, including slower growth, high inflation, worse fiscal deficits, and greater political volatility.
- We are most positive on commodities, given that inflation pressures are likely to persist longer than the market thinks.
- Interest rates are vulnerable to a broader reopening, inflation, and reductions in central-bank support.
- Downside risks include a surge in inflation that forces faster-than-expected central-bank tightening, a severe China slowdown, or new COVID strains. Upside risks include a "Goldilocks" scenario (just the right amount of monetary tightening) that extends the cycle or a lift in inflation-capping productivity.

over Europe, the US, and EM. Within commodities, we remain bullish on energy and industrial metals in light of both cyclical and structural dynamics.

Turning to fixed income, we see more upside for yields in the US and Europe, and we think strong demand technicals will continue to offset rich valuations in spread[1] markets. We also favor the relative value of EM-debt spreads, particularly in corporates.

Equities: Focusing on the Benefits of Inflation

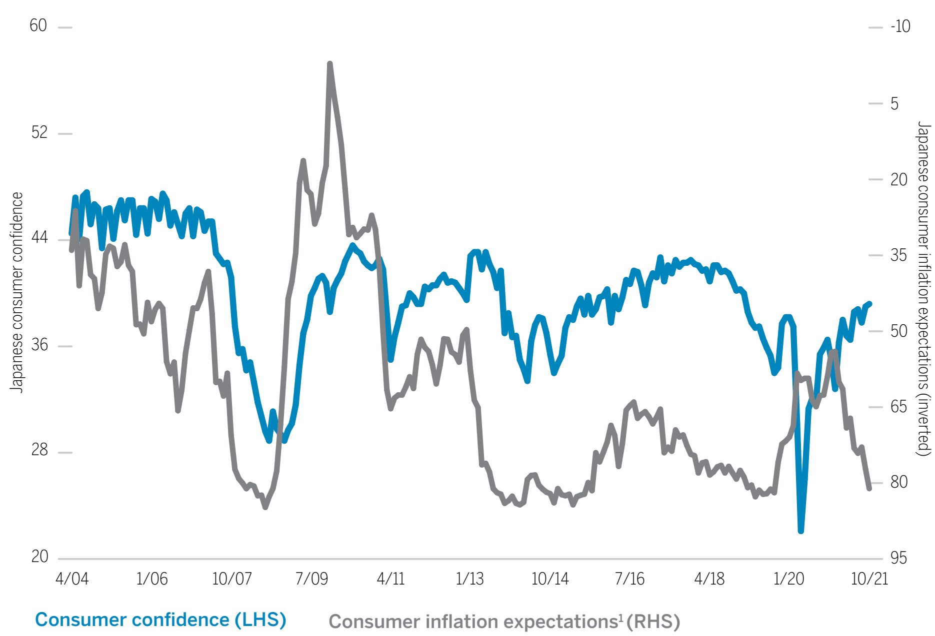
While Europe has flirted with deflation for several years, the struggle has lasted even longer in Japan. Higher inflation should incent consumers and businesses to spend and invest, rather than wait for cheaper prices ahead. On the flip side, higher inflation may be a headwind for the US, where, despite recent struggles to generate inflation, it has now moved above target, and for EM, where inflation is already much higher than target.

Japan should also benefit from a highly vaccinated population, a potential fiscal policy boost, and cheap valuations. The same arguments are true in Europe, but to a lesser extent, especially since inflation now exceeds the central bank's target. In Japan, despite some early hiccups, new Prime Minister Fumio Kishida is likely to continue reflationary policies. We are encouraged that Japanese consumer confidence has shifted higher despite inflation expectations picking up, which we see as evidence that real incomes are perceived to be rising (**FIGURE 2**). We also think the country remains a rich hunting ground for bottom-up alpha.[2]

FIGURE 2

Japanese Consumers Bullish Despite Rising Prices

Japanese consumer confidence and consumer inflation expectations*



* Consumer inflation expectations reflect the net balance of those expecting higher vs. lower inflation in one year. April 2004-October 2021. Sources: Haver, Wellington Management.

We maintain our neutral view on US equities. Despite valuation and inflation concerns, the economy is robust and supported by pent-up savings and rising wages. Our focus is on high-quality companies in value-oriented or cyclical sectors.

We are moderately bearish on EM, taking into account their vaccination challenges and lack of access to antivirals, potential for aggressive rate hikes to address double-digit inflation, poor fiscal dynamics, and political volatility—conditions that set the stage for a stagflationary environment. China has slowed, but there are

Our Multi-Asset Views

Asset class	View
Global Equities	**Moderately OW**
North America	Neutral
Europe	Neutral
Japan	Moderately OW
Emerging Market Equities	Moderately UW
Defensive Fixed Income	**Moderately UW**
US Govt.	Moderately UW
European Govt.	Moderately UW
Japanese Govt.	Moderately OW
Global IG Credit	Neutral
Growth Fixed Income	**Neutral**
High Yield	Moderately UW
Emerging Market Debt (external)	Moderately OW
Bank Loans	Neutral
Securitized Assets	Neutral
Commodities	**Overweight**
Crude Oil	Moderately OW
Precious Metals	Moderately UW

OW = overweight, UW = underweight. Views have a 6–12 month horizon and are those of the authors and Wellington Management's Investment Strategy Team. Views are as of November 2021, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities.

signs of modest policy easing. However, we are concerned that until China drops its zero-COVID policy, a robust recovery is unlikely. Within EM, we favor commodity exporters, which should benefit from our base case of higher inflation and commodity prices.

We see a tumultuous period for rates in the months ahead as markets try to divine how central banks will respond to inflation pressures.

Commodities: An Unloved Asset Class No More

While commodities have already enjoyed a strong run-up, we maintain our bullish view, given the global-inflation picture and the historical sensitivity of the asset class to rising prices. We expect supply/demand imbalances in energy, metals, and agriculture to persist as recent underinvestment (in response to shareholder pressure) collides with increased demand. In addition, the growing effort to decarbonize the economy is helping to drive up the costs of a variety of commodities.

Against this backdrop, we encourage allocators to consider having commodities exposure, either through commodities futures, energy companies, or miners. Given environmental, social, and governance concerns, we favor companies that have clear plans and have made meaningful progress transitioning their business toward renewables and reducing their carbon footprint.

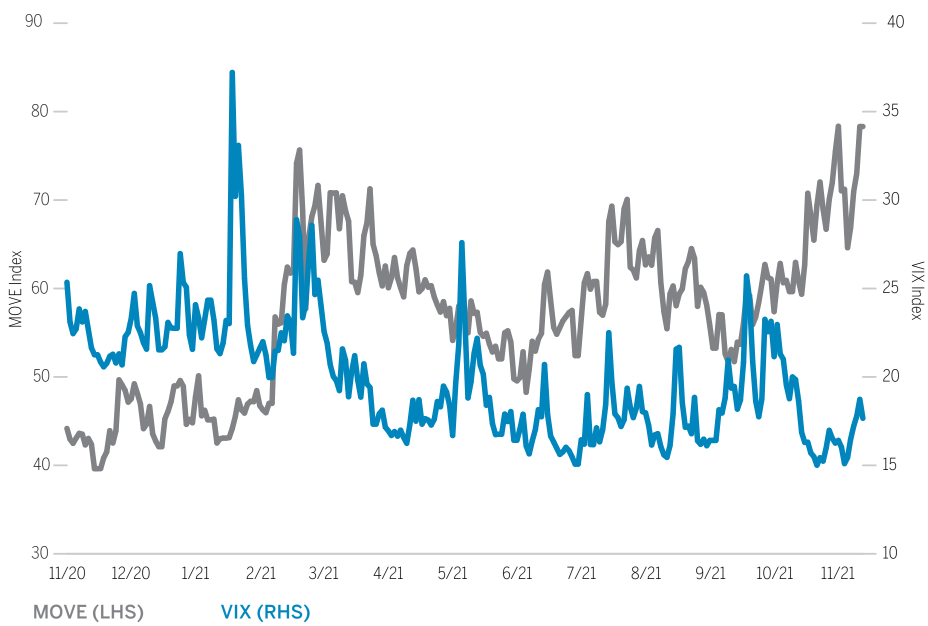
Fixed Income: Navigating Unattractive Valuations

We see a tumultuous period for rates in the months ahead as markets try to divine how central banks will respond to inflation pressures. We may be entering a paradigm shift for many central banks' reaction functions—one that, given higher inflation, is less focused on easing to address slower growth (**FIGURE 3**). As we have seen in the dollar-bloc regions, markets could test central banks by pushing up the short end and flattening yield curves. That said, market expectations in the US have moved up the first rate hike to mid-year 2022, in line with the Federal Reserve (Fed) forecast, so while we remain moderately bearish on US and European rates, we don't see much scope for a big rate rise.

FIGURE 3

Could Equity Volatility Pick Up with Higher Rate Volatility?

MOVE and VIX Indices



The MOVE Index is a yield-curve-weighted index of the normalized implied volatility on one-month Treasury options. It's a weighted average of one-month over-the-counter options on 2-year, 5-year, 10-year and 30-year Treasuries implied volatilities with weights of 0.2, 0.2, 0.4, and 0.2, respectively. **The VIX Index** is a market estimate of the expected volatilities of the S&P 500 Index and is calculated by using the midpoint of real-time S&P 500 option bid/ask quotes. **The S&P 500 Index** is a market capitalization-weighted price index composed of 500 widely held common stocks. Indices are unmanaged and not available for direct investment. Source: Bloomberg. Chart data: 11/12/20-11/11/21.

In credit, valuations are rich, with most spreads well inside of median levels. However, we think defaults are likely to stay very low and demand technicals are strong, as foreign demand for yield persists, and currency-hedged US credit yields are attractive to many non-US investors. Within credit, we prefer EM debt to US high yield as EM spreads are considerably wider. Credit valuations have been a reliable indicator of forward excess returns, a dynamic we continue to trust. We think Mexico, Russia, and various countries in Central and Eastern Europe are attractive.

We also prefer bank loans, which offer attractive valuations vs. US high yield and could benefit from Fed tightening. We find securitized credit attractive relative to investment-grade corporates from a valuation and risk perspective, given the abundance of asset types. Within securitized credit, we favor floating-rate structures in collateralized loan obligations (CLOs) and commercial mortgage-backed securities. New risk-based capital factors being adopted by the National Association of Insurance Commissioners are likely to increase demand for AAA-rated and AA-rated bonds.

Risks

Our base case is that the economic recovery will continue and demand will overtake the risks of higher inflation. Specifically, we think a high stockpile of savings and rising wages position consumers well to deal with higher prices. A policy mistake is a key risk if central banks are slow to react to inflation and inflation expectations de-anchor, leading to a rapid and significant rise in rates. Alternatively, if central banks are perceived to be too hawkish in their inflation policy, that could also derail the cycle. We think central banks can successfully thread the needle, but we are wary of a policy mistake.

COVID-19 remains a risk as part of the world moves toward the indoor winter months and about five billion people remain unvaccinated, which could give rise to new variants. Unfortunately, the COVID-19 overhang is likely to last for years in EM countries.

China's path is difficult to discern with its opaque system. If the country's credit clampdown and energy shortage become more severe or, as noted, there's no relaxation in the country's zero-COVID policy, we could see a more dramatic slowdown than expected, which could impact the global cycle.

On the upside, central banks may hit a perfect landing with their tightening decisions—a scenario that would justify a more bullish view on risk assets.[3] In addition, our inflation concerns may be ameliorated by a pickup in productivity, though that's unlikely in the near future.

Another upside risk is that antivirals, in combination with vaccines and warmer weather early next year, put an end to the scourge of COVID-19 in developed markets, unleashing stronger consumer spending.

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Investment Implications

- **Consider sticking with developed-market equities** — We think developed-market equities will continue to do well, but that Japan will outperform the US and Europe. Japan could experience more of the benefits of inflation, given its prior struggles with deflation, and its government is more likely to pursue reflationary policies.
- **Get more selective within equities** — We continue to favor a value tilt in energy and financials, and prefer cyclical sectors such as materials and some industrials. However, we think asset allocators should consider being more judicious about valuations in cyclicals as many stocks are fully priced for a recovery. Travel and leisure is one area where valuations do not yet reflect recovery in the services sector. A key attribute to look for in any company in an inflationary environment, regardless of sector, is its pricing power.
- **Remain cautious on EM** — China is key to the EM outlook, and the government's credit clampdown has been engineered to wring excess risk out of the financial system, especially in the property market. Until that changes, continued sluggishness seems likely. Outside of China, countries will face major economic pressures from COVID-19 as well as political volatility. Despite the grim overall picture, we see opportunities in commodity exporters and Central and Eastern European countries.
- **Given the risks of inflation, consider pursuing potential protection with commodities** — Inflation may reach higher levels or be more persistent than many asset allocators expect. While value-oriented equities may provide some protection, commodities (excluding precious metals) have historically been the most inflation-sensitive asset class. Real assets and inflation-linked government bonds may also play a role.
- **Focus growth fixed income in shorter duration[4]** — Central banks are on a tightening path, so we favor shortening duration, and we prefer floating-rate structures, especially in CLOs and bank loans. Most spreads are rich, but we don't see a catalyst for them widening much. We think EM sovereign and EM corporate debt offer better upside potential from a spread perspective than US corporates and high yield.
- **Maintain defensive fixed income for diversification** — While our views tilt toward an economic recovery, we think it's still prudent to consider an allocation to high-quality bonds in case of a sharp equity sell-off. A global fixed-income universe gives investors more opportunity to add value. We think municipal bonds can play a strategic role for taxable investors, especially given the trend toward larger federal deficits. Precious metals and option strategies may provide additional ways to supplement bond exposure.

The views expressed here are those of the authors and Wellington Management's Investment Strategy Team. They should not be construed as investment advice. They are based on available information and are subject to change without notice. Portfolio positioning is at the discretion of the individual portfolio management teams; individual portfolio management teams and different fund sub-advisers may hold different views, and may make different investment decisions for different clients or portfolios. This material and/or its contents are current as of the time of writing and may not be reproduced or distributed in whole or in part, for any purpose, without the express written consent of Wellington Management or Hartford Funds.

Talk to your financial professional about how you can better prepare your portfolio for 2022.

[1] Spreads are the difference in yields between two fixed-income securities with the same maturity, but originating from different investment sectors.

[2] The measure of the performance of a portfolio after adjusting for risk. Alpha is calculated by comparing the volatility of the portfolio against some benchmark. The alpha is the excess return of the portfolio over the benchmark.

[3] Risk assets refers to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

[4] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed-income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall. • US Treasury securities are backed by the full faith and credit of the US government as to the timely payment of principal and interest. • Loans can be difficult to value and less liquid than other types of debt instruments; they are also subject to nonpayment, collateral, bankruptcy, default, extension, prepayment and insolvency risks. • Investments in high-yield ("junk") bonds involve greater risk of price volatility, illiquidity, and default than higher-rated debt securities. • The risks associated with mortgage-related and asset-backed securities as well as collateralized loan obligations (CLOs) include credit, interest-rate, prepayment, liquidity, default and extension risk.• Foreign investments may be more volatile and less liquid than US investments and are subject to the risk of currency fluctuations and adverse political, economic and regulatory developments. These risks may be greater, and include additional risks, for investments in emerging markets. • Investments in the commodities market and the natural-resource industry may increase liquidity risk, volatility and risk of loss if adverse developments occur. • Investments focused in specific sectors may be subject to increased volatility and risk of loss if adverse developments occur. • Different investment styles may go in and out of favor, which may cause an investment to underperform the broader stock market.

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