30 November 2021

Investec
Investec Bank plc (UK)

Economics

Global Economic Overview

The outlook for 2022 – transit to new normal but with risk of delays

As we turn to 2022, we expect the coming year to be one of transition from the immediate post-Covid crisis recovery towards the 'new normal'.

That is not to say trend-like conditions are in store as yet. At least to begin with, the global economy is dealing with hangover effects, in the form of ongoing mismatches in product and labour markets, which will take some time to work off. The worries about inflation that have sprung up during the latter part of 2021 therefore look likely to stay for a while longer.

But high prices give ample incentives to ramp up production of goods in particularly high demand, such as semi-conductors. This should help supply chains gradually unclog. Higher wages too, will pull more people back into the labour market, alleviating some of the current global labour shortages. There is therefore a self-correcting element to high inflation. But in the transition to more normal conditions, higher interest rates will also become a part of the picture more widely, with the UK and the US both embarking on a path of tightening to prevent above target inflation from becoming entrenched.

All this, however, rests on the crucial assumption that Covid will be kept at bay through the existing vaccination programmes and recently developed therapeutics – without the Omicron variant, B.1.1.529, tarnishing their efficacy. Should that not be the case, all cards are in the air once more.

Key calls for 2022

- **Global growth will cool but remain high by historical standards**. We are looking for 4.5% expansion next year, down from 5.5% in 2021. Strong household balance sheets, as a result of pandemic savings, will stay a key support. Demand will rebalance from goods to services.

- **Inflation will stay elevated in the near term before falling closer to target**. A hump-like pattern in inflation is probable across the major jurisdictions. Price pressures will fade as Covid disruptions ease and demand and supply move closer into balance.

- **Policy tightening will extend to other major markets**. The Bank of England may sanction its first rate rise already next month, and follow up with a further 50bp of rate rises in 2022. This will usher in 'quantitative tightening', i.e. a runoff in its balance sheet. In the US, the pace of tapering looks likely to be accelerated, allowing rate hikes to start from mid-2022. The ECB may hold off from raising rates next year, however.

- **Modest rises in bond yields are on the cards**. Higher short-term interest rates will go hand in hand with higher longer-dated government bond yields. But we expect only modest rises, to 2.00% for 10-year US Treasury yields, 1.25% in 10-year Gilt yields and 0.00% in Bunds.

- **Sterling is poised to strengthen; USD strength could fade**. GBP stands to benefit from a relatively swift initial pace of tightening and reduced risks of Indyref2 in Scotland. Over time, the Euro could gain ground against USD as conditions for higher rates move closer into view.

	2021	2022
GDP Growth (%)		
Global	5.5%	4.5%
US	5.5%	4.1%
China	7.8%	5.2%
UK	6.9%	4.3%
EU19	5.1%	4.6%
Key Official Interest rates (%, end-year)		
US Fed funds	0.00-0.25	0.75-1.00
ECB Deposit rate	-0.50	-0.50
UK Bank rate	0.25	0.75
FX rates (end-year)		
€:$	1.15	1.20
€:£	0.85	0.81
£:$	1.36	1.48
$:¥	115	120
AUD:$	0.73	0.77
€:CHF	1.05	1.10

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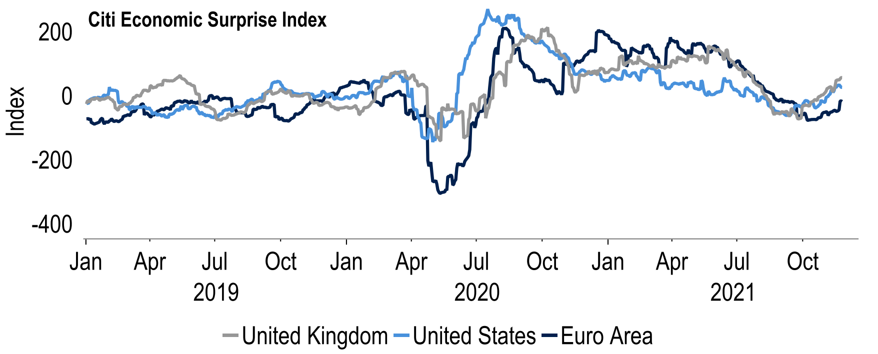
Investec

Global

As 2021 draws to a close global economic performance continues to be influenced by Covid, as well as supply issues and inflation pressures that have intensified over H2. Nonetheless activity on the whole should end the year on a solid note with indicators from the US and the UK surprising on the upside. The US in particular looks set to record robust Q4 growth of 1.3% q/q. Overall 2021 is expected to see global growth of 5.5% (downgraded from 5.6%). Looking into 2022 some familiar themes are set to be carried over into the new year. Elevated levels of inflation and whether it ultimately proves transitory will be key. We conclude that it is, as are the supply issues where there are tentative signs of improvement.

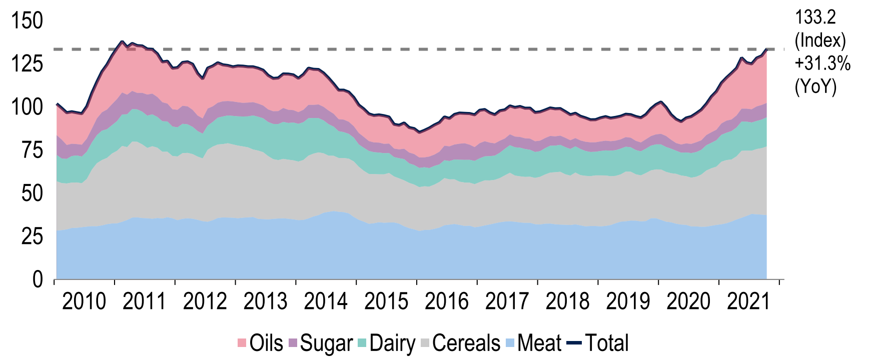
Chart 1: Recent indicators have been firmer than expected in the US and UK (at least for now)



Source: Macrobond

One such supply side issue that impacted economic activity in 2021 was labour shortages, as factors such as lifestyle changes in response to the pandemic (i.e. early retirement) and changing migration trends resulted in a decline in available labour. Specific sectors, such as HGV drivers, have been harder hit than others, with employees reportedly failing to return to the industry after finding alternative employment during the height of the pandemic. The shortages, particularly in terms of the misallocation of labour, is contributing to both the wider goods shortages and the inflation outlook. This can be seen in Malaysia, where a decline in migrant labour has hit vegetable oil production, pushing up global food prices.

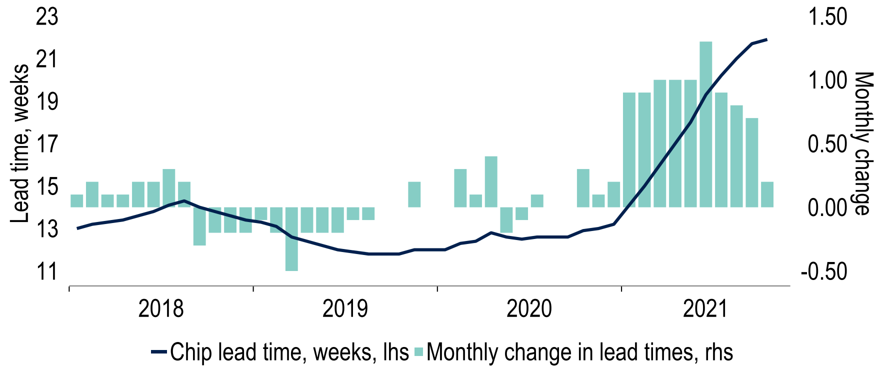
Chart 2: Labour shortages across the world feed into the inflation outlook



Source: Macrobond, FAO

Although the shortfall in labour supply is certainly exacerbating goods shortages, there are a host of factors contributing to the reported deficits. Production of semiconductors, for example, has also been limited by Covid-19 lockdowns, adverse weather and power shortages. When met with a burst in demand for goods during the pandemic, output struggled to keep pace with new orders, resulting in the shortages. However, looking ahead to next year there are promising signals that pressures are easing. One such indication is semiconductor lead times, which in October increased at its slowest pace for nearly a year (Chart 3).

Chart 3: Semiconductor lead times point to a topping out in disruptions



Lead time is the gap between placing an order and delivery

Source: Macrobond, Susquehanna Financial Group

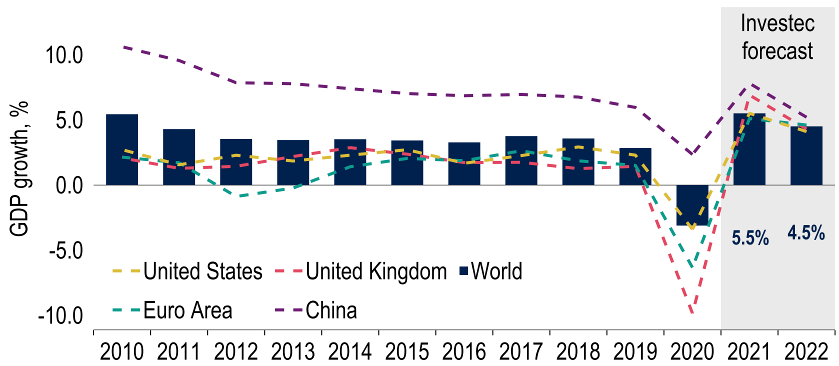
What has become clear is that the current shortages are due to a multitude of pressure points across the supply chain being triggered at once. The shipping of goods is included in this, with pandemic-related disruptions resulting in a lack of effective container ships (at the peak, over 37% were stuck at ports). This was reflected in spiralling shipping costs. Encouragingly, these have since started to decline, suggesting that shipping constraints are also showing signs of peaking. That said, supply shortfalls are still severe, and any easing will no doubt be a gradual process as backlogs are cleared. As such, shortages are highly likely to continue into 2022, impacting the economic outlook.

Chart 4: A fall in shipping costs also points to an easing in disruptions heading into 2022

*Baltic Dry Index measures average prices paid for the shipping of dry bulk, such as iron ore Source: Macrobond

But on the basis that these headwinds do fade, the 2022 outlook for global growth remains favourable, our forecast standing unchanged at 4.5%. This should be supported by some recovery in output as supply issues, such as the semi-conductor shortage, ease. Fiscal policy will also remain supportive in some jurisdictions (EU19, Japan, US). At the country level, the major advanced markets are expected to grow in excess of 4%. Meanwhile China is expected to grow by 5.2%, an easing of the recent power supply issues supporting a near-term rebound. However the emergence of the Omicron variant puts our baseline case at risk. At present we have not reflected this in our forecasts as we await clear information on its characteristics.

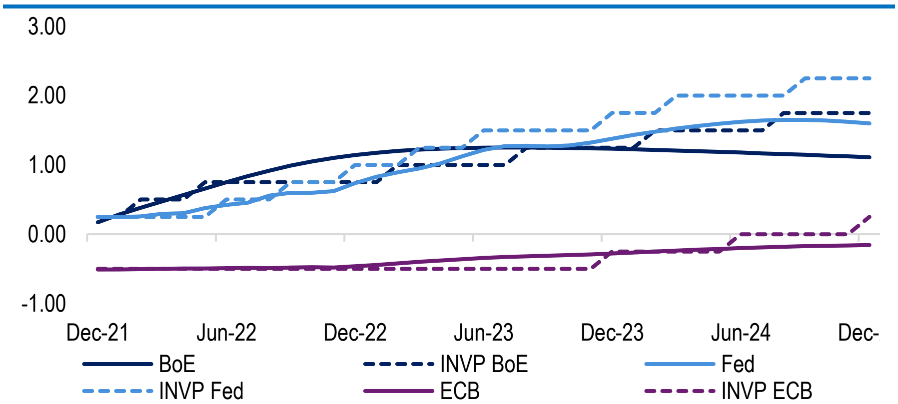
Chart 5: Global growth to remain solid in the New Year



Source: Macrobond, Investec

Covid will remain a question for markets, as will monetary policy. On the latter, 2022 should see a concerted effort globally to rein in the ultra-loose policy of the last 18 months. Most critically, in terms of the Fed, we expect rates to rise by 75bps over the year. Tighter interest rate policy should also be seen from the BoE, RBNZ, RBA and the BoC. Rates will however not be the only tool being addressed, with QE likely to end amongst all the major central banks, except perhaps the BoJ. The BoE is likely to begin QT*. One question is the reaction of risk assets, especially if pay accelerates sharply, threatening more aggressive tightening. But for now of course it is Omicron news that is the key driver.

Chart 6: Market and Investec expectations for policy tightening over 2022 and beyond

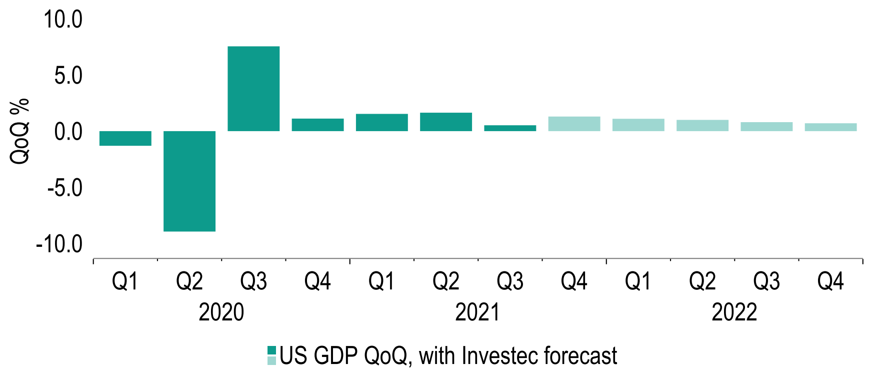


*Quantitative Tightening Source: Macrobond, Investec

United States

The pace of economic growth in the US moderated somewhat in Q3, as activity was held back by a resurgence in Covid-19 infections and Hurricane Ida. Although we are expecting a rebound in Q4, this is unlikely to offset the softer Q3 and as such we have downgraded our 2021 forecast to 5.5% from 5.8%. Heading into the new year we expect the economy to maintain the strong momentum from Q4 and receive a further boost from a levelling off in supply constraints. Accordingly, we have upgraded our 2022 forecast to 4.1% (was 3.8%). The spike in inflation does remain a risk to this view, but current data indicate that, at the aggregate, high levels of excess savings accumulated over the pandemic are cushioning the impact on households.

Chart 7: US GDP growth slowed in Q3, but the outlook is positive further ahead



Source: Macrobond, Investec forecasts

However, this protection does largely depend on the extent of the rise in prices. On an annual basis, CPI inflation exceeded 6% in October – the fastest rate of increase in over three decades – and is set to rise further. Despite this, we, as well as the Fed, do still deem the current price spike to be ultimately transitory, although there are increasing concerns regarding the broadening out in price pressures. As Chart 8 illustrates, 60/68 of sectors are now reporting price increases, with nearly 90% of those clocking above 2% increases on the year. This measure of inflation breadth demonstrates that price pressures are no longer concentrated within specific areas of the US economy.

Chart 8: US CPI sectoral detail reveals that price pressures are broadening

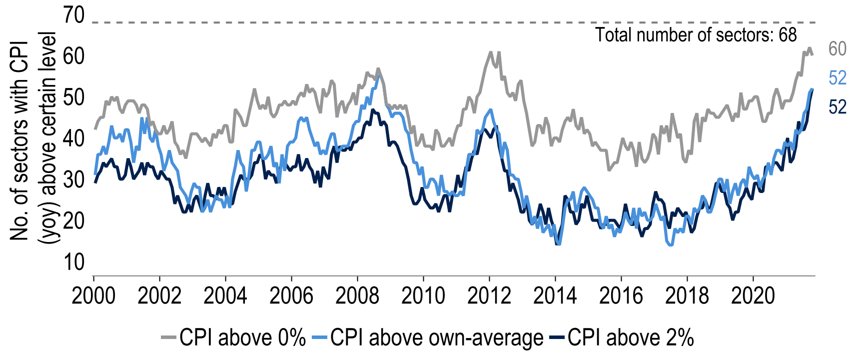
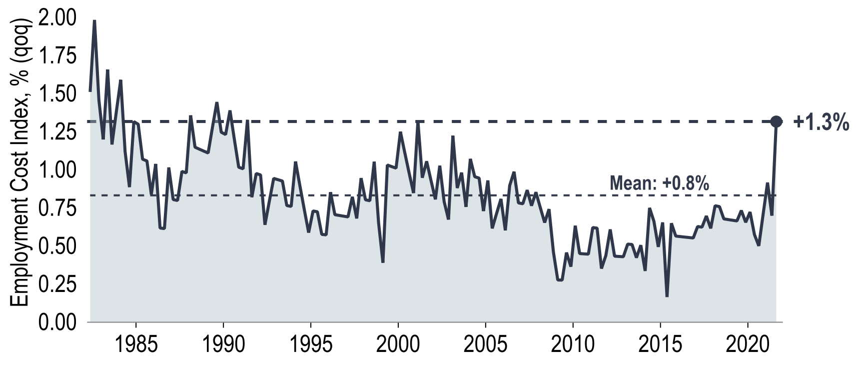


Chart uses the CPI breakdown by expenditure category at an indent 4 level

Source: Macrobond, Investec

In addition to the spread of inflation is a broadening in wage increases. The US Employment Cost Index (ECI) rose by 1.3% in Q3, a joint 30-year high. Though pandemic-hit sectors saw the biggest increases, a whopping 26 of the 28 categorised industries saw rises of 1% or greater. An important feature of the ECI – and a reason that the Fed prefers it – is that it is mix-adjusted, and so is not easily distorted by compositional factors (i.e. not affected by salary-based proportions). The view that inflation is transitory is difficult to defend if wages accelerate, with the potential for second-round inflationary effects. This conundrum is likely to give the FOMC a headache going forward.

Chart 9: US employment costs saw the joint-largest quarterly jump for over 30 years in Q3

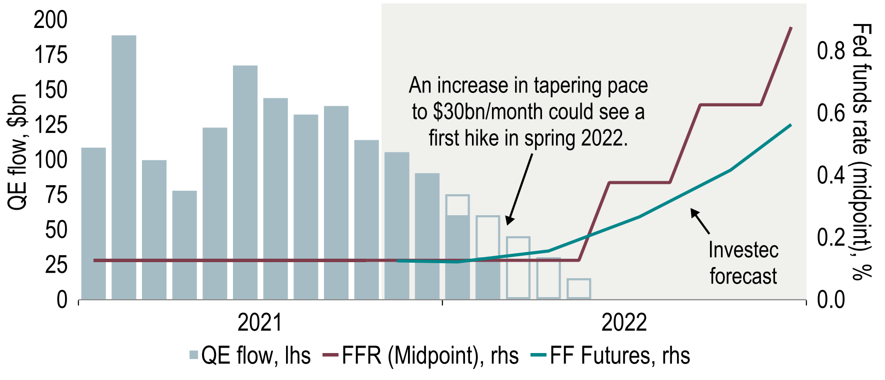


Source: Macrobond

FOMC rate hike timing will be a major story over 2022. Due to upside inflation surprises, we now expect three increases next year, starting mid-year (was Q1 2023), taking the Fed funds target range to 0.75%-1.00% by end-year. Note that the Fed has only set the pace of tapering of its monthly QE purchases for Nov and Dec this year (to $105bn and $90bn from $120bn). A $15bn pm 'autopilot' would result in QE ceasing by June. Instead we expect the Fed to use its optionality and speed up subsequent tapering, perhaps to $30bn pm, enabling it to finish QE in March and allowing it to prepare markets for a Q2 hike, which we judge will occur in June. This is not a slam dunk. The Fed… could adopt a very broad interpretation of full employment, a key threshold for raising rates. In October, employment was still 4.2m below its pre-pandemic peak. But the committee might also want to take into account population growth and also assume that the employment to population ratio (over 16s) will return to February 2020's level (61.1% - October is 58.8%). Across a population of 262m, waiting for this to occur (rather than pre-empting it) would imply that 6m extra jobs are necessary before rate lift-off! Nor can we speculate over the impact of the new Omicron Covid variant, which could delay the start of policy normalisation beyond next June, perhaps even to 2023.

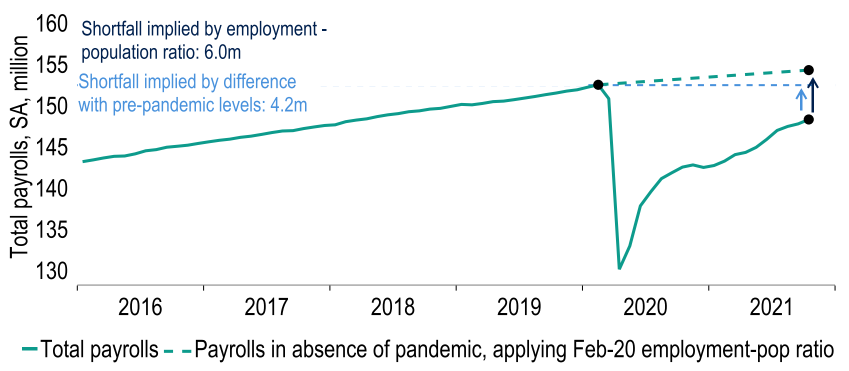
President Biden's *Build Back Better* bill has not yet seen the light of day through the Senate, after 'in party' battles between 'Moderates' and 'Progressives', provoked by the wafer thin Democratic majorities in each chamber. Midterm elections on 8 Nov 2022 may well define the scope of Mr Biden's policy agenda over the second half of his term. As well as the re-election of the entire House, 34 Senate contests are due, 20 of them Republican held. In theory the Democrats have an opportunity to gain workable majorities. Right now though they are struggling, having lost the Governor's race in Virginia, while Biden's approval ratings are highly negative. It may be a battle to save their majorities and prevent total policy gridlock.

Chart 10: A faster taper creates more comfortable space for a H1 rate hike



Sources: Macrobond, Investec forecasts

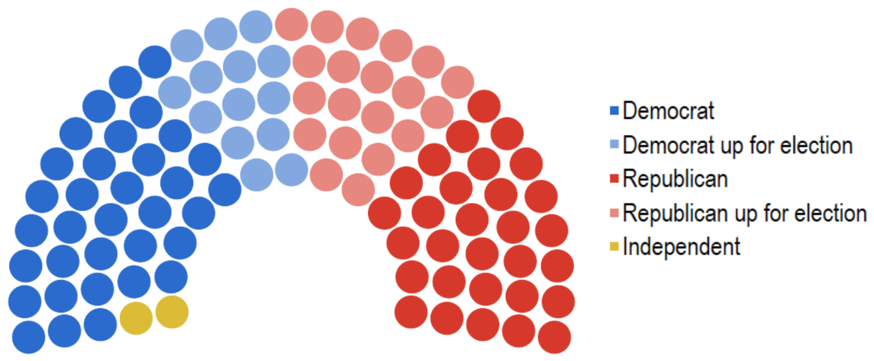
Chart 11: The US employment shortfall is even greater when looking at the pre-pandemic trend



Shortfall obtained from BLS household survey, added to payroll data

Sources: Macrobond, Investec

Chart 12: More Republican Senate seats are to be contested at the 2022 mid-terms

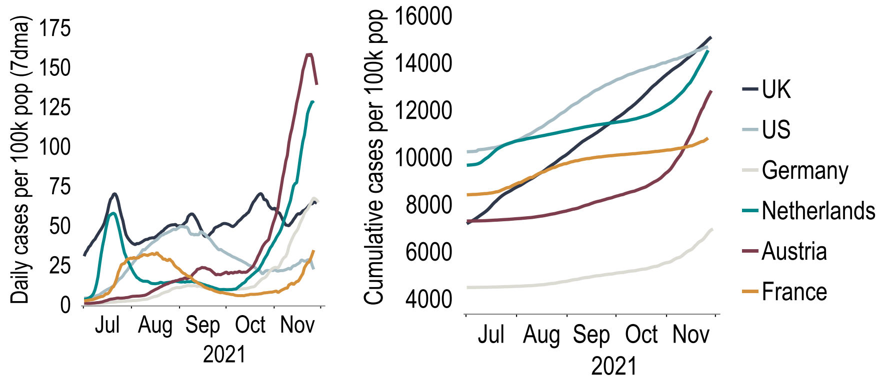


Sources: Macrobond, Flourish

Eurozone

The key development in Europe this month was the unfortunate worsening of the pandemic picture. Covid cases in many European countries are now at record highs. Vaccination rates are lower than in the UK in some places, but the key difference is lower 'herd immunity'. Chart 13 shows a greater proportion of Brits has had the virus, and so will have developed antibodies. To curb pressures on health care systems, some countries are reintroducing restrictions. Austria, for example, entered a 20-day full national lockdown from 22 Nov. Extra restrictions in major players (e.g. Germany) are likely to dampen economic growth in Q4, but unless Omicron is a game changer we do not expect them to be long lasting or…

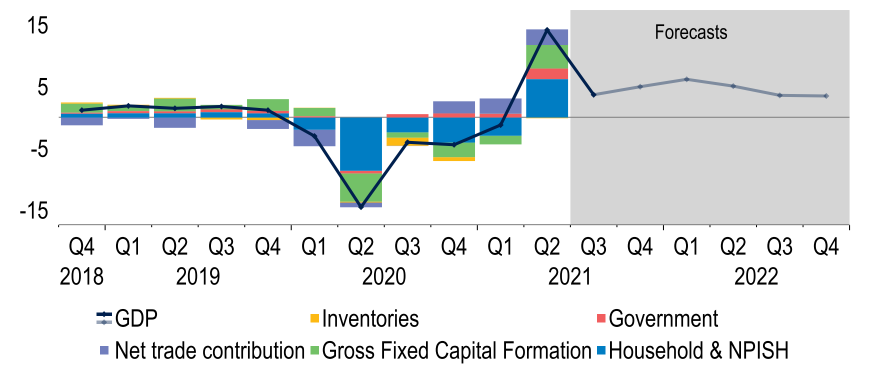
Chart 13: Covid cases ramp up across Europe, with some states imposing new restrictions



Source: Macrobond

…derail the recovery. If anything the most recent data for November (PMIs) have been surprisingly strong. Following an expected rebound of 5.1% in 2021 the Euro area is expected to put in another solid performance in 2022, with 4.6% growth. Consumer demand should stay a primary driver, but also investment, which will be supported by further financing from the EU's Recovery and Resilience facility, where €166bn is still to be disbursed from the 2021-22 grant allocation. To note, the distribution of this will be uneven: Southern European countries such as Italy and Spain stand to receive outsized allocations. Green policies will also be a focus, with 37% of funds being allocated to green investments and reforms.

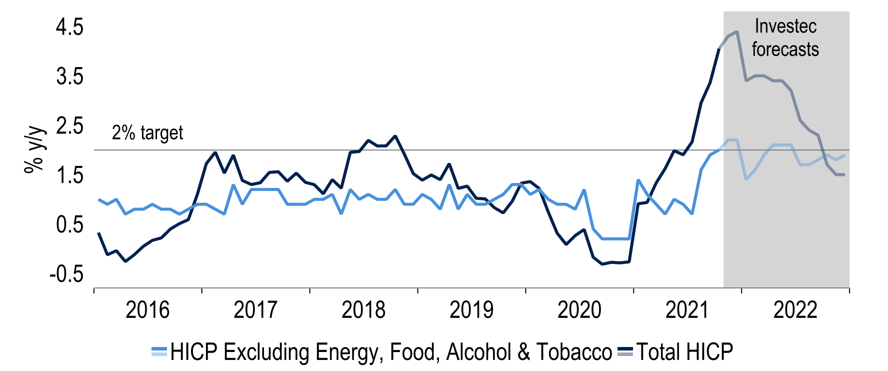
Chart 14: Growth to remain robust in 2022 : EU19 GDP and contributions (y/y)



Source: Macrobond, Investec

Despite this solid growth backdrop, and after what may well be further rises as 2021 draws to a close, Eurozone inflation looks set to fall at the start of 2022: Germany's VAT rise and introduction of CO2 pricing on transport and heating in Jan 2021 falling off the annual comparison alone may cut inflation by ½%pt. If energy prices drop as futures suggest, headline inflation could be below 2% in Q4 '22, averaging 2.7% in 2022 as a whole (Chart 15). But underlying inflation may stay higher than prior to Covid as wages accelerate, despite easing supply chain pressures. Clearly this outlook for inflation will be the key driver of monetary policy. However with the ECB's three criteria for raising…

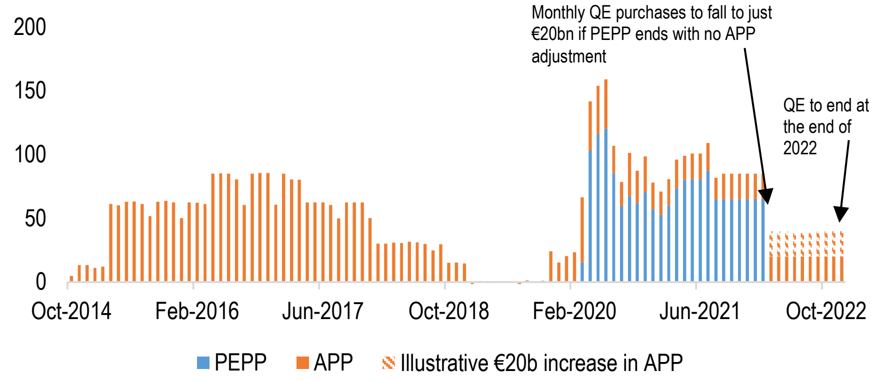
Chart 15: Headline inflation looks likely to subside in 2022 – but core inflation to stay higher



Source: Macrobond, Investec forecasts

…rates, as stated in its guidance, unlikely to be met in the near term, market pricing of a possible 2022 hike looks to be overdone. Our view is that the ECB will wait until Q4 2023 to lift the Deposit rate. However there is still scope for policy adjustments in the short-term, notably via a 'recalibration' in December. Issues to address are the prospective end of PEPP in March and preventing a cliff edge in asset purchases when QE reverts solely to APP. We expect this will be addressed by an increase in APP, helping to transition to a lower purchase pace, which ultimately should see QE ending in Q4 2022. TLTRO-III may also be extended given the support it has given to financing conditions.

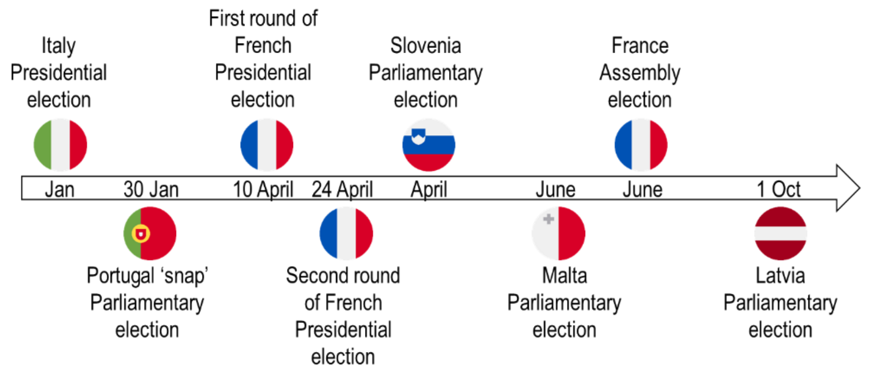
Chart 16: ECB to 'recalibrate' policy in December (€bn)



PEPP- Pandemic Emergency Purchase Programme, APP- Asset Purchase Programme Source: ECB, Investec

On the political front, there are a number of key upcoming events (Chart 17). The German 'traffic light' coalition government is due to take office before the end of the year. Beyond overcoming Covid, key priorities include supporting the energy transition, but also higher minimum wages and tighter rent controls, while returning to fiscal discipline. In Italy, a new President is to be chosen in January. Mario Draghi has long been touted for the role, but it is not clear who could succeed him as PM without toppling the unity government. And Portugal has a snap election on 30 January. France will see presidential elections in April, in which Emmanuel Macron will see numerous challengers; the race so far looks open.

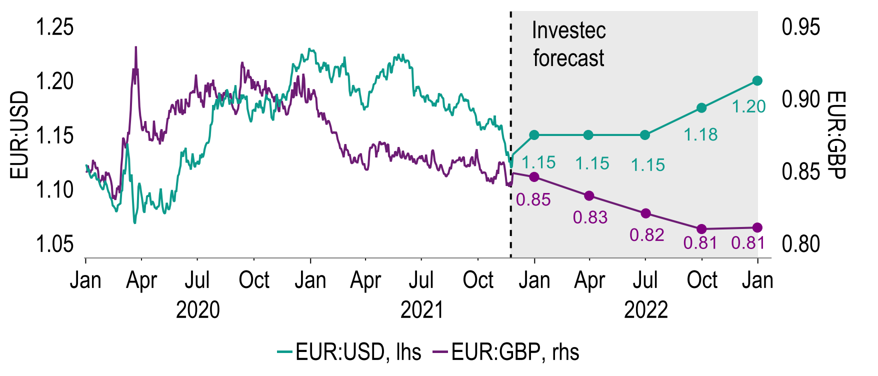
Chart 17: A number of political events are coming up in 2022 – some with event risk attached



Source: Investec

As far as the euro is concerned, we have downgraded our near-term forecasts, now expecting the single currency to end 2021 at $1.15. This would imply only a slight recovery vis-à-vis current levels, as the tougher social restrictions in response to the current surge in Covid-19 restrictions could hold back EUR. As 2022 progresses, we do however envisage that conditions for a potential 25bp rate hike by the ECB in late 2023 will come into view. That should allow some strengthening in the euro, to perhaps $1.20 by end-2022. Against sterling, our forecasts are 85p by end-2021 and 81p by end-2022 (Chart 18). But much will depend on how serious a threat the Omicron Covid variant is.

Chart 18: The euro looks likely to gain ground over the course of 2022

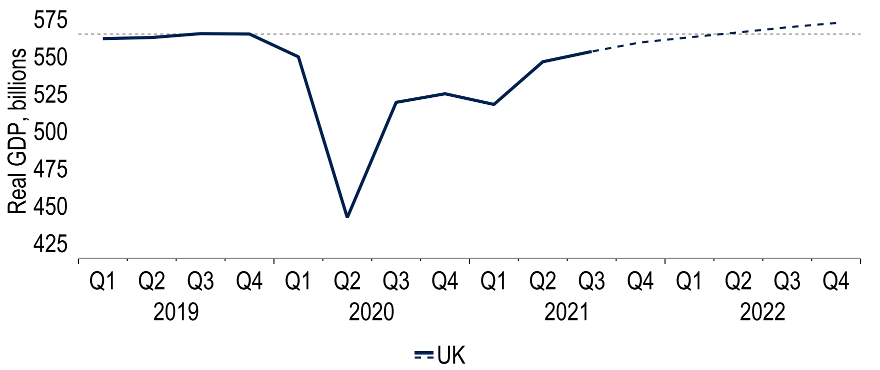


Source: Investec and Macrobond

United Kingdom

GDP looks poised to end 2021 with strong quarterly of 1.1% in Q4, giving full-year expansion of 6.9%. Even if vaccines are effective against Omicron, momentum in '22 is unlikely to match that pace. Not only is GDP already close to pre-pandemic levels (Chart 19), but the potential pool of labour to fuel expansion is less deep now that unemployment is low and inward migration more limited than before Brexit. Still, supply chains should gradually unclog, and, aided by tax incentives, ample scope remains for firms to invest. Through this capital deepening relative to the number of people employed, productivity can rise. But as interest rates increase, this incentive will diminish. We anticipate GDP growth of 4.3% in 2022.

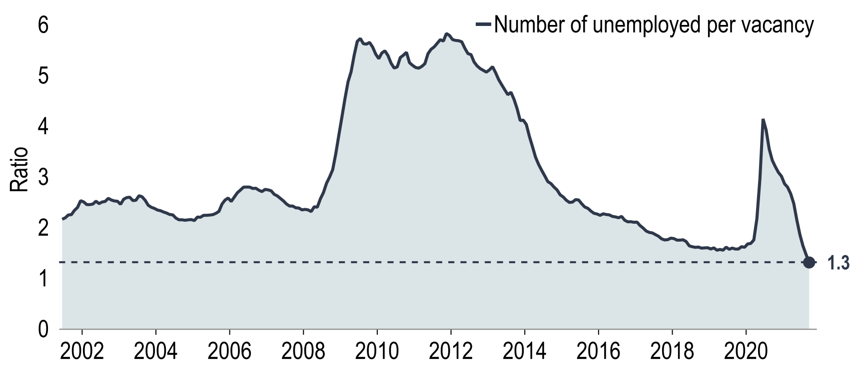
Chart 19: The recovery in UK GDP has come a long way already, so growth stands to slow



Source: ONS, Investec and Macrobond

Gauging how much spare capacity there is in the labour market is challenging. Headline (ILO) data on how the jobs market fared following the end of furlough are not yet available. But employee figures based on real-time PAYE returns, which have showed a rather different trend in the pandemic but are arguably more reliable, are encouraging, pointing to jobs having risen by 160k in October. This strengthens our expectation that unemployment rose only marginally post furlough; we look for a peak rate of 4½% and gentle declines thereafter. Still, there is little question that the labour market is very tight, as evidenced by the low ratio of unemployed per vacancy (Chart 20). In…

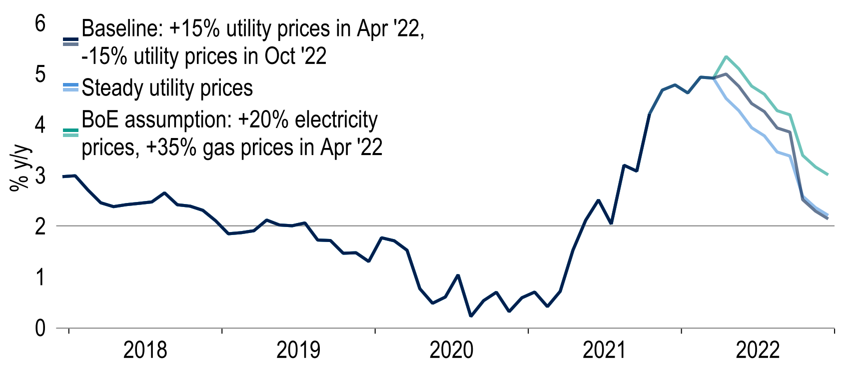
Chart 20: Employers have a lot less untapped labour to hire from than usual



Sources: ONS, Investec and Macrobond

…this context, it seems increasingly a risk that firms, competing for labour in this tight market, will push up aggregate wage growth relative to labour productivity. Such 'unit labour cost growth' is a key determinant of consumer price inflation, as firms may seek to pass these extra costs onto consumers. Rate hikes could (and, we expect, will) limit these dynamics, but their impact will mainly be from 2023. In our baseline forecasts, we foresee inflation rising to a peak of 5% in April and then falling gradually towards 2% by end-'22, resulting in an annual rate of 4.0%. This assumes a 15% rise in utility prices in April and a 15% fall in October. But other assumptions could yield a substantially different path (Chart 21).

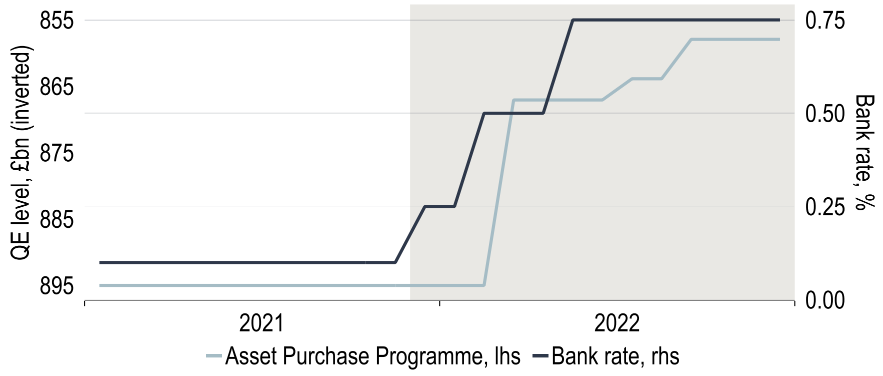
Chart 21: The expected profile of inflation forecasts depends heavily on utility price assumptions



Source: ONS, Investec and Macrobond

With the MPC standing pat on the Bank rate at 0.10% on 4 Nov, attention turns to its next meeting on 16 Dec. Given signs that the labour market remains robust after the closure of the furlough schemes, a 15bp hike still looks likely. Through next year, the yield curve for a while priced in the policy rate climbing up as far as 1.25%. Our forecast is still that it will close 2022 at 0.75%. We judge household balance sheets can withstand inflation rising to 5.0% next year, though the hit to purchasing power will have some impact on spending. Note too that the MPC will allow QE gilts to 'run off' its portfolio once the Bank rate reaches 0.50% i.e. it will not replace maturing gilts. This should result in outstanding QE falling by £37bn to £858bn by end-2022, from £895bn.

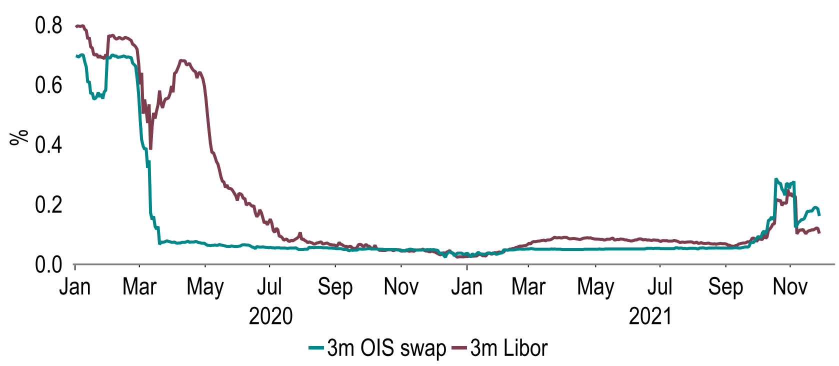
Chart 22: The MPC looks set to tighten policy through 2022 via QE runoff as well as rate hikes



Source: Macrobond, Investec forecasts

A major change at the turn of the year is the scrapping of the long established (and deeply flawed) LIBOR benchmark. In sterling markets, this will be replaced by 'risk free rate' (RFR) measures, especially SONIA (Sterling Overnight Index Average) based benchmarks. So for example, our forecasts of UK interbank rates will be based on equivalent SONIA swaps. This should not make a material difference to our projections – the recent 3m OIS/LIBOR relationship is shown in Chart 23. Other jurisdictions are following similar approaches, which will result, for example, in GBP/USD cross currency swaps based on SONIA/SOFR (the US Secured Overnight Financing Rate).

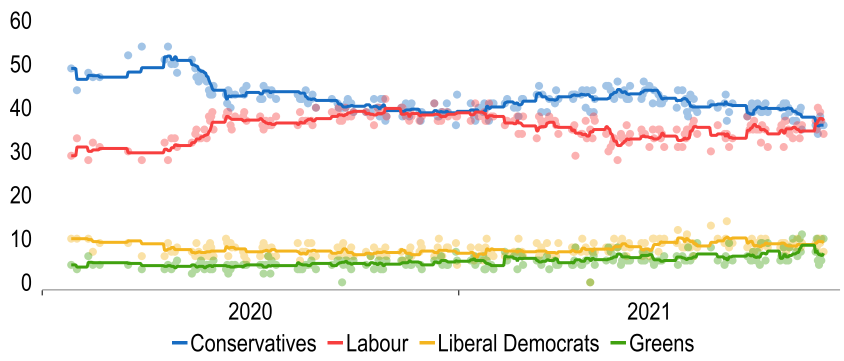
Chart 23: Libor and OIS have tracked each other closely other than in periods of market stress



Source: Macrobond

Boris Johnson's popularity ratings have fallen recently given his handling of various scandals and policy U-turns. A recent ComRes opinion poll showed the Tories trailing Labour by 6%. Mid-term blues? Perhaps, but there does seem to be disenchantment with the PM within his own party as well. Meanwhile the SNP's drive for a 2nd independence referendum seems to have stalled. This should ease downside for risks to sterling. Although our forecasts have been nudged lower, we still see the pound rising over 2022 with end-year targets of $1.48 and 81p against the euro. But this does depend on no further Covid lockdowns and a prompt agreement on the post-Brexit NI Protocol.

Chart 24: Mid-term blues? The Conservatives have slipped in the polls



Sources: Macrobond, Britain Elects

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Global Forecasts

GDP Growth (%)

	Global	US	Japan	China	UK	EU19	Germany	France	Italy
2016	3.3	1.7	0.8	6.9	1.7	1.9	2.2	1.0	1.3
2017	3.8	2.3	1.7	6.9	1.7	2.6	2.7	2.4	1.7
2018	3.6	2.9	0.6	6.8	1.3	1.9	1.1	1.8	0.9
2019	2.8	2.3	0.0	6.0	1.4	1.5	1.1	1.8	0.3
2020	-3.1	-3.4	-4.6	2.3	-9.8	-6.3	-4.6	-8.0	-8.9
2021	5.5	5.5	1.8	7.8	6.9	5.1	2.8	6.8	6.3
2022	4.5	4.1	2.5	5.2	4.3	4.6	4.6	4.4	4.8

Source: IMF, Macrobond, Investec forecasts

Key Official Interest rates (%, end quarter):

	US Fed funds	Eurozone refi rate	Eurozone deposit rate	UK Bank rate	Australia cash rate
Current	0.00-0.25	0.00	-0.50	0.10	0.10
2021					
Q1	0.00-0.25	0.00	-0.50	0.10	0.10
Q2	0.00-0.25	0.00	-0.50	0.10	0.10
Q3	0.00-0.25	0.00	-0.50	0.10	0.10
Q4	0.00-0.25	0.00	-0.50	0.25	0.10
2022					
Q1	0.00-0.25	0.00	-0.50	0.50	0.10
Q2	0.25-0.50	0.00	-0.50	0.75	0.10
Q3	0.50-0.75	0.00	-0.50	0.75	0.10
Q4	0.75-1.00	0.00	-0.50	0.75	0.25

Source: Macrobond, Investec

10-year government bond yields (%, end quarter):

	US	Germany	UK
Current	1.54	-0.31	0.86
2021			
Q2	1.45	-0.19	0.83
Q4	1.75	-0.25	1.00
2022			
Q2	2.00	-0.25	1.25
Q4	2.00	0.00	1.25

Source: Refinitiv, Investec

FX rates (end quarter/ annual averages)

		Current	2021				2022				2020	2021	2022
		30-Nov	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	average	average	average
Euro	€:$	1.129	1.18	1.19	1.16	1.15	1.15	1.15	1.18	1.20	1.14	1.18	1.16
Sterling	€:£	0.846	0.85	0.86	0.86	0.85	0.83	0.82	0.81	0.81	0.89	0.86	0.82
	(£:€)	1.182	1.17	1.16	1.16	1.18	1.20	1.22	1.23	1.23	1.13	1.16	1.21
	£:$	1.335	1.38	1.38	1.35	1.36	1.38	1.40	1.45	1.48	1.28	1.37	1.41
Yen	$	113.4	111	111	112	115	117	118	119	120	107	111	118
	€	128.1	130	132	129	132	135	136	140	144	122	130	137
	£	151.5	152	153	150	156	161	165	173	178	137	151	167
Aussie Dollar	$	0.715	0.76	0.75	0.72	0.73	0.75	0.75	0.77	0.77	0.69	0.75	0.76
	€:AUD	1.579	1.54	1.58	1.60	1.58	1.53	1.53	1.53	1.56	1.66	1.58	1.54
	¥	81.14	84.2	83.3	80.6	84.0	87.8	88.5	91.6	92.4	73.6	82.5	89.0
	£:AUD	1.866	1.81	1.84	1.87	1.86	1.84	1.87	1.88	1.92	1.86	1.83	1.87
Swiss Franc	€	1.043	1.11	1.10	1.08	1.05	1.06	1.07	1.08	1.10	1.07	1.09	1.07
	$	0.924	0.94	0.93	0.93	0.91	0.92	0.93	0.92	0.92	0.94	0.92	0.92
	£	1.233	1.30	1.28	1.26	1.24	1.27	1.30	1.33	1.36	1.20	1.26	1.30

Source: Refinitiv, Investec