Global Insights

Catalysts as We Turn the Calendar

The cold hard truth is that making money in 2022 will likely be tricky. In fact, the average fund of hedge funds underperformed a 70% stock/30% bond portfolio by 3.3% through November. As we turn the page on what’s been an unusually strong calendar year for passive strategies, there are a couple of catalysts that we are on the lookout for next year.

First is the potential for additional COVID-19 related disruptions. Vaccination progress and new variants will play an outsized role as investors screen for opportunities. Second, central banks are tightening monetary policy to contain inflationary pressures. While emerging market central bankers started proactively tightening earlier this year, we anticipate the policy focus to ramp up in developed markets in 2022. Finally, next year offers a busy election calendar. The outcome of select elections around the globe will have a meaningful impact on local and regional outlooks.

This edition of Global Insights highlights four major catalysts. Herein we consider COVID-19, central banks, inflation and select elections.
Wide Disparities Exist in Global Vaccination Progress

Preliminary data out of South Africa suggests that the Omicron variant of COVID-19 may not be as bad as initially feared. That said, it could be weeks before investors have a more complete picture. In our April 28 Global Insights “COVID-19 Vaccines and an Uneven Recovery,” we explored the possibility of a growing divide in rates of vaccination between high-income nations and the rest of the world. After nearly eight months, we find that lower-income countries have struggled to keep up (see Exhibit). At the time of writing, just 3% of people in low-income countries are fully vaccinated, which compares to more than 65% in high-income countries. Health experts contend that a return to normal requires that more than 75% of the population be vaccinated. Unfortunately for low-income nations, reaching this figure remains a long way off. In fact, a 2021 McKinsey study details that for at-risk countries, it could take until early 2023 to achieve the necessary vaccine coverage to bring an end to the pandemic. Given this dynamic, we see strong headwinds to growth in emerging markets with low vaccination rates.

Spending on Services Has Not Fully Recovered

At the onset of the global pandemic, countries imposed strict stay-at-home lockdowns to limit the spread of COVID-19. As the crisis evolved, support from fiscal policy led to an unprecedented increase in the household savings rate. According to the OECD, in 2020, G7 household savings grew at the fastest pace since at least 1995. In fact, the world’s largest nations amassed $2.9 trillion in extra savings and contributed to considerable gains in orders for durable goods, according to Bloomberg Economics. Spending on services has only recently started to recover, but the Omicron variant poses a challenge for policymakers. Several European nations have decided to reimpose restrictions as new cases soar. Should the Omicron variant turn out to be milder than the Delta variant, we see opportunities in services sectors where spending remains below pre-COVID levels in real terms (see Exhibit).

Traders Move Up Expectations for Rate Hikes

Traders are beginning to consider the possibility of higher interest rates next year (see Exhibit). At the onset of the global pandemic, ultra-low interest rates helped stabilize markets. As growth improved, central banks prepared to tighten monetary policy. Until now, many policy moves centered on emerging economies, specifically Latin America. In 2022, we think that pattern will change. Morgan Stanley & Co.’s economists estimate that nearly 25% of developed market central banks will have started removing policy accommodation by the end of the fourth quarter 2021. We see the pace accelerating next year. While the market’s expectation of rate hikes heading into 2022 could be exaggerated, investors should be prepared for central bankers that are more hawkish.
Emerging Market Central Banks Are Hiking Rates

Investors remain wary of inflation in emerging markets. In our July 21 Global Insights "Some EMs Are Not Like the Others," we explored the limits of making investment decisions for emerging markets as a whole and discussed how the current bout of inflation poses a challenge for policymakers. Morgan Stanley & Co.’s economists estimate that nearly 70% of emerging market central banks will have started removing policy accommodation by the end of the quarter. Brazil’s central bank is among the most aggressive (see Exhibit), having delivered 150 basis points hikes at both the Oct. 27 and Dec. 8 meetings. Weighed down in part by double-digit inflation, Brazil’s stock market has lagged global benchmarks. In fact, since the end of June, the MSCI Brazil Index has underperformed the MSCI Emerging Markets Latin America Index and MSCI Emerging Markets Index by 8.6% and 17.6%, respectively. Morgan Stanley & Co.’s economists do not think that Brazil’s central bankers are done hiking and forecast another 150 basis points increase at the February 2022 meeting as they attempt to get a handle on prices.

Inflation Is Elevated but Shows Signs of Moderating

Supply chain challenges, labor shortages and pull-forward demand are at the heart of the recent surge in prices. Although inflation troubles could extend into 2022, we see evidence that pandemic-driven price pressures are easing. In fact, an equally weighted basket composed of the Baltic Dry Index, coal and natural gas prices provides evidence that inflationary pressures could roll over alongside sizable inventory builds and a growing body of evidence that consumer demand has shifted toward services and away from goods (see Exhibit).

A Contested Election and Cooling Economy May Spark Volatility in 2022

On Oct. 2, 2022, Brazilians will head to the polls to select their next president. The contest will pit incumbent President Jair Bolsonaro against former President Luiz Inácio Lula da Silva. Bolsonaro, who has his eyes set on a second term, is facing declining approval ratings and lackluster growth in 2022. Lula da Silva, Brazil’s President from 2003 to 2010, is currently leading in opinion polls. In an attempt to boost his falling approval ratings ahead of next year’s elections, Bolsonaro has proposed a new cash-transfer program that will give $70 per month to low-income Brazilians by breaching Brazil’s fiscal spending-cap rule. As the news broke, the Brazilian two-year/10-year spread inverted and the Ibovespa slid further (see Exhibit). Taken together, a close election race, weaker economic growth and unorthodox fiscal spending measures will likely contribute to elevated market volatility.
Stimulative Policies Should Benefit Cyclicals

The South Korea presidential election is scheduled to be held March 9, 2022. Democratic Party candidate Lee Jae-myung will square off with Yoon Seok-youl of the conservative People Power Party. According to Morgan Stanley & Co.’s Asia Pacific strategists, the general policy direction for Lee Jae-myung and Yoon Seok-youl are disparate—especially relating to welfare, real estate and taxes. Lee Jae-myung’s key policy pledges include introducing basic universal income of 1 million won per year to all citizens, 2 million won per year to 19- to 29-year-olds, supplying 2.5 million homes via public development and introducing a property ownership tax. Yoon Seok-youl’s platform does not offer a basic universal income but does pledge 2.5 million homes via private sector development and outlines plans to lower capital gains taxes for homeowners. Both pledges are broadly stimulative. We think that private consumption will broaden, and, as such, cyclical sectors such as semiconductors and materials could benefit.

With Support Narrowing for Macron, a Loss Could Spell Trouble for Markets

The first round of the 2022 French presidential election will be held on April 10, 2022, with the incumbent, President Emmanuel Macron, facing stiff competition (see Exhibit). Should Macron win, we anticipate modest changes in policy, and therefore the impact to markets should be minimal. However, current polling suggests a narrow lead for Macron over more conservative challengers such as Marine Le Pen and Valérie Pécresse in the first round. In the second round of voting, polling suggests that Macron leads voting intention, with 56% of the vote versus 44% for Le Pen. This is narrower than the 2017 election where Macron led with 66% of voting intention versus 34% for Le Pen. According to Morgan Stanley & Co., EU-wide fiscal, trade and regulatory policy would be more difficult if any of the more conservative challengers were to win the presidency. We expect European equity and fixed income markets to experience bouts of volatility in the months leading to the election, especially if voter’s attitudes change as the election day approaches.
Charts You Can't Miss

Exhibit 1: Set-It-Forget-It Outperforms Fund of Hedge Funds Year to Date

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Nov. 30, 2021

Exhibit 2: Taiwan Chipping Away at Backlog of Orders

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Nov. 30, 2021

Exhibit 3: Germany Tightens Restrictions as it Records Highest-Ever Number of New COVID-19 Daily Cases

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Nov. 30, 2021

Exhibit 4: Investors Bet on Strong Chinese Consumer

Current Readings From Our Quantitative Framework

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Ongoing Development Spotlight

Chilean Risk Assets Overly Punished

For years, Chile has grappled with uncertainty around its macro policy. The rewriting of its constitution and the Dec. 19 presidential runoff vote should offer a degree of resolution to macro concerns. Election front-runners Gabriel Boric of the leftist coalition and Jose Antonio Kast of the right-wing Republican Party represent starkly different views. That being said, the outcome of the election will provide clarity and direction for investors. Morgan Stanley & Co.'s Latin America strategists think that investors have overly punished Chilean risky assets over the past two years and they see opportunity for multiple expansion from the currently depressed 10.4x forward P/E toward the 16.2x 10-year average. At the time of writing, Gabriel Boric holds a narrow lead, with 40% of voter intentions versus 35% for Jose Antonio Kast. — Brad Fulton

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