

ALLIANZ RESEARCH

ECONOMIC OUTLOOK: DON'T LOOK UP!

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- Global growth should remain robust but uneven, with rising divergence between advanced and emerging market economies.** We expect omicron-related uncertainty to shave off (only) up to -0.3pp of GDP growth in advanced economies in Q1, due to increase disruptions in terms of labor and global trade. However, just like in the eponymous movie, whose title we borrowed for this report, current growth dynamics might keep us from looking up during the current phase of the recovery. Advanced economies will continue to drive more than half of global GDP growth (+2.2pp in 2022 and +1.6pp in 2023) while emerging markets lag — for the first time since the global financial crisis (GFC). Our 2022 GDP forecast remains broadly unchanged, with the Eurozone and the US expected to grow by +4.1% and +3.9%, respectively, while growth in China slows to +5.2% due to ongoing disruptions in the real estate sector and the government's focus on financial stability. China's lowest contribution to global GDP growth since 2015 is likely to have negative spillover effects on emerging markets whose recovery will be shallower compared to past crises.
- Global trade is expanding once again above the long-term average but will be disrupted by labor and supply chain bottlenecks, amplified by omicron.** We expect global trade in volume to grow by +5.4% in 2022 and +4.0% in 2023. In the short run, the omicron outbreaks will keep disruptions and cost pressures high. During the next two to four months, we expect some lost value added in hard-hit sectors with low (or no) telework possibilities and higher supply chain driven-inflation due to production shortfalls in China to account for about one-third of elevated inflation at 1.5pp to 2.0pp in the Eurozone, the US and the UK. But we still expect a turning point during the second half of this year due to: (i) a cooling of consumer spending on durable goods, given their longer replacement cycles and the shift towards sustainable consumption behaviors; (ii) lower input shortages as inventories return to (or even exceed) pre-crisis levels in most sectors and (iii) shorter delivery times as higher capacity eases shipping constraints.
- We continue to expect pervasive supply-demand imbalances to keep inflation high until the end of the first half of 2022 in both advanced and emerging markets.** Inflation is likely to decelerate this year as the recovery becomes entrenched, mainly reflecting the phase-out of transitory factors, fading catch-up effects of goods demand and declining energy prices during the second half of the year. Amid continued uncertainty about the scale and duration of inflationary pressures, central banks are shifting towards a more hawkish monetary stance to prevent inflation from becoming embedded in expectations. We have identified 10 emerging countries that are most at risk from a faster-than-expected US monetary tightening given their elevated liquidity risk and cyclical weaknesses: Argentina, Brazil, Chile, Egypt, Hungary, Nigeria, Romania, South Africa, Turkey, and Ukraine. The fiscal impulse in Europe will be stronger than in the US this year but diminish quickly as most countries start their consolidation path. Most emerging market countries are reducing budget deficits and re-building fiscal space, but commodity exporters remain vulnerable to slowing external demand from China.

- **Gradually rising rates will continue to provide a benign but increasingly fragile capital market environment.** Unchanged or even lower risk premia, declining real interest rates and excess savings have supported favorable financing conditions and helped risky assets outperform while fixed income assets have struggled amid rising inflation expectations. However, the positive risk sentiment underpinning historically high valuations in equity markets comes with rising market volatility and remains dependent on the continued growth momentum and the gradual removal of crisis-related policy measures.
- **What could go wrong?** Despite the emergence of yet another Covid-19 mutation, the economic impact of the pandemic is generally weakening. We estimate that potential disruptions to labor markets due to sanitary restrictions could put 2-3% of the value added at risk in advanced economies. In addition, tighter financial conditions or a premature withdrawal of policy support could undermine the recovery and increase private and public sector vulnerabilities, with the potential for cliff-edge effects in some countries. Greater divergence of fiscal and monetary policy normalization across countries could further increase imbalances and disrupt the recovery of international trade. As the gap between monetary and fiscal policy stances in Europe and the US is bound to widen, there is a rising risk of decoupling, which could feed into capital market dislocations. The spillover effects of higher capital outflows and FX volatility as the US begins to tighten financing conditions, the (largely) self-inflicted currency crisis in Turkey and rising uncertainty about the implications of slowing external demand from China could weigh on the outlook for emerging markets.

+4.1%

Global GDP growth forecast for 2022

ADVANCED ECONOMIES WILL CONTINUE TO OUTPACE EMERGING MARKETS IN 2022

The post-crisis recovery remains robust but continues to be uneven, with rising divergence between advanced and emerging economies. Despite renewed concerns about the evolving virus dynamics, growth momentum has been held up by resilient consumption, rising investments and strongly rebounding global trade. We expect global output to increase by +4.1% in 2022 before converging to trend growth at +3.2% in 2023. The Eurozone and the US will grow broadly in line with the global economy at +4.1% and +3.9%, respectively. With a growth rate of +5.2% in

2022, China will make its lowest contribution to global GDP growth since 2015 in 2022 (+0.9pp, excluding 2020). Vaccination rates, the unwinding of supply bottlenecks and policy choices will critically influence the scale of catch-up as policy support is gradually withdrawn. However, just like in the eponymous movie whose title we borrowed for this report, current growth dynamics might keep us from looking up during the current phase of the recovery. While output is expected to reach its potential level until the end of 2022, output loss relative to the pre-

crisis trend is likely to be considerable, especially in emerging markets. Advanced economies will continue to drive more than half of global GDP growth (+2.2pp in 2022 and +1.6pp in 2023) while emerging markets are lagging the pace of the global recovery — for the first time since the GFC. We expect this divergence to continue over the medium term as the still low vaccination rates will keep the global economy exposed to high volatility and delays in the recovery due to the risk of further Covid-19 variant developments.

Figure 1: Global GDP growth forecast (2021-23)

	2019	2020	2021	2022	2023
World GDP growth	2.5	-3.4	5.4	4.1	3.2
United States	2.3	-3.5	5.6	3.9	2.8
Latin America	0.2	-6.9	6.3	3.0	2.1
Brazil	1.4	-4.1	4.8	1.5	1.2
United Kingdom	1.4	-9.9	7.1	4.4	2.6
Eurozone members	1.5	-6.5	5.2	4.1	2.3
Germany	1.1	-4.9	2.7	3.7	2.3
France	1.8	-8.0	6.7	3.6	1.9
Italy	0.3	-8.9	6.3	4.5	2.1
Spain	2.1	-10.8	5.0	5.7	3.2
Russia	2.0	-3.0	4.0	3.0	2.5
Turkey	0.9	1.8	10.7	1.5	4.2
Asia-Pacific	4.0	-1.0	5.8	4.7	4.4
China	6.0	2.3	7.9	5.2	5.0
Japan	0.0	-4.7	1.9	2.5	1.6
India	4.1	-7.3	8.5	7.1	6.9
Middle East	0.4	-4.1	3.1	3.7	2.5
Saudi Arabia	0.3	-4.1	3.0	4.7	2.4
Africa	1.7	-2.6	2.9	3.5	3.8
South Africa	0.3	-6.4	4.4	2.0	1.4

Sources: Euler Hermes, Allianz Research

Note: fiscal year for India

Inflation is likely to decelerate this year as the recovery becomes entrenched, mainly reflecting the phase-out of transitory factors and declining energy prices in H2. The ECB and the Fed still deem rising inflation to be non-structural but acknowledge that it is now lasting longer and has a more uncertain future path than initially expected¹. While inflation expectations have remained well-anchored, catch-up effects have morphed into pervasive supply-demand imbalances pushing up inflation almost everywhere for much longer than originally expected. Supply chains remain clogged, energy prices are still stubbornly high and

parts of the labor market are becoming exceedingly tight, especially in sectors that already experienced labor shortages before the pandemic. The release of pent-up demand has resulted in some overheating of Covid-exposed sectors, such as construction, with limited local production capacities, resulting in significant price pressures. These are particularly high in countries that have closed the output gap already². Pockets of elevated inflation are also visible in sectors with stronger pricing power (automotive, building materials and, to some extent, in retail and warehouse services). In the context of rising uncertainty due to the

omicron variant, it may well take until mid-2022 to get a better grasp on the stickiness of key inflation drivers, including supply-chain disruptions, elevated energy prices and the healing of the labor market³. We expect the Brent oil price to decline to USD75/barrel by the end of the year before decreasing by close to 10% to USD69/barrel until the end of 2023. Overall, we expect average annual inflation this year to remain high in 2022 at 4.4% and close to 3% in the US and Eurozone, respectively, before declining to levels broadly in line with the respective inflation targets in 2023.

Table 2: Inflation rate forecast, %

	2021	2022f	2023f
United States	4.7	4.4	2.0
Eurozone	2.6	2.8	1.8
Germany	3.2	3.1	2
France	2.0	2.6	1.9
Italy	2.0	2.4	1.3
Spain	3.1	3.9	1.8
United Kingdom	2.5	3.8	2.2
Japan	-0.3	0.8	0.9
China	0.9	2.5	2.0

Sources: Markit, Euler Hermes, Allianz Research

¹ For Q3 2021, the US PCE deflator declined to annualized rate of 5.3% q/q (down from 6.5% in the previous quarter) amid broadening wage pressures, but the cost of employment index has risen to a decade-high. This raises doubts over whether inflation is still running persistently below the Fed's longer-run 2%-inflation goal, given the accelerating catch-up during the Covid-19 crisis. The PCE level is above target even with a 10-year look-back window.

² Inflation prints during the last quarter of last year confirm this concern, with particularly high inflation data in Germany and the Netherlands.

³ So far, wage pressures are more pronounced in the US and spotty in the Eurozone.

Despite negative real purchasing power, excess household savings will continue to support consumption in 2022-23, notably in Europe.

Despite the renewed Covid-19 outbreaks, pent-up demand that turned into additional consumption reached EUR20bn in Italy (+1.2pp of GDP) and EUR5.4bn in the Netherlands (+0.8pp of GDP) in 2021. In France, Belgium and Germany, the release of pent-up demand during summer boosted GDP by about +0.5pp. We expect consumer confidence to remain positive and broadly unchanged as the fear factor has reduced significantly. While the saving rate reached its pre-crisis level in the US at end-2021, it remains +6pp above at 19% in the EU. This should provide

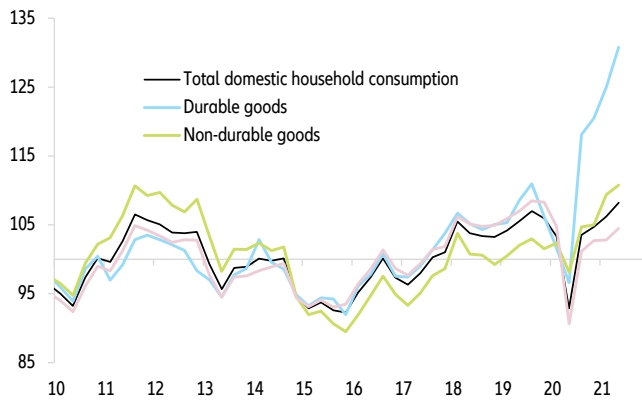
support to spending despite declining real purchasing power until the end of the year. Since excess savings are accumulating in the higher net income bracket and the elderly, which tend to have a lower propensity to consume, we expect that only between 20% and 40% of pent-up demand has been absorbed in 2021⁴.

In the US, consumer confidence increased by more than expected in December on account of a tight labor market.

The labor differential—the difference between the percentage of respondents saying jobs are plentiful and those saying jobs are hard to get—remains near all-time highs. As opposed to the US, consumption in

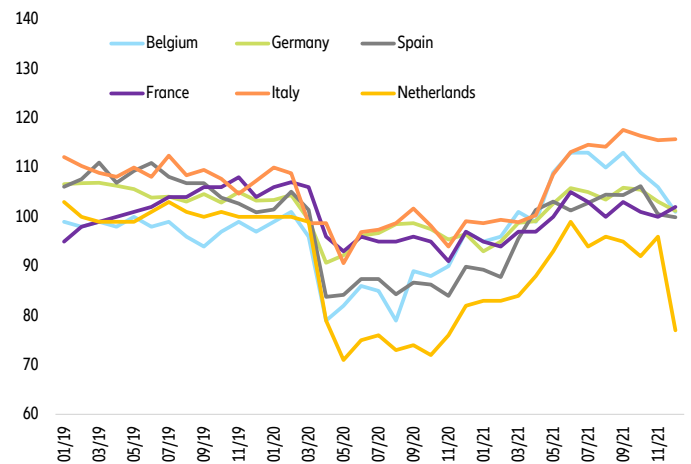
most European countries is still significantly below pre-crisis levels, including Spain (-8%), Italy (-3.5%) and Germany (-2%). However, it has (almost) caught up with pre-crisis levels in Belgium (+0.2%), France (-0.9%) and the Netherlands (-0.8%). We expect the consumption recovery to lose steam in early 2022 amid tightening mobility restrictions. The household spending preference on (durable) goods rather than services (Figure 1) is likely to continue but goods-intensive catch-up demand will slow. At the same time, virus concerns will delay the rotation of demand back to services, barring renewed mobility restrictions due to further virus outbreaks.

Figure 1: Advanced economies—Domestic household consumption (100 = average over 2010-2019)



Sources: Refinitiv, Euler Hermes, Allianz Research

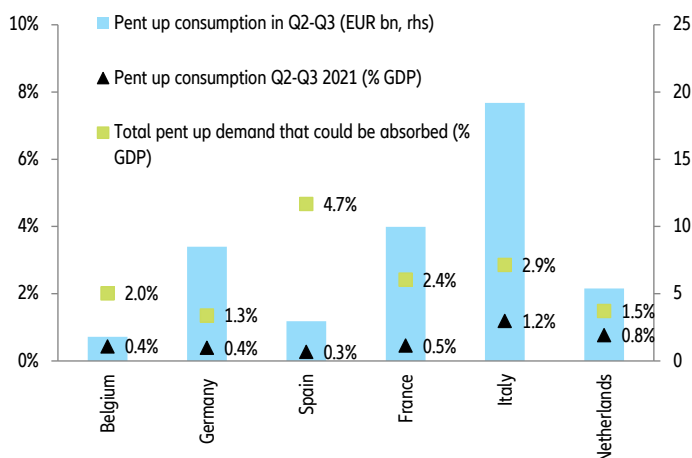
Figure 2: Europe—Consumer confidence indicator



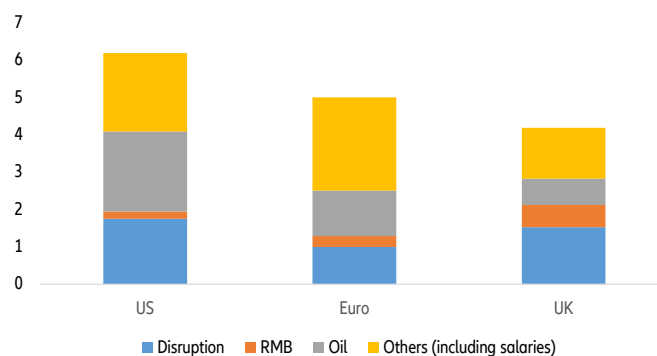
Sources: Eurostat, Euler Hermes, Allianz Research

Note: To make the series comparable, we first mean-centered them as of 1998 (first observation available for Italy) and rebased to 100 and impose standard deviation to be the same as the French series.

⁴We calculate the scale of dis-saving supporting consumption in hard-hit, contract-intensive sectors (wholesale & retail trade, transport, accommodation & food services) as the deviation from underlying trend growth.

Figure 3: Pent-up consumption in Covid-exposed sectors

Sources: Eurostat, Euler Hermes, Allianz Research

Figure 4: Supply-side disruptions' contribution to inflation (October or November 2021, pp)

Sources: Datastream, Euler Hermes, Allianz Research

Households will increasingly allocate their Covid-19 savings to real assets (real estate, financial investments).

Inflows into equity markets have continued to push up asset valuations (see next section on the capital markets outlook) and some areas of the real estate market are showing signs of over-heating. For instance, the price-to-rent ratios in France and the UK have reached record highs. While some countries, such as France, have new macroprudential policies coming into action (strict debt service-to-income ratio since January this year) this is unlikely to meaningfully slow the pace of appreciation in the real estate sector.

Investment is slowly recovering, especially in the US.

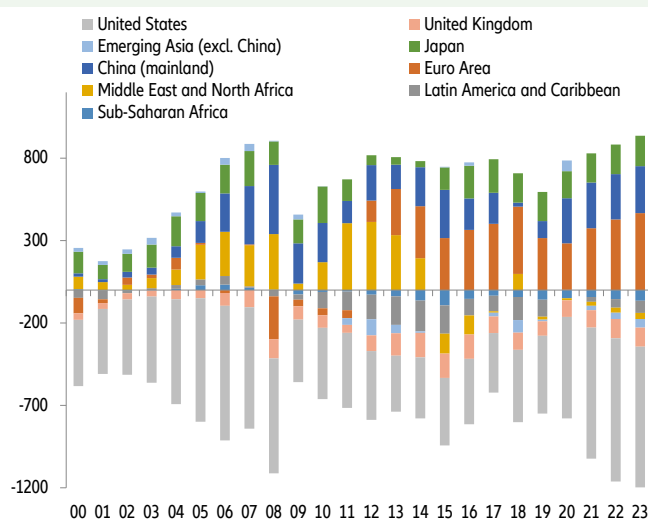
Investment picked up significantly in the US during the second half of last year due to greater business confidence and high levels of capacity utilization. Capital expenditure in several sectors (e.g. computers and machinery and equipment) has increased above long-term averages. In Europe, investment growth remains muted, suggesting a significant poten-

tial for catch-up effects this year, given favorable funding conditions and elevated corporate cash positions. Most companies have delayed investment decisions due to supply-chain bottlenecks and input shortages. We expect global capex expenditures to grow by +4.3% in volume terms this year, with resilient margins, thanks to (i) to above-trend demand allowing to pass-on higher input prices; (ii) fixed costs being amortized on greater volumes; (iii) high liquidity (partly supported by government guarantees, such as in France and the UK), and (iv) price-pressure relief on some inputs (e.g. energy). Cash buffers are particularly large in the US (USD650bn) and the Eurozone (USD760bn).

Global trade is expanding above the long-term average, once again.

We expect global trade in volume to grow by +5.4% in 2022 and +4.0% in 2023. While short-run disruption is expected to remain high, given the renewed Covid-19 outbreaks, we anticipate a decreasing tensions for trade as transportation bottlenecks reach a turning

point during the second half of this year due to three factors: (i) a cooling of consumer spending on durable goods, given their longer replacement cycles and the shift towards sustainable consumption behaviors; (ii) less input shortages as inventories return to (or even exceed) pre-crisis levels in most sectors and (iii) declining delivery times and transportation costs as higher capacity eases shipping constraints. Shipping congestions should be less acute in H2 2022 as capacity is increasing: global orders for new container ships have reached record highs over the past few months (to 6.4% of the existing fleet). The USD17bn port infrastructure plan in the US should also reduce global pressures. Container prices (Asia to Europe, Asia to North America) are declining (-11% in November 2021 vs peak for the global container rate, USD per FEU) but remain six times above pre-pandemic levels. However, China is expected to keep its zero-Covid policy at least until the fall this year, which will continue to bring volatility into global supply chains.

Figure 5: Current account balances, bn USD

Sources: Eurostat, Euler Hermes, Allianz Research

However, external imbalances are increasing, too. In the US, the current account deficit widened to -3.4% of GDP, the highest level since 2008, and will remain high over our forecast horizon (-3.0% to -3.5% of GDP). Current account deficits are also widening in emerging markets, especially Latin America. On the other side, China's current account surplus is estimated to remain high in 2022-23 (+1.7% and +1.4% respectively) because of continued strong global demand for electronics and China's lower services trade deficit as overseas travels slumped. The Eurozone's current account surplus is also expected to increase to above pre-pandemic levels (+3.5% in 2023) and should be boosted by the surplus in services. Large Eurozone countries will continue to register opposite developments: expect the trade surplus in Germany to widen in 2022, in the same way as the trade deficit in France.

As the recovery takes hold, the gradual withdrawal of monetary and fiscal policy support needs to ensure an effective rotation towards private demand and sustainable growth. Differences in the normalization of policy support across countries has increased imbalances across countries. On fiscal policy, the fiscal consolidation in the US will be stronger than in Europe. Most EMs are reducing budget deficits, but commodity exporters remain vulnerable to a downcycle in the future. On monetary policy, current inflationary pressures in advanced economies imply a slightly more hawkish monetary stance without a fundamental change in the expected hiking cycle while key EMs are already hiking rates.

Monetary policy is becoming less accommodative. Central banks in advanced economies have been cautious about withdrawing monetary stimulus too early but are now moving forward

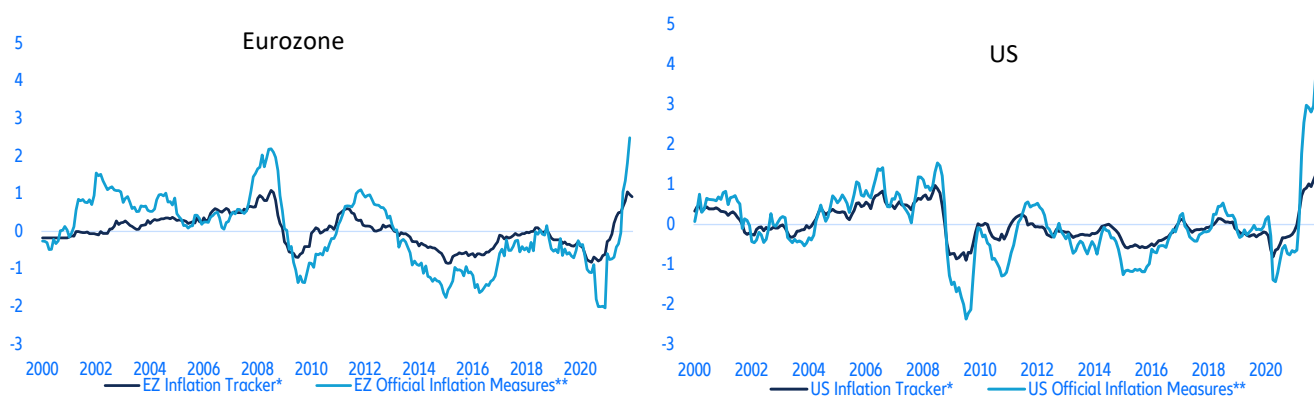
to prevent a de-anchoring of inflation expectations. The Fed is already dialing back its accommodative stance by speeding up the pace of tapering, with stronger inflation and growth outturns suggesting economic slack diminishing more quickly than anticipated. After accelerating the tapering of its asset purchases until March, we expect that the Fed will start a two-year tightening cycle in the second quarter. The recent surge in the long-term yields in the US indicate that markets are anticipating a more aggressive monetary stance, which has also increased the price volatility in bond markets. The ECB is expected to remain patient and tolerate some overshoot in inflation as inflation expectations remain largely anchored and wage growth spotty, with no rate hikes likely before 2023. Tapering is likely to be announced in December 2022 and concluded by mid-2023 with a first rate hike expected in September 2023.

Other large central banks have similarly began shifting their forward guidance towards a less accommodative monetary stance. For emerging markets, rate hikes will remain the norm to contain FX depreciation as the US and other advanced economies start their tightening cycle. Looking at two main indicators for emerging markets: (i) liquidity risk, an indicator that includes, current account balance, external debt repayment in 2022, imports cover ratios and credit growth to the private sec-

tor, as well as (ii) cyclical weaknesses, based on currency volatility & depreciation, inflation rates, stock and bond market performance as well as bond spreads, we identify 10 emerging countries most at risk from a faster-than-expected monetary policy by the Fed: Argentina, Brazil, Chile, Egypt, Hungary, Nigeria, Romania, South Africa, Turkey and Ukraine. We expect the most aggressive rate hikes to come from Latin America, Eastern Europe and, to a lesser extent, from Africa. Asia

will remain an exception, with a very progressive normalization in ASEAN. Conversely, China will strengthen the policy easing that started in July 2021 through further rate cuts (at least -10bp in loan prime rate in H1 2022) and liquidity injections (-50bp in reserve requirement ratio in H1 2022, along with open market operations) to stabilize economic growth and avoid contagion risks from the real estate sector.

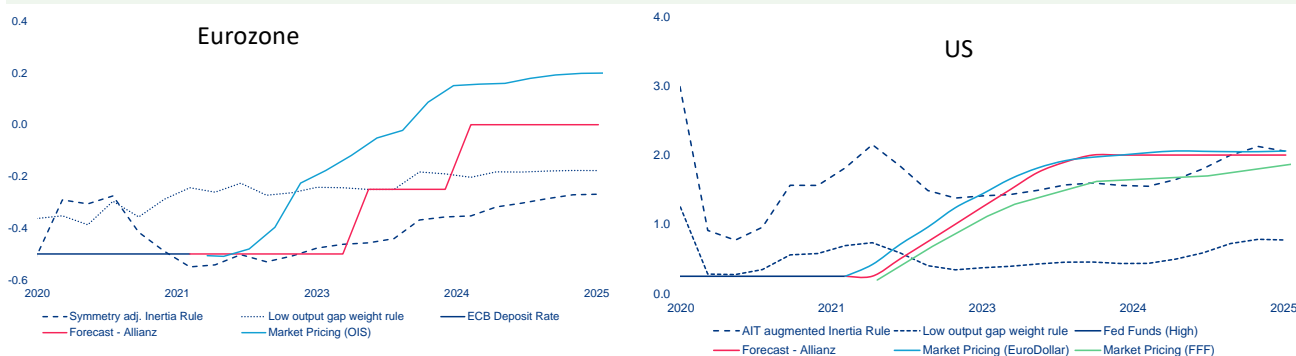
Figure 6: Eurozone and US-Inflation (z-score)



Sources: Refinitiv, Euler Hermes, Allianz Research.

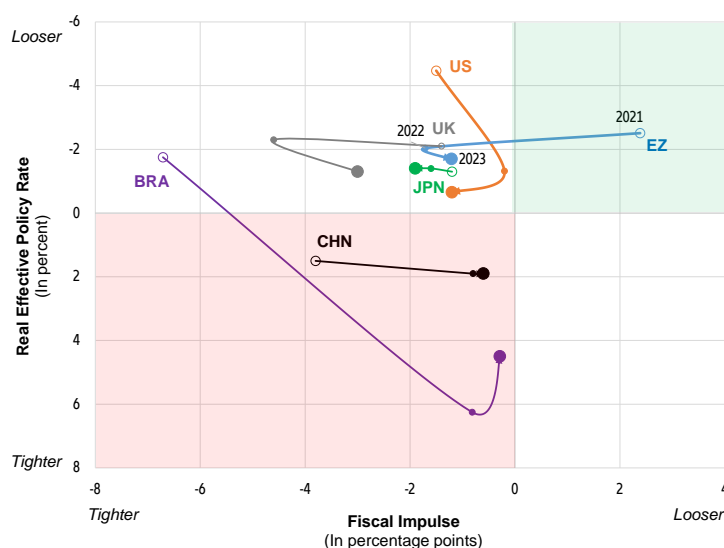
Note: */ Equally-weighted and normalized composite measure comprising 15 subsegments (underlying trends (modified/trimmed measures), forecasts, market-based inflation measures, expected inflation implied by term structure models, monetary aggregates, consumer and producer price components, labor market indicators, commodity prices, corporate margin & profitability and proxies for price effect from supply chain disruptions); **/ Equally-weighted and normalized composite measure comprising headline and core inflation reported by national authorities.

Figure 7: Eurozone and US - Expected policy rates



Sources: Refinitiv, Euler Hermes, Allianz Research.

Figure 8: Selected advanced and emerging market economies: monetary and fiscal stance (2021-23)



Sources: FAO, Euler Hermes, Allianz Research

Fiscal consolidation is underway. While the fiscal impulse in most countries is diminishing, the US has slowed fiscal consolidation while Europe will begin structural tightening only next year. Chinese authorities' policy stance has shifted towards easing to support domestic demand and mitigate the impact from the real estate market. Most EMs have improved their fiscal position due to higher government revenues, resuming remittances, export revenues and capital inflows. In 2021, budget deficits narrowed in almost all EMs compared to 2020, except for Czechia, Latvia, Nigeria, Slovakia and Tunisia and several emerging Asian economies, though most of the latter group and the three EU economies have sufficient fiscal space. However, current budget deficits, the materialization of contingent liabilities (from state-owned enterprises and state guaranteed loans), but also increasing debt-service costs in an environment of higher interest rates, will drive public-debt accumulation. Argentina and Brazil in Latin America; Tunisia and Ghana in Africa; Bahrain, Jordan, Oman in the Middle

East and Sri Lanka, Pakistan, the Philippines and India in Emerging Asia will be debt sustainability hot spots in 2022.

Financing conditions remain favorable, but financial stability risks are building.

Banks remain broadly well-capitalized, with capital buffers likely large enough to absorb loan losses. They have been able to slowly absorb rising impairments without a significant change in their capital ratios, thanks to continued borrower support and effective capital-conservation measures. However, deteriorating asset quality as support measures expire could test the adequacy of current loan-loss provisioning, especially in countries where private sector leverage is high, and banks are heavily exposed to hard-hit sectors. In some countries, there has been excessive risk-taking in a context of low interest rates, heightened competition and rising house prices. Looser lending standards combined with high growth in residential real estate prices suggest that vulnerabilities might be building up.

Adverse virus dynamics would slow the recovery and exacerbate global imbalances.

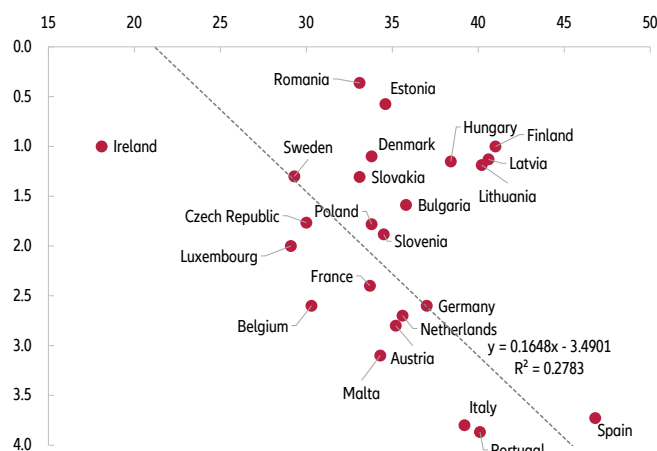
The emergence of yet another Covid-19 mutation has created renewed uncertainty about the growth outlook, though the economic impact of the virus is generally weakening. Rising infection rates underscore that as long as vaccination rates remain below the coverage required to reach herd immunity and continue to differ significantly between most advanced and emerging markets, virus mutations raise the prospects of renewed lockdowns and keep the recovery uneven and incomplete. A new Covid-19 wave could significantly prolong the current imbalance between goods-intensive catch-up demand and squeezed supply. Tighter restrictions as well as partial (and more targeted) shutdowns could slow the recovery momentum and decrease aggregate demand but less so compared to previous waves (with real activity adjusting better to stricter containment measures). The economic implications of current virus dynamics, especially the potential increase in the severity, transmissibility

and containment measures have yet to be fully understood. We estimate that omicron-related uncertainty and soft stops could shave off (only) up to -0.3pp of quarterly GDP growth in advanced economies in Q1 2022, thanks to a diminishing sensitivity of domestic

demand and global trade to health-related restrictions. A slower recovery would mean additional economic scarring, with further adverse distributional effects and rising inequality. While most countries are reaching their pre-crisis output levels, the cumulative out-

put loss has been sizeable, especially in economies with higher shares of contact-intensive sectors, which could also be more affected by repeated virus waves and associated economic impacts (Figure 10)

Figure 9: Europe: expected crisis output loss vs. share of highly-affected sectors* (2022) (in percent)



Sources: Refinitiv, Euler Hermes, Allianz Research

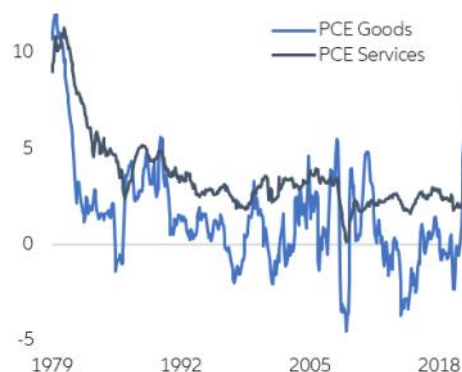
Note: */ Expected output loss based on current forecast of GDP level in 2022 relative to projected GDP level in 2022 as of end-2019 (pre-crisis); x-axis shows the share of highly-affected sector in gross value added (GVA); chart excludes Greece (with output loss of 9.0%) due to scaling.

Downside risk to inflation could force central banks to hasten withdrawing their support and risk over-tightening their monetary stance. As pandemic-related technical/one-off factors are fading, one of the key questions relates to what will happen to underlying inflationary pressures if the emergence of the potentially more damaging omicron variant slows the recovery momentum and delays the pace of re-opening. For instance, the US Fed has signaled that it would act faster if needed to keep long-term inflation expectations and yields under control.

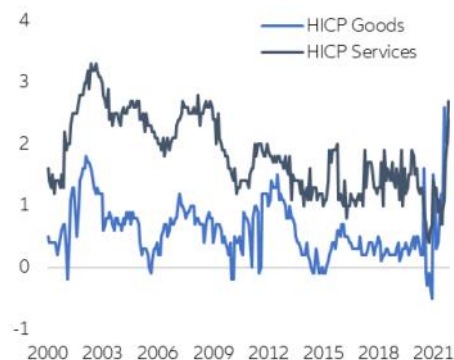
Core inflation in both the Eurozone and the US continues to be driven in large part by catch-up effects underpinning robust aggregate demand (Figures 10 and 11), not just supply-side constraints (with are difficult to overcome with monetary policy tools). Record levels of net disposable household income mean that there is still plenty of spare cash to disproportionately flow into the consumption of goods, especially if the pandemic disruption drags on for longer than expected. This might also delay the rotation of consumption back to services,

where price pressures tend to be more short-lived. Household spending preferences on (durable) goods rather than services is likely to continue but goods-intensive catch-up demand will slow. At the same time, virus concerns could delay the rotation of demand back to services, barring renewed mobility restrictions due to further outbreaks. However, the replacement cycle for durable goods seems to be coming to an end, which would facilitate the adjustment of demand to tighter supply and soften price pressures⁵.

⁵ UN Moreover, there are upside risks for inflation: permanent costs of resilient rather than efficient supply chains, downward price rigidities in concentrated sectors, lower productivity due to inefficient resource reallocation.

Figure 10: US core inflation (y/y %)

Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 11: EZ core inflation (y/y %)

Sources: Refinitiv, Euler Hermes, Allianz Research

The risk of policy mistakes is looming large. Tighter financial conditions or a premature withdrawal of policy support could undermine the recovery and increase private and public sector vulnerabilities, with the potential for cliff-edge effects in some countries. Conversely, if inflationary pressures persist, central banks could fall behind the curve, with overshooting inflation causing potential adverse wage-price feedback effects that could stymie growth dynamics. The divergence of policy normalization across countries could be disruptive to international trade and cause adverse spillover effects to emerging markets. Given the increasing divergence of the monetary and fiscal stance in Europe and the US, there is a rising risk of decoupling, which could feed into capital market dislocations. The spillover effects of higher capital outflows and FX volatility as the US begins to tighten financing conditions, the (largely) self-inflicted currency crisis in Turkey and rising uncertainty about the implications of slowing external demand from China for commodity-exporters could weigh on the outlook for EMs. In addition, adverse geo-political developments,

including the further deterioration of Sino-American relations and the brewing conflict in Ukraine, could trigger another round of political risk with adverse effects on markets.

Several key developments will shape the balance of risks this year. We could see rising volatility around the Fed's expected tapering conclusion in March 2022 as markets prepare for the onset of a fresh rate hiking cycle. With the ECB a late-bloomer in rolling back its crisis support, the high-flying USD could weigh on the global economy and EMs until mid-2022. For the ECB, a communication shift in the second half of the year with fresh macroeconomic forecasts eventually extending as far as 2025, is likely to bring interest rate hikes back on the agenda and in turn a further widening in Italian spreads. Assuming a pro-EU Italian presidential candidate wins the elections scheduled for late January, dynamics should remain manageable. On fiscal policy, a highlight includes the EU fiscal framework reform discussions. A further standstill could seriously undermine the success of the Green Deal. Political risk also looms large this year. As far as the

"known unknowns" are concerned, the (mis-) handling of the Covid-19 crisis is likely to take center stage in national polls. Aside from a heavy election schedule in Europe with key votes taking place in Portugal, Sweden, France and Hungary (a vote on its EU future), the two largest economies in the world will also head to the polls. In China Xi Jinping will likely embark on his third five-year mandate further cementing his political grip when the communist Party chooses its new leadership at the 20th Party Congress in late 2022. There will also be key elections in other large economies (Australia, Brazil and India; Figure 12). Meanwhile, the Biden administration in the US could see its policy wings clipped in mid-term elections in November if current polls are anything to go by. In emerging markets, voters in economic heavyweights including the Philippines, Columbia and Brazil will cast their votes. On the geo-political front, the US-China relationship is likely to remain strained, with the Olympic Winter Games in Beijing likely to pose a first test as to whether tensions might flare up again.

Figure 12: Overview of General and Presidential Elections in 2022

Sources: Euler Hermes, Allianz Research

Besides accelerating the vaccination rollout, the key policy priority is to calibrate support to the pace of the recovery, while gradually shifting to more targeted measures focusing on growing firms and sectors. Another important challenge is to identify the potential size of the reallocative needs and the role that policy should play in facilitating reallocation in response to the scale of structural transformation.

- On fiscal policy, the US Administration will likely need to amend the Build-Back-Better (BBB) Framework to ensure Senate approval so that additional capital-spending plans on infrastructure and climate policy can be funded and implemented in the near term. Without the BBB, our growth forecast for this year would materially decline by about 0.5pp. On the other side of the Atlantic, the EU will face a pivotal discussion on the future of the suspended fiscal rules and the scope of potential changes once they are restored. Recognizing the

elevated debt levels of member countries, reforming the fiscal rules could entail shifting to an expenditure growth rule with a debt anchor, along with a permanent centralized fiscal capacity for stabilization and investment⁶. A particular focus on climate investment could also be a more efficient way to progress toward the EU's common climate goals, given that investment returns may be higher in countries with less fiscal space and that the benefits of reducing carbon emissions are felt across national borders.

- On monetary policy, the ECB and the Fed should be ready to act if price pressures broaden and threaten to become self-reinforcing, raising the prospect of an adverse feedback loop between inflation expectations and wages. In the fresh round of macroeconomic projections, both the Fed and ECB project higher inflation but lower growth, especially

over the near term. Rising inflation expectations triggered by broadening price pressures in recent above-consensus inflation prints could considerably erode the effectiveness of forward guidance and alter the scale and duration of monetary policy normalization (i.e. the "hiking cycle"). Over the longer term, the development in labor markets and its impact on inflation developments (outturn and expectations) as well as the crisis impact on trend growth, will be key aspects of the evolving stance. Despite the higher stakes for credible forward guidance, with the possibility of a slightly more hawkish tone, we still expect the overall tightening cycle to be less aggressive than suggested by current market pricing: shallow and protracted relative to historical standards in the US and little real tightening in the Eurozone.

⁶ Such a reform would drastically simplify the rules and improve compliance with and enforcement of the rules. It would also implicitly take account of the differing conditions of EU countries, by allowing high-debt countries a longer period to achieve the common debt objective than those starting with more modest levels of indebtedness and by linking expenditure growth to a country's nominal growth rates. Setting up a central fiscal capacity for macroeconomic stabilization and investment could help in various ways: (i) providing incentives for compliance with the fiscal rules by making access contingent on compliance; (ii) boosting public investment in the EU and (iii) enhancing the resilience of the Eurozone.

REGIONAL OUTLOOKS

US: still going strong but less monetary and fiscal support

After +5.6% in 2021, we expect US GDP growth of +3.9% in 2022 and +2.8% in 2023. The fiscal impulse of crisis-related support is waning but continues to support growth, with the focus shifting towards long-term spending measures, such as infrastructure projects and social security. We expect the US deficit to be close to 6% of GDP against 12.5% in 2021. If the Build Back Better program is further delayed (or not approved at all by the US senate), we would revise down our forecast by 0.5pp in 2022, 0.25pp in 2023 and 0.2pp in 2024 to account for the missing capital spending of EUR514bn for new public infrastructure until 2031. Renewed restrictions due to the omicron variant are likely to reduce annualized q/q growth by about 3pp between Q4 2021 and Q2 2022 (assuming half the economic impact compared to previous waves).

The peak of inflation surprised on the upside in 2021, suggesting economic slack diminishing more quickly than anticipated. We have revised on the upside our inflation forecast to 4.4% in 2022 and 2.0% in 2023. We continue to see the major drivers of this overshoot as temporary. The Fed has already accelerated the tapering of its asset purchases, and we expect the first rate hike no later than the end of Q1 2022, followed by up to two additional rate hikes this year and four rate hikes in 2023. While the projected hiking cycle will be protracted and shallow by historical standards, the time period between the end of tapering and the first rate hike will be shorter compared with previous episodes of monetary policy normalization (e.g. in 2014, the first rate hike occurred two years after the start of tapering). There are two main reasons for this: (i) unlike after the GFC, financial institutions and banks are in a much better shape, and rising interest rates would not create a credit

squeeze, especially given the cash buffers of households and corporates, thanks to crisis-related support and (ii) pressures on prices and salaries are much stronger today, with unemployment at 4.2% (November 2021). With rapidly rising wages, the major upside risk to the inflation forecast is that higher inflation becomes embedded in the economy, creating an adverse price feedback effects amid a tightening job market. While inflation expectations still remain elevated, the labor participation rate remains below the long-term average (61.8% in November 2021 compared with 64.5% since 2000) and artificially dampens the unemployment rate, especially for low-skilled workers, which have seen a stronger acceleration of wages than their higher-skilled peers. However, the participation rate is likely to normalize over the coming months as most support programs are about to expire.

Eurozone: recovery on track but losing steam

The Eurozone economic cycle will remain volatile in 2022, reflecting developments on the pandemic front. Following a strong consumption-led growth spurt last summer, growth dynamics turned decidedly weaker towards the end of 2021. In addition to prolonged supply-chain stresses keeping a lid on industrial prospects until mid-2022, the recovery in private consumption – notably services - is now also on pause as another Covid-19 wave sweeps the region and the pick-up in inflation is hurting household purchasing power. As a result, Eurozone GDP growth should slow to on average +0.5% q/q in both Q4 2021 and Q1 2022, down from +2% q/q in Q3 2021. Nevertheless, the Eurozone still kicks off the year 2022 with GDP back at pre-crisis levels.

Following a weak start to the year, the Eurozone's growth stars will once again realign come spring, with quarterly GDP growth rising above +1% q/q between April and September. For one, supply-side challenges should start to fade and energy prices recede mark-

edly from recent highs. Moreover, Eurozone services should benefit from an improving pandemic situation, making up for most of the output lost during the fourth wave. In that context, still-elevated household savings and a strengthening labor market - with unemployment swiftly returning to pre-crisis levels - should provide fertile ground for a pick-up in consumption during the second half of the year. Fiscal flagship measures – including public business support measures and furlough schemes – will be extended in the most affected countries and help prop up domestic demand. Eurozone fiscal policy will continue to remain modestly supportive as some modest reforms of the suspended EU fiscal rules are likely to provide some breathing space to national governments from 2023 onwards. Tailwinds from the NGEU recovery package will peak in 2022-23, contributing up to 1.5pp to GDP growth. Overall, GDP growth is forecast to slow to +4.1% in 2022 and +2.3% in 2023 after +5.2% last year.

Similar to the US, the inflation overshoot in the Eurozone is proving more pronounced and stickier than initially expected but current price pressures

remain non-structural in nature and should dissipate during the course of this year as the effects of supply-demand imbalances and higher energy prices fade. Inflation expectations remain largely anchored and wage growth spotty. We expect inflation at 2.8% this year and 1.8% in 2023. Lower inflation this year will give the ECB breathing room to manage a gradual transition from the expiring crisis-related asset purchase program (PEPP) and delay “real tapering”, i.e. winding down the APP program, until January 2023. We expect a first rate hike after the conclusion of the APP in September 2023 – a first since summer 2011 and the beginning of the first meaningful hiking cycle since late 2005 – more than a year after the Fed. However, inflation risks remain skewed to the upside over the medium term. If inflation remains above target next year, the ECB will have to shift its current monetary policy stance much more abruptly than currently envisioned, which could weigh on the growth dynamic and raise financial stability concerns.

Germany: no longer leading the Eurozone recovery

While Germany originally fared better than most Eurozone economies during the crisis, its growth momentum substantially weakened in late 2021. With 2021 GDP growth at +2.7%, according to our current estimates, the region's largest economy has fallen not only behind France but also Italy in its return to pre-crisis GDP levels. Growth is likely to pick up to +3.7% this year before slowing to +2.3% in 2023. No major leaps can be expected from German industry until Q2 this year, when we expect supply-side bottlenecks to ease and energy prices to moderate. Consumption, the most important driver of the recovery, is likely to decelerate during the next few months as catch-up demand fades and renewed Covid-

19-related restrictions hinder the normalization of services demand. Services that require direct customer interaction, such as the leisure industry and hospitality as well as physical retail services, are likely to be particularly affected, but some of the economic impact would be cushioned by public support measures, which we expect to be extended until at least end-March. Most of the output lost during the winter wave should be made up over the course of 2022. On the whole, the growth impact should prove less severe than in previous waves as consumers have already adjusted their behavior. Inflationary pressures due to base and reopening effects have been stronger and more long-lasting than initially thought but are still non-structural. We have revised up our inflation forecast to 3.1% this year and

2.0% in 2023, but remain convinced that elevated inflation remains non-structural.

Creative fiscal maneuvering will allow for a more, albeit limited, expansion of fiscal policy in the coming years. Additional below-the-line investment spending aimed at circumventing the constitutionally-enshrined debt brake will still see total deficit spending capped at about 1% of GDP between 2023 and 2025. Moreover, the fiscally conservative Liberal Party, the junior coalition partner in the new German government in charge of the finance ministry is expected to keep fiscal plans in check. Still, a precedent of circumventing the debt brake will be set. Expect off-balance-sheet debt to remain a feature of German fiscal policy in the coming years.

France: strong momentum from consumer confidence as the labor market begins to tighten

While the renewed Covid-19 wave has muted rising business and consumer confidence during the last quarter, the economic implications seem limited so far and concentrated on lower-than-expected tourism activity. In Q1 2022, we expect real activity to slow slightly as infections peak, followed by a progressive normalization during the remainder of the quarter; we expect growth at +0.2% q/q, with an estimated -0.3pp drag on activity from the renewed Covid-19 outbreak. Private consumption will continue to drive growth this year as real purchasing power will remain slightly positive. We expect overall GDP growth to reach +3.6%, followed by +1.9% next year.

Like in other Eurozone countries, inflation (CPI) rose significantly to an average of 2% last year (after 0.5% in 2019) and will remain elevated in H1 2022 before decreasing slightly to 2.0% by the end of the year (2.6% on average in 2022). On the back of the dynamic labor market recovery, the unemployment rate is expected to decline further from 8.1% in Q4 to 7.8% in H1 2022. However, long-lasting structural issues (e.g. the lack of qualified workers, skill mismatches and little incentives to take up work) will prevent a significant drop of unemployment below the pre-crisis level of 7.5%. Amid higher consumer prices, wages pressures are set to intensify, in particular in tradable services. We expect average wage growth to increase to +2.5% in 2022 (up from 1.8% in Q4 2021).

In a context of a positive labor market outlook, maintaining purchasing power will emerge as the dominant economic topic of the presidential elections that will take place in April 2022 (at a time when France will also hold the EU presidency). President Macron is expected to run again but has not yet officially declared his candidacy. Recent opinion polls indicate that he would be the lead candidate in the first round (27% voting intentions). Valérie Pécresse, the candidate of the conservative party (LR) appears to take a similar stance to Macron on tax policy but has advocated for greater fiscal discipline – with the aim of cutting public debt to GDP to 100% (by -14pp) in ten years. So far, the campaigns have been mostly silent on economic policies to tackle the challenges from the “green transition”.

Italy: strong short-run momentum but long-term challenges

Italy continues to experience a very dynamic recovery, with private consumption and foreign trade being the main drivers of a strong growth impulse during the second half of last year. In the short run, high-frequency indicators are signaling a continued expansion of economic activity, especially in the manufacturing sector where the PMI reached an all-time high of 62.8pts in November. GDP growth is now clearly above the Eurozone average, which resulted in a recent rating upgrade by Fitch from “BBB-” to BBB. GDP is now only 1.4% below the pre-crisis level, similar to Germany despite Italy’s much stronger recession in 2020 (-9.0% vs -4.9%). While Italy is expected to reach its pre-crisis GDP level in mid-2022, it will probably not be able to close the output gap until 2023. The renewed sanitary restrictions in response to the fifth Covid-19 wave may shave off 0.2pp of quarterly growth in Q4 and Q1. But a significant part of these costs may only occur if tightened travel restrictions affect tourism. In the coming quarters, private consumption will remain the

major source of growth support as households draw down their excess savings, with the savings rate projected to decline from 14% to 10% of disposable income. We expect GDP growth to reach +4.5% this year, followed by +2.1% in 2023.

Inflationary pressures have remain contained. We expect inflation to rise only moderately to 2.4% this year (up from 2.0% last year). The current inflation differential to Germany is close to an all-time high of 1.4pp, which should support the relative price competitiveness of Italian manufacturing, which tends to be more price elastic compared to that of Germany. In 2022, the difference should remain at 0.7pp, which can be explained, among other things, by subdued wage pressure (+0.6% in 2022), with a still high unemployment rate of 9.1% next year. It will be partly compensated by government spending as the effects of the recovery plan unfold and fiscal policy remains expansive (-5.6% deficit in 2022 and no return to -3% level before 2025).

Mario Draghi’s national unity government continues to deliver, especially on the adoption of the roadmap for the

recovery plan and major structural reforms (e.g. legal procedures, retirement age). However, the initiated reforms and the effects of the NGEU investments will only have a noticeable impact on potential growth in the medium term. We estimate a cumulative growth impact of around 2.0% until 2026. But by frontloading fiscal expansion and delaying consolidation efforts after 2024, public finances will become more sensitive to interest rate risk. In an environment where signs point to a tightening of monetary policy, this may cause tensions in the future, especially on sovereign bond markets. The upcoming presidential elections could become a significant downside risk when the seven-year mandate of Italian president Sergio Mattarella comes to an end in February 2022. Prime Minister Mario Draghi signaled his willingness to be a candidate and if he were to run and be elected, a government reshuffle or snap elections could be on the cards. If Mario Draghi were to leave office, the specter of Italy’s fiscal policy could return at a time when the ECB exits from its crisis-related asset purchase program (PEPP) and European leaders start discussing the future of the EU fiscal rules.

Spain: steady recovery with the best yet to come

Spain has experienced the largest economic scarring amongst the Eurozone's big economies but has coped well with the renewed wave of virus infections. While the economic impact of moderate sanitary restrictions has been limited, the delayed rebound in tourism limits positive spillovers from strong growth of +2% q/q during the final quarter of 2021. The continued fiscal impulse until 2023 will support greater public investment, while the funds from the NGEU recovery package will inject a total of EUR70bn into

the Spanish economy, of which around 40% will be allocated to climate policy and renewable energy generation. Improving labor market conditions, favorable financing conditions and the NGEU funds will be key drivers of growth in 2022 by boosting private consumption and investment. However, expected inflation close to 4% this year, especially high energy prices, will weigh on households' real purchasing power. We expect GDP growth to be +5.7% this year, followed by +3.4% in 2023.

Despite a significant rebound in job growth, the labor market remains

weak due to high structural unemployment. Job creation was particularly strong in hospitality, arts and entertainment, IT and communications. Labor markets have been more resilient than in previous crises as efforts to put in place job-retention schemes seem to have paid off. We expect a return to the pre-pandemic unemployment rate of 13.9% this year, thanks to the extension of the partial unemployment scheme until February 2022. Risks to employment stem from the predominance of SMEs, which are more vulnerable to liquidity shocks, and from the high share of temporary contracts.

UK: starting the normalization

Strong domestic demand has supported the recovery on the back of improving business sentiment. We expect GDP growth to reach +4.4% this year, followed by +2.6% in 2023. We expect business investment to continue to recover (+5.8%) as disruptions to global supply chains delayed some decisions last year. Non-financial corporates still accumulate cash at a higher speed compared to their pre-crisis pace, with cash buffers having risen to GBP138bn (i.e. 6% of GDP), which should boost capital expenditure. Tight labor markets will keep wage growth at 3.5% in 2022 and 3% in 2023. Hence, the fall in real disposable income is expected to remain moderate (-0.3% in 2022) and above-pre-crisis household savings (+5pp of gross disposable income) will continue to boost consumer spending this year (+6.3%), before slowing down next year (+2.7%). We estimate that only half of the pent-up demand was absorbed by consumer spending last year. Restrictive measures in response

to the new wave of infections will delay catch-up effects but not derail them, shaving -0.3pp off real UK GDP growth at the turn of the year.

The Bank of England has commenced a cautious tightening cycle to keep inflation expectations anchored and prevent an adverse wage-price loop in light of rising wage pressures. Household inflation expectations have risen to their highest level since 2013, with two-thirds of current inflationary pressures driven by higher energy prices, tax increases, Covid-19 related base effects and supply-chain bottlenecks (which were amplified by Brexit). We expect price pressures from supply-side constraints to remain high during the first half of this year, which should add more than +1pp to headline inflation (3.8%). Energy prices are also likely to stay elevated due to the revision of the energy price cap in April 2022. We do not see the BoE going beyond a maximum of three rate hikes in 2022 (with two being our baseline for the time being). The hiking cycle will determine

the pace of tapering, which will not start until the policy rate reaches 0.5% at least, so not before H2 2022. With a markedly lower share of household mortgages at variable rates, the squeeze in cash flow from the rise in interest rates should remain limited.

Fiscal consolidation is underway. The UK has already started the post-crisis fiscal consolidation, with a focus on revenue measures. The threshold for personal tax allowances for households is frozen as of this year for four years and, as of April 2023, the corporate tax rate for companies with profits of GBP250,000 or greater (around 10% of firms) will be raised from 19% to 25%, slightly above the advanced economy average. Overall, the announced tax hikes will increase the tax burden from 34% to 35% of GDP in 2025-26, its highest level since the late 1960s. Renewed Brexit-related challenges could amplify supply-chain disruptions this year. The UK was the only G7 country to experience a fall in exports in volume in 2021 (-2.8%).

Also, as part of the transitional Brexit arrangements, border controls for imports will be introduced this year. This is going to further shape the UK's trade structure, given its high dependency on

imported intermediary goods for its exports. Imports from the EU in 2021 remained 19% below the 2018-19 average (against +5% above for non-EU imports) while exports to the EU stood -

12% below (against -10% for non-EU). We estimate that one fourth of current supply-chain disruptions have been driven by Brexit.

China: stabilization is coming but domestic demand remains below pre-crisis levels and risks are on the downside

Against the background of an improving external environment, further policy easing should support the current growth trajectory, even though a full normalization of domestic demand is unlikely this year. The economy quickly bounced back from the Covid-19 shock, with total GDP exceeding the pre-crisis trend as soon as Q4 2020. Important growth drivers during the initial stages of the recovery, especially exports along with infrastructure and real estate investment, gave way in 2021 to more broad-based, private sector-led demand in response to a shift of policy (see Figure 13). In 2021, real estate development stood -5.6% below the pre-pandemic trend, compared with -2.5% in 2020. Conversely, manufacturing investment performed better and reached last year a level just -3.1% below the pre-pandemic trend (compared with -8.0% in 2020). Similarly, private consumption has rebounded, although the gap remains larger (-4.6% last year vs. -9.9% in 2020).

Going forward, we expect Chinese authorities' zero-Covid strategy to remain in place for most of 2022 – as confirmed by the policy reaction to the Omicron variant (against which China's Covid-19 vaccine is less efficient). Depending on the regions affected, this could imply a temporary slowdown in exports and risks delaying the normalization of supply-chain bottlenecks that have been weighing on global growth for more than a year now. Domestically, the zero-Covid strategy puts a lid on services demand and could make overall private consumption volatile. However, fundamentals are solid, with urban unemployment rate back to its pre-crisis level and the savings rate almost back to normal.

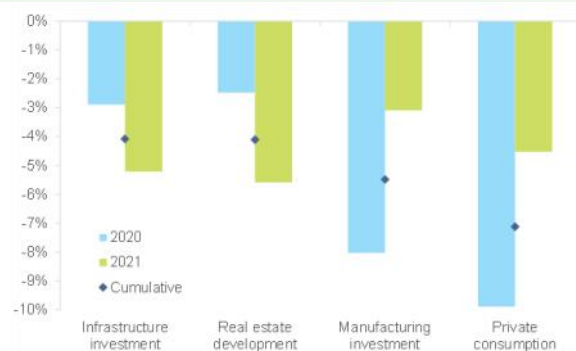
Troubles in the real estate sector will continue to be a drag on investment. Solvency concerns about the most vulnerable developers are likely to keep construction activity weak in the coming quarters. In contrast, infrastructure investment should rebound, thanks to more accommodative fiscal policy (the fiscal deficit is expected to remain above the 2019 level in 2022-2023). Similarly, manufacturing investment will benefit from robust external de-

mand growth and further monetary easing.

Even though we do not expect a full-blown stimulus like that of 2016 or 2020, monetary policy is likely to ease further. The unexpected small cut in the one-year loan prime rate (-5bp), which targets business lending rather than real estate, in December 2021 is another signal that policymakers are now more focused on stabilizing, broad-based growth. We expect at least another 10bp cut in the coming months. The PBOC is likely to closely manage liquidity in the financial system, through active open market operations and another 50bp cut in the reserve requirement ratio in H1 2022. Regulators will aim to support credit allowance through window guidance and by selectively easing macroprudential rules (e.g. around SMEs, mortgages, funding for real estate sector consolidation, etc.).

We expect China's GDP to grow by +5.2% this year and +5.0% in 2023, resulting in the lowest contributions to global GDP growth since 2015 in 2022 (at 0.9pp, excluding 2020).

Figure 13: China: distance to pre-pandemic trend, yearly (%)



Sources: National Bureau of Statistics of China, Euler Hermes, Allianz Research

Emerging markets: Lagging the pace of the global recovery

Vaccination rates, the unwinding of supply bottlenecks and policy choices will critically influence the scale of catch-up as policy support is gradually withdrawn. While output is expected to reach its potential level by the end of 2022, output loss relative to the pre-crisis trend is likely to be considerable, especially in emerging markets. Emerging markets—for the first time since the GFC—are lagging the pace of the global recovery in 2021. We expect this divergence to continue over the medium term as the still low vaccination rates will keep the global economy exposed to high volatility and delays in the recovery due to the risk of further Covid-19 variant developments.

Most emerging market economies are successfully rebuilding policy space by reducing their fiscal imbalances, thanks to higher revenues and rebounding remittance flows. However, the faster-than-expected normalization of Fed monetary policy is expected to put pressures on most vulnerable countries such as Turkey, Romania, Hungary, Argentina, Nigeria, Brazil, South Africa, Chile, Egypt and Ukraine.

Last year, budget deficits narrowed in almost all EMs (relative to the previous year) with the exception of a few countries in Emerging Europe (Czech Republic, Latvia and the Slovak Republic) and Africa (Nigeria and Tunisia), which have been heavily affected by previous virus outbreaks but have sufficient policy space. Public debt is projected to rise further this year but to a smaller extent than during the previous Covid-19 waves in 2020 and 2021. Recurrent budget imbalances, the materializa-

tion of contingent liabilities (from SOEs and state guaranteed loans) but also increasing debt-service costs in an environment of higher interest rates will increase debt levels. Debt sustainability is becoming particularly challenging in Argentina, Bahrain, Ghana, India, the Philippines and Tunisia.

External imbalances have declined in commodity exporters and will remain moderate this year, thanks to a strong recovery in demand from advanced economies.

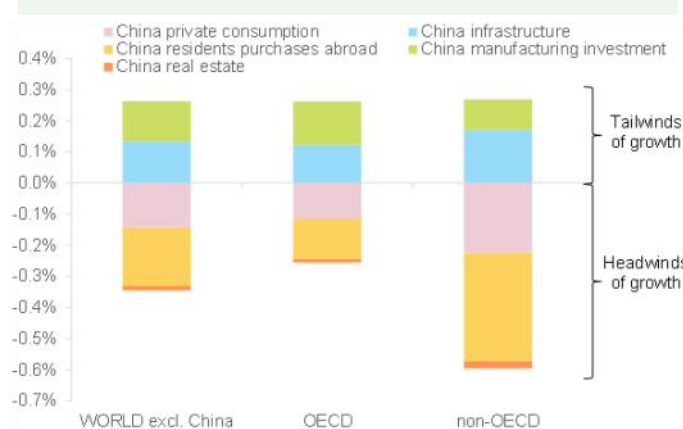
However, there are a few exceptions: countries strongly reliant on energy imports (J-curve impact) continue to see a widening of their current account deficits compared to 2020. In Africa, Tunisia, Morocco, Egypt and Burkina Faso will see current account deficits only improve slightly in 2022 after deteriorating in 2021. In Emerging Europe, most countries will post current account surpluses or small deficits, with the exception of Romania, where a very loose monetary policy stance has caused rising imbalances. In the Middle East, external balances have improved, thanks to improving terms of trade from higher oil prices despite elevated deficits in Bahrain, Jordan and Oman. In Emerging Asia, India, Indonesia and the Philippines are the only countries expected to post current account deficits. A deterioration is expected in the coming few years, but the deficits are not likely to exceed 2% of GDP by 2023 in all cases.

Rising interest rates this year are expected to slow the recovery in EMs, but their effectiveness in taming inflation will be limited. The experience from the countries that started their tightening cycles earlier in Latin America and Eastern Europe suggests that though

rising interest rates helped stabilize exchange rates (and thus limit the pass-through of higher import prices), they have failed to contain inflationary pressures. We expect South Africa, Kenya, Nigeria, Brazil, Chile, Colombia, Mexico, Peru as well as major non-Eurozone economies in Emerging Europe to (further) raise their interest rates. Turkey is an exception, following its unorthodox policy stance of lowering rates despite higher inflation, though markets will likely force it to reverse course later in 2022. In Emerging Asia, the normalization path that was delayed by new variants of the virus should materialize in late 2022, with policy rate hikes likely in India, Indonesia, Malaysia and the Philippines.

China's economic slowdown should mainly be a drag on overall growth for the Emerging Asia region, especially commodity exporting countries.

With China's domestic demand (real estate development and private consumption) staying below-normal for longer, trading partners could suffer. Accounting also for purchases made by Chinese residents directly abroad, we find that these headwinds could represent a drag of up to -0.3% of output for OECD countries and -0.6% for non-OECD countries. Tailwinds coming from China – namely, infrastructure and manufacturing investment – could be sufficient to make up for the drag for OECD countries, but would fall short for the non-OECD group. Partner economies in the Asia-Pacific region are the most vulnerable, while Brazil, Kazakhstan, Morocco, Peru, Argentina and South Africa are the emerging economies most at risk outside the region.

Figure 14: Chinese demand as a share of partner region output (%)

Sources: OECD, Euler Hermes, Allianz Research

We expect GDP growth for Emerging Asia excluding China to reach **+6.9% in 2022 and +6.7% in 2023 (after +7.8% in 2021 and -2.9% in 2020)**. Coming into 2021, we had expected South and Southeast Asia GDP growth to accelerate significantly after the large 2020 contractions. However, the Delta wave and vaccinations slow to ramp up delayed the recoveries. The region is now still vulnerable against renewed Covid-19 outbreaks, but less so than a year ago. A catchup in H2 2021 means that several economies in the region are now better inoculated, although India, Indonesia and the Philippines are still comparatively lagging (less than 40% of the population fully-vaccinated as of mid-December 2021). As mobility restrictions are eased, South and Southeast Asia should see a more visible recovery in private consumption and investment, leading to an overall growth catchup in 2022. That should bring their growth rates closer to or even above their respective potentials in the coming few years. The path for more export-exposed economies (Taiwan, Hong Kong, Singapore and South Korea) is a little different, with growth rates likely to soften in 2022-2023 com-

pared to 2021, but remaining above-normal. They should comparatively see a much lower amount of GDP lost by 2023-end, compared to the rest of Emerging Asia. These economies have been more resilient in 2020-2021, and should continue to see tailwinds from external demand. On top of the implementation of the Regional Comprehensive Economic Partnership at the start of 2022, the global trade environment should remain overall supportive. North and Eastern Asia, Singapore and Malaysia will be among the beneficiaries of continued strong demand for electronics. Though peaking, commodities prices are likely to remain high going into 2022, which is positive for countries such as Indonesia. The Philippines and Thailand would particularly benefit from a return of international travel and tourism, more likely late into 2022.

In this context, ASEAN central banks' monetary policy normalization, which was delayed by Delta, should take shape in 2022. Looking at price dynamics, base and weather effects may be at play in some economies (e.g. food prices) but core inflation should rise on the back of our economic and

domestic demand recovery scenario. As such, we expect MAS (Singapore) to steepen further the SGD NEER slope in April 2022. BNM (Malaysia) and BI (Indonesia) are likely to start hiking their policy rates in Q2-Q3 2022. The BoT (Thailand) and BSP (the Philippines) may wait until late-2022 or early-2023 to start their tightening cycles. In the rest of the Emerging Asia, the Bank of Korea is likely to carry on the tightening cycle started in August 2021, with two rate hikes per year in 2022 and 2023.

We expect Emerging Europe real GDP to expand by +3.3% in 2022 and +3.4% in 2023 (after +5.6% in 2021). Fourth waves of Covid-19 cases hit Emerging Europe in Q4 2021 and are ongoing in Czechia, Slovakia, Hungary, Croatia, Poland, Turkey and Russia (ordered by size of incidence), though abating elsewhere. A comparatively low vaccination rate suggests a higher vulnerability to virus variants and a fifth Covid-19 wave. Lockdown measures are likely to remain relatively low to moderate, significantly less stringent than during earlier waves. Consumer sentiment has remained below the long-term aver-

age but forward-looking sentiment indicators indicate that firms remain cautiously optimistic. Inflation is expected to peak in Q1 2022, before gradually retreating thereafter. Monetary policy will continue to be tightened as it has been somewhat behind the curve, especially in Central Europe. Nonetheless, the exchange rates of EU member states should remain broadly stable in 2022; only the Romanian RON and the Hungarian HUF are somewhat exposed to taper tantrum. Meanwhile, the RUB will be vulnerable to politic events. And the TRY is forecast to continue to slide due to policy mistakes. Fiscal policy leeway in the region is diverse amid rising public debt levels. Policy support will be phased out though economies with moderate debt (e.g. Czechia, Poland, Slovakia, Russia) may continue, if and as needed. At the same time, EU members will benefit from NGEU funding, with an impact of +0.25pp on annual real GDP growth in 2022-2023.

Latin America: short-term strong recovery, but medium-term challenges. The relatively good recovery in 2021 had been driven by strong base effects and the rebound in commodity prices, on which most countries continue to depend. In the medium term, we expect growth to return to moderate levels, given persistent structural obstacles and moderate fiscal space. Responses to the pandemic will probably remain heterogeneous. Even if countries cannot achieve full population inoculation, the economic situation is dire and they are unlikely to react with strict measures to new Covid-19 waves as the election season is kicking-in in Brazil, Chile, Argentina and Costa Rica. Some countries such as Mexico have favored a commitment to fiscal prudence rather than stimulating the economy, while others such as Brazil provided strong support

to businesses and households. We expect fiscal consolidation to be gradual, but limited fiscal space will push the government to quickly remove support measures despite the spread of the new variant. Countries such as Brazil or Argentina will be especially vulnerable to the fiscal path given the already high levels of public debt, but election season is coming and they will probably not want to antagonize voters.

Despite the strong monetary tightening across Latin American countries, inflation expectations for 2022 remain above target inflation rates, with Brazil being most concerning. Central banks have raised official interest rates faster than initially expected, but have yet to manage to keep inflation in check. The central banks have underlined that although inaction is unacceptable, moving the policy rate will probably not be effective because inflation is not coming from an overheating of the economy, but rather is being imported (mainly through food and energy prices). Monetary tightening has helped protect currencies, but more needs to be done.

In the Middle East, higher oil and gas prices in 2021-2022 will allow some additional fiscal stimulus in hydrocarbon-exporting economies and thus support the recovery. Regional real GDP is forecast to expand by +3.9% in 2022 and +2.5% in 2023, but to remain subject to ongoing political tensions. Currency pegs in the GCC provide for exchange rate stability, low inflation and low interest rates, which are also supportive for the recovery. The scars of the pandemic (combined with lower oil prices from 2014-2020) have dramatically worsened public and external debt positions in the GCC. Yet still large FX assets, including Sovereign Wealth Funds in Saudi Arabia, the UAE, Qatar

and Kuwait, provide a buffer for at least five more years. Bahrain and Oman do not have such buffers and would be at risk of default without the support from their rich neighbors.

After being the slowest growing region in 2021, Africa will register mild growth in 2022 (+3.5%) as vaccination rates will remain very low (32% in the overall continent but only 4% in Sub-Saharan Africa). In 2022, oil exporters such as Angola and Algeria will continue to benefit from the commodity upcycle tailwind. On the other hand, amid rapidly rising inflation to double digits in most countries, monetary policy rates are expected to increase in Kenya, Nigeria, Ghana, South Africa and Egypt. In an environment of continued sanitary uncertainty, this monetary tightening is expected to put a brake on growth. In addition to rising energy prices, food inflation has soared to hardly bearable levels in Angola, Ethiopia, Nigeria and Ghana. The food security situation is likely to deteriorate in 2022 in southern and eastern Ethiopia, Kenya and Somalia as a result of adverse climate events (drought in the Horn in end 2021). The deteriorating security situation in Ethiopia entails significant risk of spillovers to the region, including migration flows to the Kenyan border. Tunisia has high chances of defaulting on its public debt in H1 2022 if the government fails to reach a financial agreement with the IMF. Ghana, Mozambique, Kenya and South Africa are other hot spots regarding debt sustainability.

CAPITAL MARKETS: STILL BENIGN BUT RISING UNCERTAINTY

Over the last year, gradually rising rates have supported a benign market environment. With central banks in advanced economies shifting towards a more hawkish monetary stance, risk-free rates have slowly increased and triggered a repricing at higher interest rate levels in fixed income without causing any dislocations in markets. Unchanged or even declining risk premia, and declining real interest rates, have supported favorable financing conditions and the performance of risky assets. Emerging market asset classes saw a mixed picture, with strong performance of hard currency debt while local currency debt underperformed (Table x below). However, recent market volatility due to rapidly rising inflation and reemerging uncertainty about the pace of recovery due to the omicron variant has dented investor confidence. The risk sentiment underpinning historically high valuations remains dependent on the gradual removal of policy support.

Against the backdrop of a still strong recovery, we expect asset prices to move sideways over the near term as we enter a consolidation phase. The transition to a mid-cycle environment this year should lead to slightly higher rates but still support risky assets such as corporate credit and equities. Market sentiment is likely to remain positive as central banks are expected to effectively manage the withdrawal of their accommodative policies and inflation pressures should dissipate during the first half of this year.

For the main asset classes within the scope of our surveillance, we expect the following:

- *Corporate credit.* Fundamentals still support the overall valuation of corporate credit. However, we expect a moderate widening of spreads this year as monetary conditions are beginning to tighten and real yields remain negative for investment-grade issuers.

- *Equity markets.* Equity markets have been buoyed by household savings and strong earnings growth. We expect a continued positive albeit much more muted performance this year. However, an increasing share of firms with declining valuations in mid-2021 suggests risks may be skewed to the downside.
- *Emerging markets.* Local currency debt has had a decent performance but hard-currency fixed income and equity markets have lagged advanced economies. While we retain a positive view, several emerging markets are highly vulnerable to tighter financial conditions.

Table 3: 2021 Performance of major asset classes

Asset Class	Unit	Value as of 31.12.2021	12M Change
10y US Treasury	yield	1.5%	59bps
10y German Bund	yield	-0.18%	40bps
EM Sovereign Bonds	yield	4.83%	63bps
Euro IG Corporate Bonds	spread (OAS)	98bps	5bps
US IG Corporate Bonds	spread (OAS)	98bps	-5bps
Eur High Yield	spread (OAS)	331bps	-24bps
US High Yield	spread (OAS)	310bps	-76bps
Eurostoxx	points	479	23.4%
S&P500	points	4766	28.7%

Sources: Refinitiv, Euler Hermes, Allianz Research

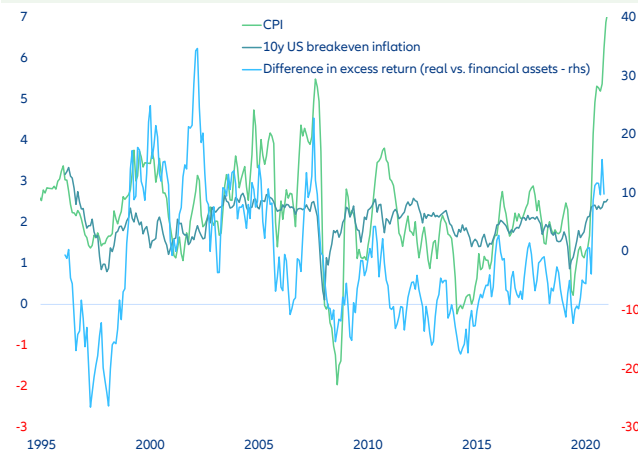
Staying Positive – continued momentum in real assets

The crisis-induced surge in inflation has prolonged investors’ preference for high-yielding “real assets.” Over the last two years, capital markets have been characterized by an extraordinary outperformance of variable income assets. Ultra-low (real) yields of fixed-income assets have pushed more

and more investment into equities, real estate and commodities (Figure 15). As central banks withdraw their monetary accommodation and inflation pressures begin to dissipate later this year, we expect returns to normalize. The hunt for higher yield by portfolio managers and the investment industry has

also amplified the rotation into more illiquid, alternative assets (Figure 16). However, this rotation is likely to continue as the “lower for longer” fixed-income outlook does not grant a favorable environment for yield-seeking portfolio managers.

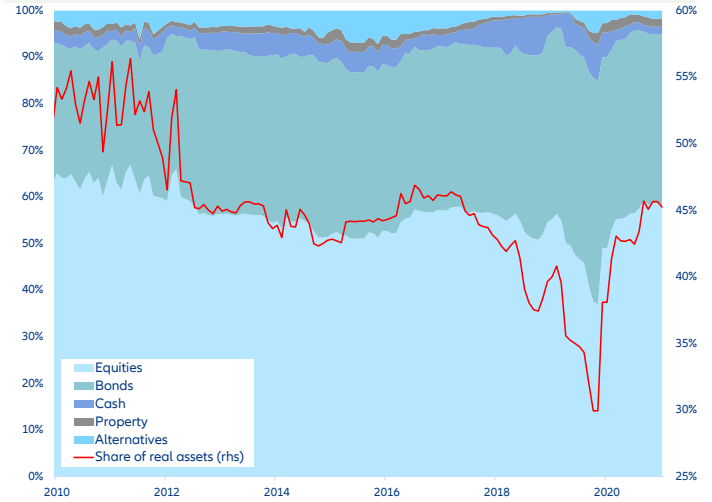
Figure 15: US-Comparison of relative performance of real assets vs. inflation (in y/y% return)



Sources: Refinitiv, Euler Hermes, Allianz Research

Note: real assets= real estate and commodities; financial assets= equities and government bonds

Figure 16: Refinitiv US investment management asset allocation poll (in %)



Sources: Refinitiv, Euler Hermes, Allianz Research

A “belly dance” – opposing forces tearing at the short and long end of the curve

Markets are increasingly challenging central banks’ less hawkish forward guidance, despite rising inflationary pressures, and are pricing in an earlier lift-off of key interest rates. This shift in

market expectations has increased both volatility and illiquidity in rates and bond markets, especially at shorter maturities (Figure 17). The rising uncertainty about the economic impact

of the omicron variant has recently intensified this development and increased bond market volatility.

Figure 17: US-implied volatility of equities and bonds



Sources: Refinitiv, Euler Hermes, Allianz Research

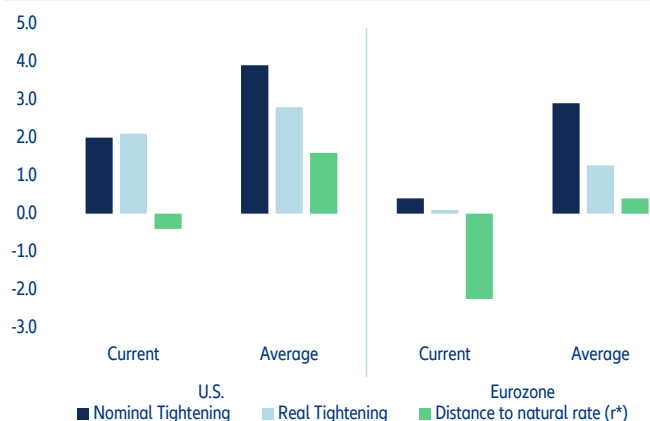
Earlier tightening has become the central scenario as central banks have begun to assess the current rise in inflation as longer lasting than originally expected. Price dynamics in the fixed income market suggest that investors have now turned their attention to determining the end point of the upcoming cycle. Both market pricing and our forecast assume that central banks will start tightening sooner but will not adopt an aggressive hawkish mon-

etary stance. In both the US and the Eurozone, the expected increase in nominal and real interest rates could be very moderate by historical standards. Compared with the natural rate, monetary policy remains accommodative, especially in the Eurozone (Figure 18).

In the US, the market already anticipates the end of the hiking cycle before it has even started. The recent inversion of longer US money market

rates implies already significant probability that no meaningful monetary tightening could take place in two years from now (Figure 19). Currently, market participants are positioned for a temporary inflation overshoot and short-lived rise in interest rates. However, with long-term rates declining again, market concerns seem to shift from inflation overshooting to slowing growth in the future, limiting the scale of a potential hiking cycle.

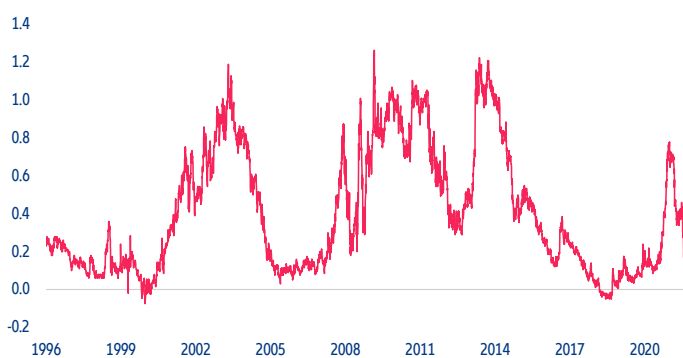
Figure 18: EZ and US-expected rate changes during the current hiking cycle compared to the historical average of previous cycles (in pp)



Sources: Refinitiv, Euler Hermes, Allianz Research

Note: nominal tightening = change in effective policy rate, real tightening = change in change in key policy rate deflated by expected core inflation (real

Figure 19: Euro Dollar futures: spread between 3y-2y contracts (in bps)



Sources: Refinitiv, Euler Hermes, Allianz Research

As central banks are about to withdraw monetary stimulus, opposing forces are operating along the term structure, especially in the case of the US. We observe a rising short end, driven by rising inflationary pressures, and a stagnant long end, subject to down-

ward pressure from the Fed's asset purchases, excess liquidity and a subdued long-term growth outlook. As a result, the US yield curve shows a pronounced curvature at the 3y-5y segment (Figure 20). The behavior of this "belly" relative to the rest of the curve

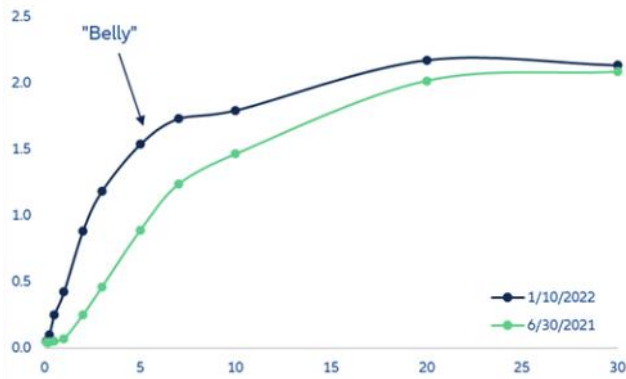
will signal the prevailing post-Covid narrative in fixed income markets this year. Currently, market participants are positioned for a temporary inflation overshoot and short-lived monetary policy tightening.

We expect the tactical positioning on the US curve to moderate over this year. The potential for an even stronger “belly” is likely to be exhausted by the end of this quarter (Q1 2022). Once the Fed’s forward guidance becomes clearer and inflationary pressures ease, we expect short-term rates to trend

slightly downward. Long-term yields should moderately increase (1.7% in 2022 and 1.9% in 2023) with the (looming) end of central banks’ net asset purchases (Fed in Q3 2022, ECB in Q3 2023) and greater certainty about the potential impact of the omicron variant on growth and inflation. In

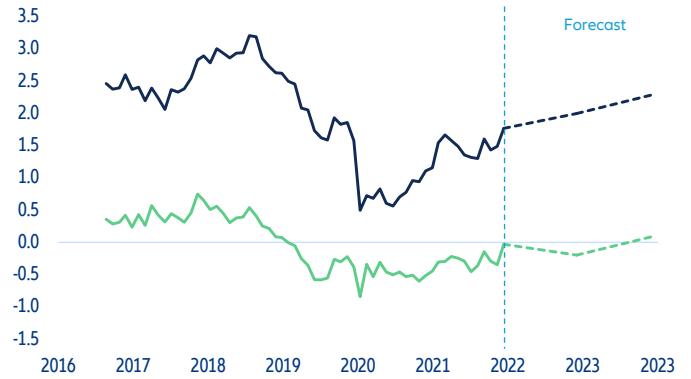
the Eurozone, the curvature story is less prominent but the underlying dynamics are comparable. Consequently, by the end of the year, we expect the German 10y benchmark to rise gradually (-0.2% in 2022 and -0.3% in 2023) (Figure 21).

Figure 20: US-evolution of yield curve over the last three months



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 21: US and Germany: outlook for 10y government bond yields (in %)



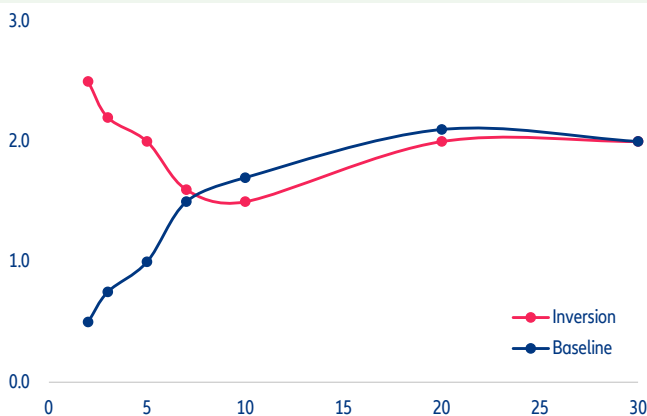
Sources: Refinitiv, Euler Hermes, Allianz Research

The uncertain inflation outlook could result in monetary policy errors. The current equilibrium in the fixed income market will remain fragile if central banks misjudge the durability of inflationary pressures amid persistent supply-demand imbalances. The structural upside risk to inflation has increased: the permanent costs of resilient rather than efficient supply chains, downward price rigidities in concentrated sectors

and lower productivity due to resource misallocation as crisis-related policy support leaves the legacy of an overstretched presence of the state in the private sector. Rising interest rates could invert the yield curve and choke off the recovery, alongside potential dislocations in financial markets (Figure 22).

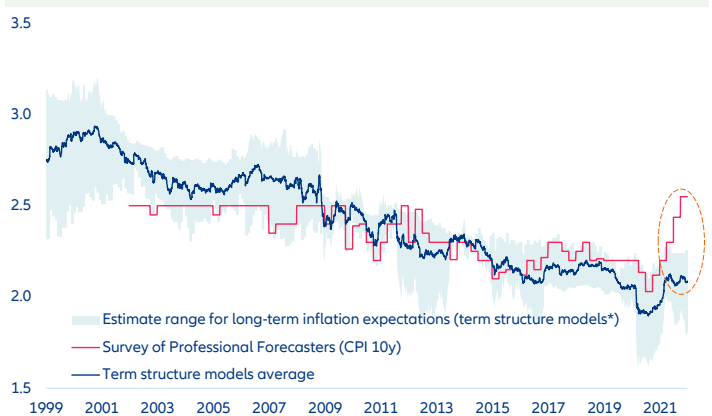
US market-based inflation measures remain clearly above the central bank price target (10y inflation swap at 2.7%, 5y5y forward swap at 2.5%). Even professional forecasters have raised their long-term inflation expectations to 2.5% in 10 years. This reflects a risk of de-anchoring inflation expectations through a self-reinforcing feedback loop between inflation, goods prices and wages (Figure 23).

Figure 22: US: crisis exit scenarios (US yield curve)



Sources: Euler Hermes, Allianz Research

Figure 23: US-Market-implied vs professional inflation expectations



Sources: Refinitiv, Euler Hermes, Allianz Research

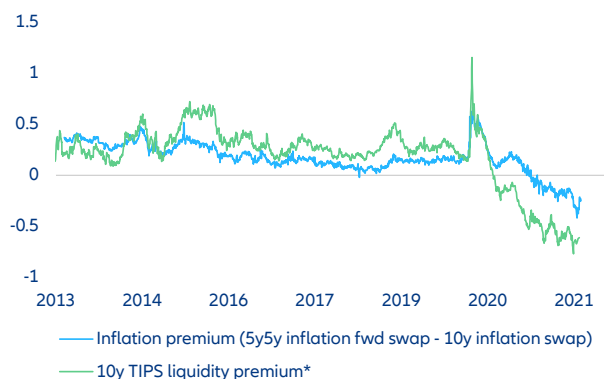
Note: */ Based on Abrahams and others (2016), Haubrich and others (2012), D’Amico and others (2017), Christensen and others (2015)

Market-based inflation expectations remain elevated but are partially detached from fundamentals. They are the result of overpriced inflation protection and market frictions. For in-

stance, in the US, the liquidity premium for 10y inflation-linked bonds (TIPS) is over 60 bps. In the swap market, investors pay a premium for the 10y inflation swap over the 5y5y forward swap

of 23bp in the US and 10bp in the Eurozone (normally there is a discount) (Figure 24).

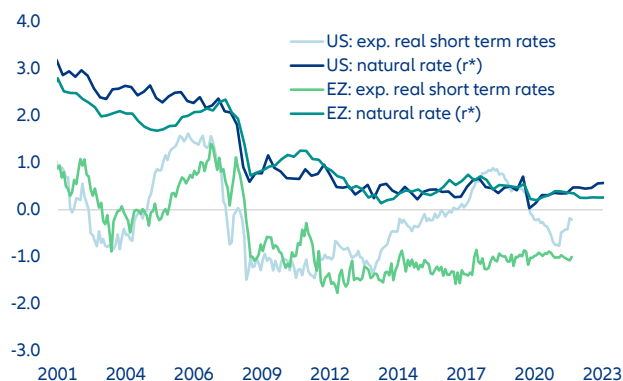
Figure 24: US—high inflation uncertainty meets strong market distortions



Sources: Refinitiv, Euler Hermes, Allianz Research

Note: */ Liquidity premium estimate based on Abrahams and others (2016) as well as D'Amico and others (2017)

Figure 25: EZ and US—markets remain positioned for a low-for-longer scenario



Sources: Refinitiv, Euler Hermes, Allianz Research

Note: expected real short term rate = derived from Adrian and others (2013), D'Amico and others (2017), Christensen and others (2015). Natural rate (r^*) estimation based on Holston and others (2017).

We believe that an alternative scenario of aggressive hiking is rather unlikely. The term structure of the nominal yield curves also shows stable inflation expectations. So, behind the market noise, bond markets continue to be-

lieve in the central bank's ability to control inflation. However, the low expected real neutral rate show casts doubt on whether the recent growth-oriented revisions to the monetary policy strategies will be successful in stimu-

lating higher levels of aggregate demand (i.e. average inflation targeting (AIT) for the Fed and a symmetric inflation target for the ECB) (Figure 25).

However, even moderately rising policy rates could challenge the debt sustainability of private and public balance sheets and diminish monetary policy space in the future. Slowing real growth could delay the normalization of policy rates but would also result in

higher longer-term interest rates; this would imply the steady presence of central banks in the government bond market to keep financing conditions favorable. Currently, amid early signs of acute inflationary pressures abating, rising skepticism about growth pro-

spects suggests that central banks will start tightening in real terms only once their medium-term price target has been durably reached. And this might trigger a steeper curve as hikes would be priced out and higher growth is priced in.

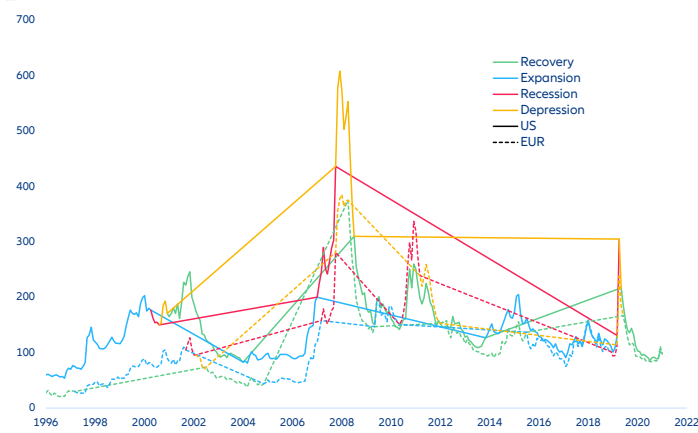
Corporate spreads have little room for further compression

Record low corporate credit spreads have little room for further compression. Extensive monetary and fiscal support measures since the first wave of the pandemic have prevented a

surge of corporate defaults and adverse effects on corporate bond performance. During this period, large inflows into the asset class made corporate credit spreads resilient to bad

news as investors were tactically trading spread volatility (i.e. spread widening episodes) (Figure 26).

Figure 26: Corporate credit spreads and the business cycle (in bps)



Sources: Bank of America, Refinitiv, Euler Hermes, Allianz Research

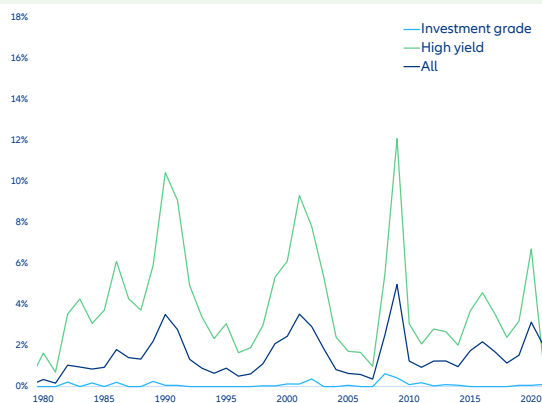
Note: US=filled line, EUR=dotted line.

However, corporate spreads are expected to become more volatile, with a clear widening bias as supportive policies normalize. At current levels, corporate credit looks overbought and offers only a very small credit risk premium as all possible good news are already priced in. The normalization of monetary policy paired with gradual rate increases should help credit markets stay aligned with market sentiment.

Despite the predicted corporate spread widening, fundamentals are still supportive and should lead to a moderate widening of credit spreads. Underlying drivers of credit risk (earnings and debt repayment capacity) remain favorable and do not hint at any major structural concern within the next two years. Against a positive growth outlook and delayed fiscal consolidation, we expect muted default

rates both in 2022 and 2023, especially since most issuers seem to have already secured the necessary financing for the next two years and should restore moderate profitability (Figure 27).

Figure 27: Corporate defaults (in % - total market)



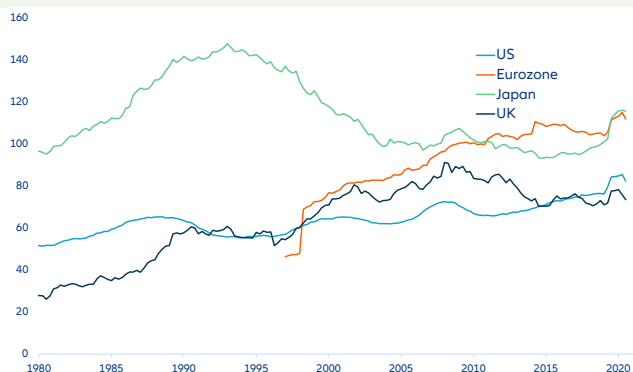
Sources: Moody's, Refinitiv, Euler Hermes, Allianz Research

Downside risk due to rising corporate leverage and debt duration profile remains contained. Despite elevated debt levels, valuation metrics, such as interest coverage ratios, keep improv-

ing on the back of stronger earnings and profits. However, we expect debt-repayment capacity to start declining in 2022 and 2023 due to slower earnings and profit growth. This mild deteri-

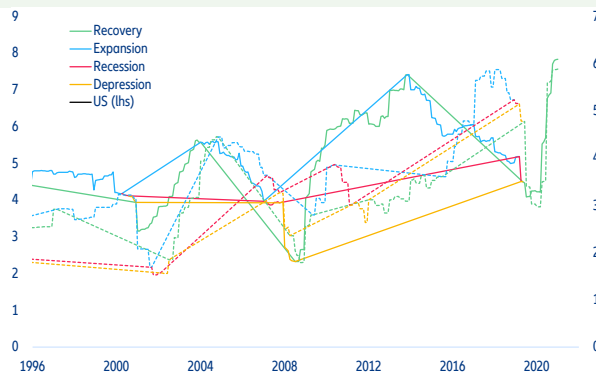
oration is consistent with the expansionary phase of the business cycle and should not pose a big challenge to credit risk pricing (Figures 28-32).

Figure 28: Corporate debt to GDP ratio



Sources: BIS, Refinitiv, Euler Hermes, Allianz Research

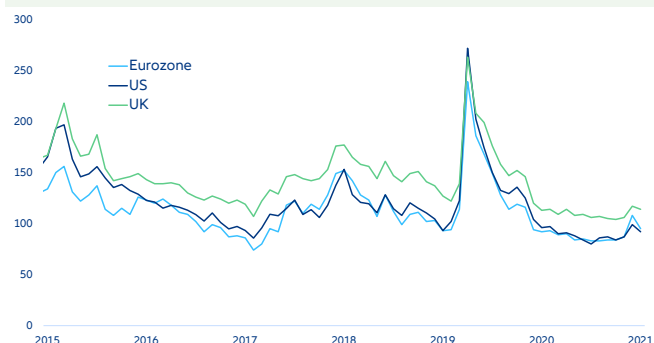
Figure 29: Interest coverage ratio (in %)



Sources: Worldscope, Refinitiv, Allianz Research

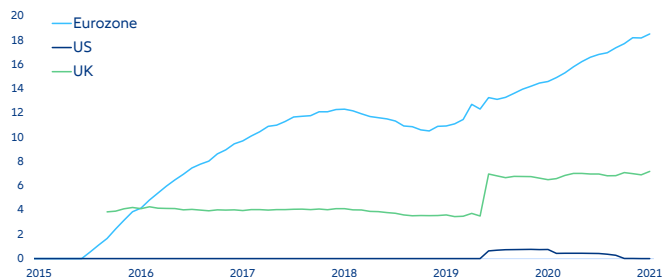
Note: US=filled line, EUR=dotted line.

Figure 30: Investment grade corporate spreads (in bps)



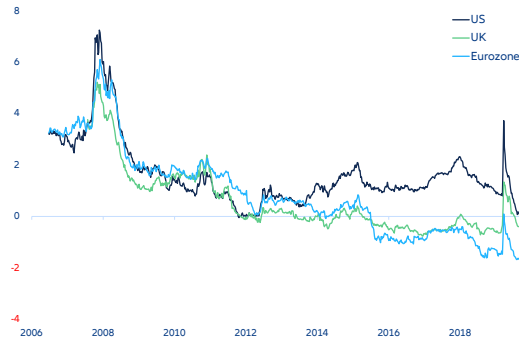
Sources: Bank of America, Refinitiv, Allianz Research

Figure 31: % of local corporate credit market owned by central banks (in %)



Sources: Bank of America, Refinitiv, Allianz Research

Figure 32: Investment grade corporate real yield (in %)



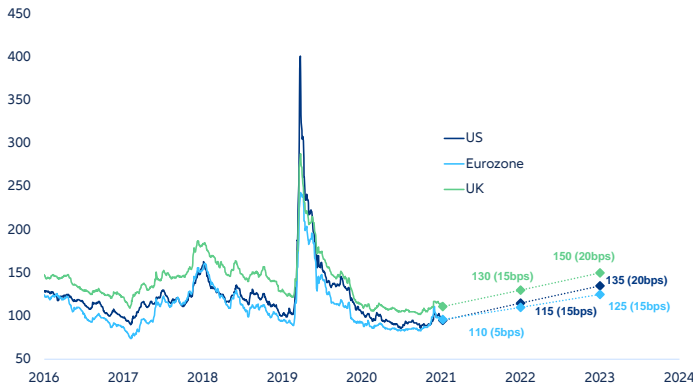
Sources: Bank of America, Refinitiv, Allianz Research (inflation expectations proxied at 10y maturity)

Investment grade corporate credits spreads are expected to slowly widen over time. We expect spreads to stay close to current levels in 2022 before gradually widening until the end of the forecast horizon. Negative real rates could weaken investor demand for

corporate credit. Investment grade corporate bonds currently yield negative returns (close to all-time lows), which could add to widening pressures as investors start rotating out of the asset class (Figure 33). Our top-down spread decomposition approach sug-

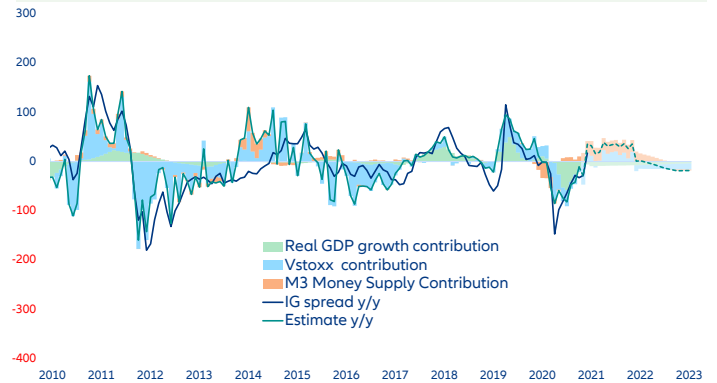
gests that the predicted slowdown in money supply paired with higher equity volatility and a slowing growth momentum could lead to a widening of spreads both in the Eurozone and the US by up to 50 bps in 2022, followed by a slight decline in 2023 (Figure 34).

Figure 33: Investment grade corporate spread forecasts (bps)



Sources: BIS, Refinitiv, Euler Hermes, Allianz Research

Figure 34: EUR IG corporate spread decomposition (y/y bps)



Sources: Bank of America, Refinitiv, Allianz Research (IG: Investment Grade)

If comprehensive lockdowns related to the omicron variant of the virus delays the recovery phase, we expect policy support to cushion the initial spread widening. We believe that govern-

ments and central banks will once again act as a backstop against recession-like increases in corporate default risk. Should this scenario materialize, we would expect spreads to peak at

lower levels than those seen in March 2020 and to gradually revert back to a range between 100 and 120bps.

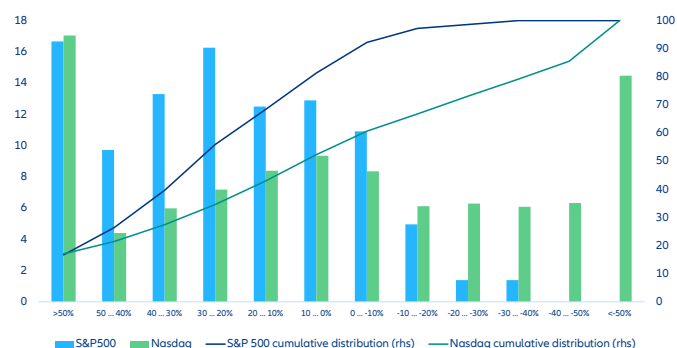
Equity markets will have to live in a new market environment

The strong overall equity market performance in 2021 belies significant underperformance by many small caps and high-growth firms. 2021 has proven to be extremely lucrative for developed market equity investors,

with yearly returns around 20%. This above-average performance can be mostly attributed to extraordinary profit growth, expanding profit margins and resilience to input inflation pressures against the background of

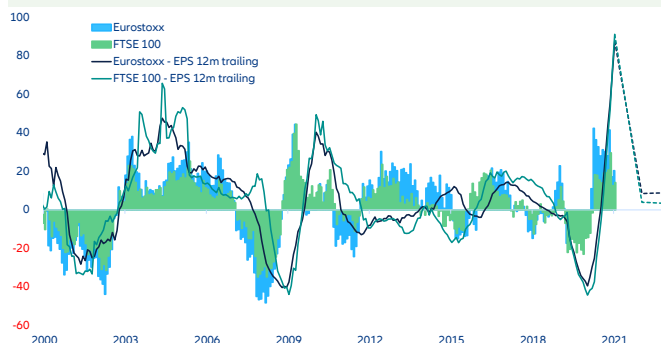
loose monetary policy. However the bull run has not been broad-based but rather concentrated in a few very large technology companies (Figure 35).

Figure 35: 2021 US equity return distribution (in % of total companies)



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 36: EUR & GBP EPS growth (y/y%)



Sources: IBES, Refinitiv, Euler Hermes, Allianz Research

Declining earnings growth in the US and Eurozone will weigh on near-term performance. Profit growth is projected to drop to upper single digits, point-

ing towards muted but still above average equity returns in the next two years. The UK is expected to lag behind its developed market peers, with im-

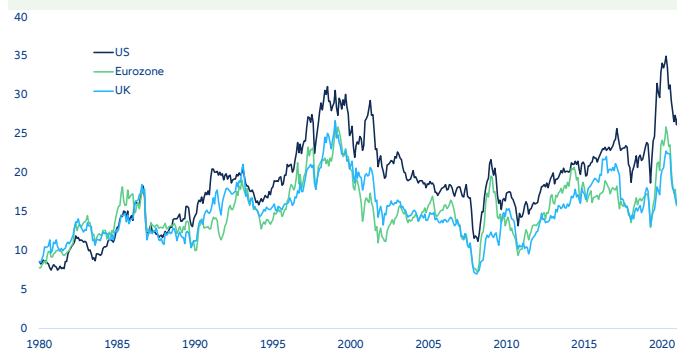
plied equity returns being close to low single-digits (Figure 36).

Equity market volatility is likely to increase amid record-high valuations. Despite the benign fundamentals-based outlook, several valuations met-

rics (price-to-earnings, enterprise value/EBITDA). This expensive valuation context is bound to catalyze and amplify sporadic market selloffs within the

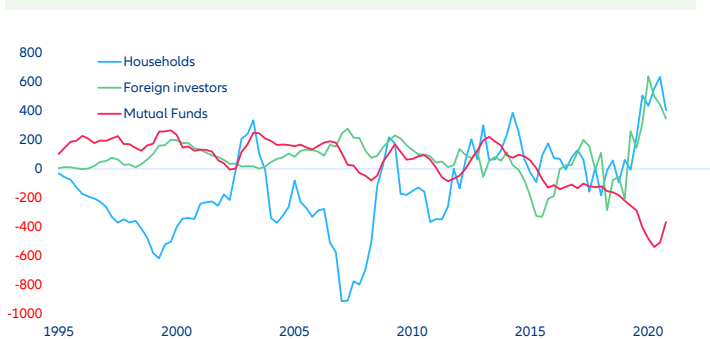
next two years. However, we do not expect higher volatility to derail the predicted positive equity performance (Figure 37).

Figure 37: Price-to-earnings ratios



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 38: US equity flows by sector (USD bn, 4Q sum)



Sources: Refinitiv, Euler Hermes, Allianz Research

Private investor demand has been the driving force behind strong equity market performance. Increasing inflows from households, corporates (through share buybacks) and foreign investors (in the case of the US) have played a key role in sustaining the market frothi-

ness. US households hold about 40% of their savings in equities (of which three-quarters are direct allocations and the remainder through mutual funds and pension entitlements). The last time households had a comparable exposure to equity markets was back in the

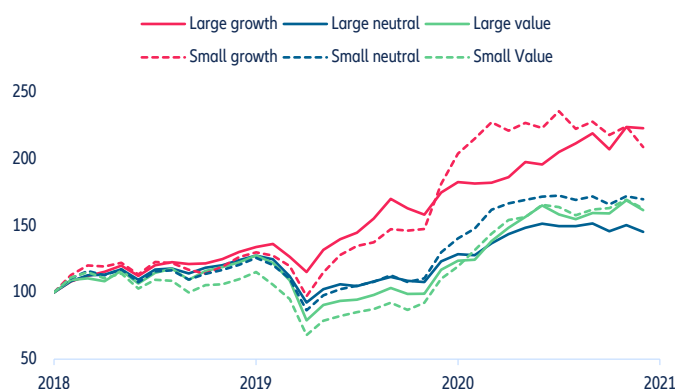
1960s. This high exposure of US households has also fueled FOMO-like investor behavior (fear of missing out), which is set to perpetuate market volatility at lower inflow levels as excess savings are partially unwound during the next two years (Figure 38).

The performance of equity markets is likely to be very uneven over the next two years. The 2021 equity rally has not been broad-based as a handful of companies are responsible for having

dragged global equity indices to all-time highs, especially those in the high-growth segment (Figure 39). Market fragility is expected to remain high in 2022 and could lead some equity sec-

tors/markets to heavily correct. Obviously the FANGs (Facebook, Amazon, Apple, Netflix, Google) and the technology sector are natural candidates.

Figure 39: US equities—decomposition of total returns by category



Sources: Refinitiv, Allianz Research

Note: Fama and French apply their taxonomy of equity styles to a stock universe that consists of all the stocks listed on the NYSE, the AMEX and the NASDAQ. Based on market capitalization and book value, their criteria are relative. A stock is deemed large (resp. small) if its market capitalization is higher (resp. lower) than the median market capitalization on the NYSE. A stock is deemed to be a value (resp. growth) stock if it ranks amongst the lowest (resp. highest) 30% in terms of market price-to-book value ratio. The 40% of stocks in between value and growth are deemed neutral. As for the stocks listed on the NYSE, such criteria imply the following mapping: large growth—15% (50%x30%), large neutral—20% (50%x40%), large value—15% (50%x30%), small growth—15% (50%x30%), small neutral—20% (50%x40%), small value—15% (50%x30%). In aggregate, as the stocks listed on the NASDAQ and the AMEX tend to have lower market cap than those listed on the NYSE, the stocks deemed large surely account for less than 50% of all listed shares. As for large growth stocks, they account for less than 15% of all listed shares.

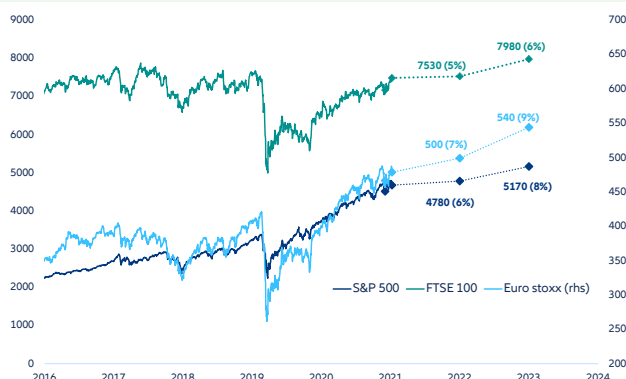
Equity markets will most likely have to adapt to a new, more volatile market environment.

The combination of tightening monetary policy, intermittent Covid-19 infection waves and lower earnings growth will put a lid on mean-

ingful gains. The combination of declining money supply paired with declining inflation expectations and a slow real economic recovery will weigh on equity returns. So far, valuations seem to have outpaced the increase in monetary

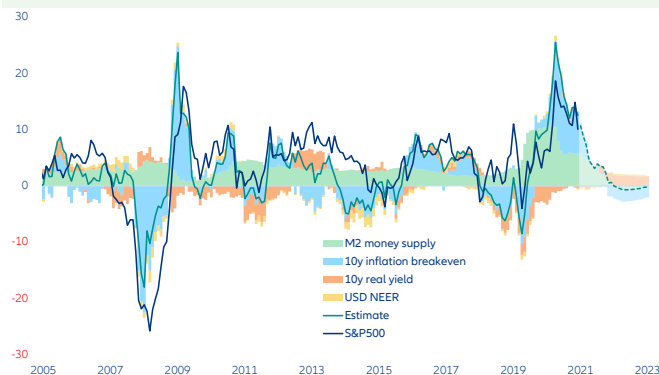
aggregates, indicating some room for further appreciation. In this context, we expect equity markets to post low single-digit returns in 2022 and 2023 (Figures 40-42).

Figure 40: 2022 – 2023 equity market forecasts



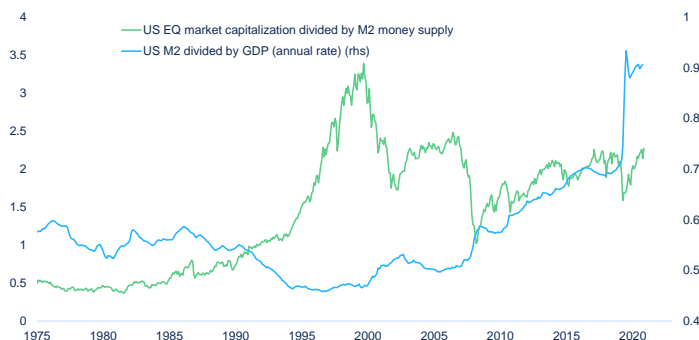
Sources: Euler Hermes, Allianz Research

Figure 41: US equity index decomposition (in y/y%)



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 42: US money supply and equity markets



Sources: Refinitiv, Euler Hermes, Allianz Research

We expect a significant but manageable correction of equity markets in an adverse scenario of renewed virus-related lockdowns and slowing growth. In this situation, we would expect a downward correction of between 5% and 15% (depending on

market characteristics and price dynamics at the time). Such a shock is likely to be rapidly contained as markets would start to factor in another round of policy rate cuts and looser monetary policy. Structurally it would mean annual equity returns below the long-

term average (6%) and roaming around the 0% line. However, as our baseline, we do not expect a large market correction but a muted continuation of the 2020-2021 trend, with high volatility episodes.

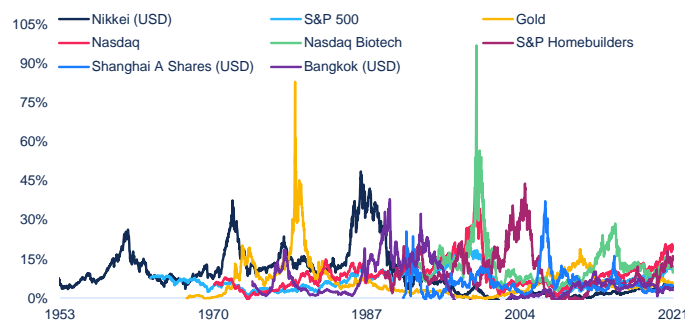
Growing bubbles in equity markets

Many pundits label the current capital market conditions as the “everything bubble”. A financial bubble is a rapid rise of an asset price to a level that is unprecedented and judged not sustainable, because it does not seem warranted by “fundamentals”⁷. We have adapted EWMA⁸ (“perceived return”) to spot asset price imbalances

through history. Our approach to calculating the perceived return reflects that (during a bubble) people tend to focus on more recent observations, so that the past becomes increasingly irrelevant. Thus, in an environment of rapidly increasing prices, expectations become increasingly exuberant and feed an accelerating price momentum.

Using this approach, we can identify at least 49 bubble episodes since WWII (Figure 43). A common feature of bubbles seems to be that at the bubble peak, smaller asset classes tend to experience higher perceived returns; in other words, the smaller an asset class, the bigger the bubble.

Figure 43: Contemporary bubbles based on perceived returns



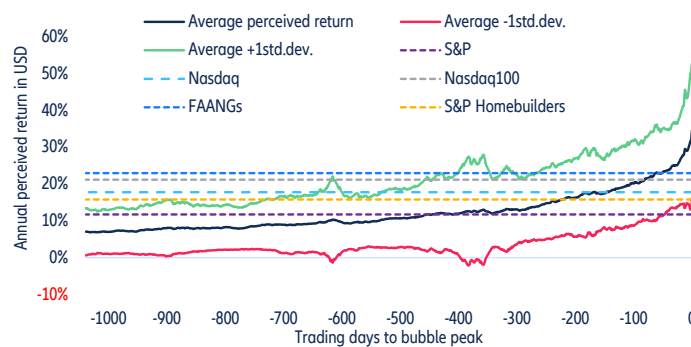
Sources: Refinitiv, Euler Hermes, Allianz Research

At current prices, some asset markets already qualify as bubbles. We find that the FAANGs+ and the tech-heavy

Nasdaq index seem to already be in bubble territory, with perceived returns (20-30%) already above the historical

15% upper bound (Figure 44).

Figure 44: The typical anatomy of a market bubble



Sources: Refinitiv, Euler Hermes, Allianz Research (260 = 1 year)

⁷ We characterize bubbles by either (1) the high-water mark reached at the asset price peak lasts, and (2) during the upswing, the perceived return rises above 15% a year.

⁸ Exponentially weighted moving average

In more than a few instances, the perceived return peaked before the price itself. In this respect, it is noteworthy that the perceived returns of a number

of important stock market indices have now failed to reach new highs for some time, with their perceived return starting to plunge, which leads us to think

that bubble bells are starting to ring in some major markets/sectors (Figure 45).

Figure 45: Equally-weighted average of perceived returns across 15 asset classes



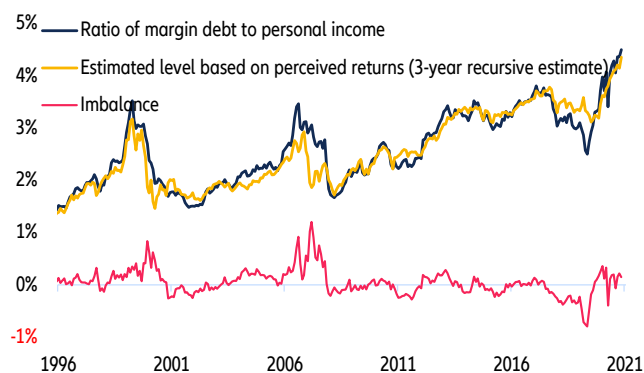
Sources: Refinitiv, Euler Hermes, Allianz Research

However, avoiding bubbles is difficult due to the high opportunity cost of an early exit. Following Keynes' famous quip, according to which "markets can remain irrational for longer than you can stay solvent," investors tend to face a critical trade-off. During the last year

before the peak, prices on average double (the cumulative return to peak is close to 90%). As a result, most portfolio managers that perform relative to benchmarks find it difficult to exit in time. Relatedly, there is a clear correlation between margin debt and equity

perceived returns. In the US, the relationship is non-linear, with the causality running from the perceived returns to the margin debt and not the other way around (Figure 46).

Figure 46: Margin debt and the perceived equity return in the US



Sources: Refinitiv, Euler Hermes, Allianz Research

How does this translate to current equity market levels? By comparing the relationship between the level of the perceived return and subsequent one-, two- and three-year annualized (log) returns, we find that the higher the per-

ceived return, the lower the subsequent returns. For one-year subsequent return, the perceived return threshold is around 20%. For two- and three-year subsequent returns, the perceived returns threshold is around 18%. Accord-

ing to these observations, the NASDAQ, the NASDAQ 100 and the FAANGS+, should deliver close to zero returns over the next two to three years. But the S&P 500 could still deliver positive returns (Figure 47).

Figure 47: Equity market subsequent return vs perceived return



Sources: Refinitiv, Euler Hermes, Allianz Research

Note: The hump at the beginning of each line reflects the cost of an early exit.

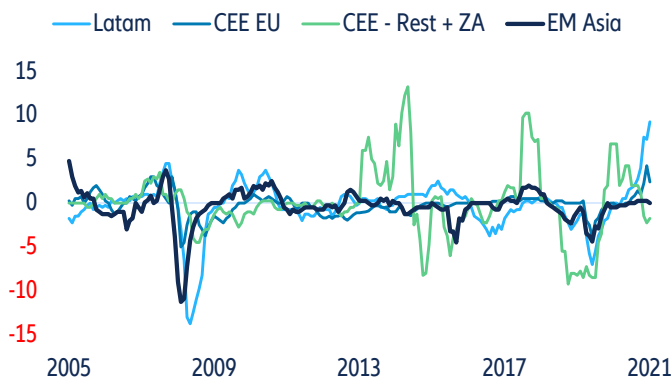
Emerging markets with large and diverse challenges

Limited policy space and rising external vulnerabilities required many EM economies, mainly in Eastern Europe and Latin America, to start normalizing

their monetary policies much earlier than advanced (Figure 48). Local yields increased significantly until the end of last year, having already priced in most

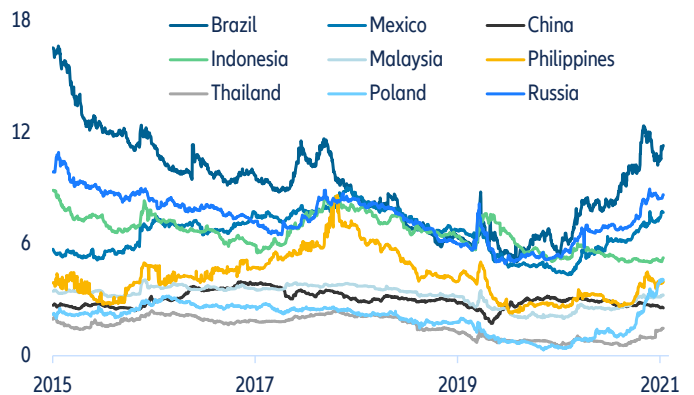
of the bad news flow (Figure 49). We expect yields to stabilize through 2022.

Figure 48: Asian exception: net change in policy rates from one quarter ago (ppts).



Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 49: 5Y sovereign local yields in selected countries (in %).



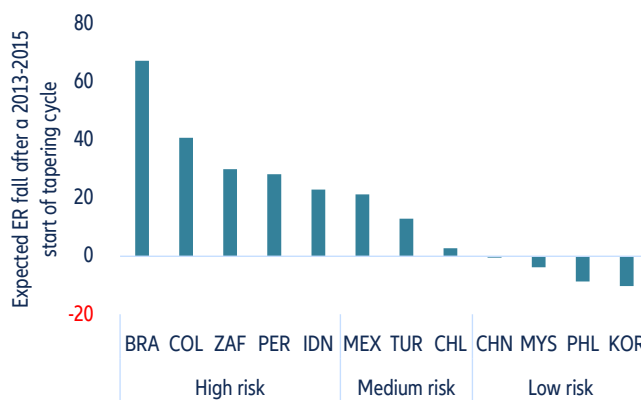
Sources: Refinitiv, Euler Hermes, Allianz Research

As the long period of loose financial conditions seems to come to an end, tighter monetary policy in advanced economies and potential spillover effects have raised the specter of the 2013-2015 sovereign debt crisis. While initial conditions then were very different, with lower fiscal deficits and debt levels, central banks in EMs have been

quick in raising policy rates to mitigate the risk of potential FX depreciation (and associated capital outflows). However, in most cases, preserving external stability did not necessarily help tame supply-side-driven inflation pressures domestically. We identify the countries that have showed higher sensitivity in the past (Figure 50): Brazil

and Colombia stand out as the countries most exposed to an FX shock if financing conditions were to tighten. Even though Turkey is assigned only a “medium risk” score, a rapidly deteriorating external balance could amplify spillover effects from tighter financing conditions and a retrenchment of capital flows.

Figure 50: Sensitivity of sovereign spreads to Federal Reserve's tapering of asset purchases tapering (in bps increase)



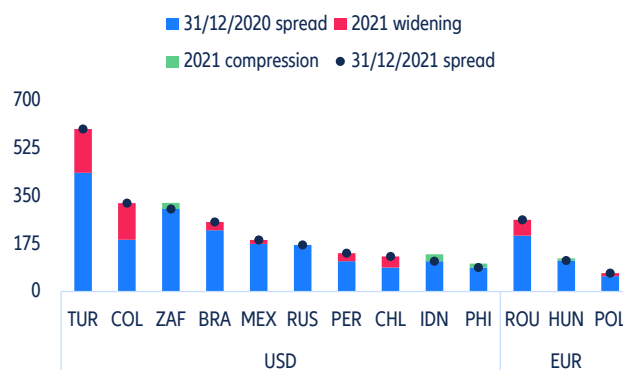
Sources: Refinitiv, Euler Hermes, Allianz Research

Figure 51 illustrates the bumpy ride for spreads last year. Although part of the rise responds to the prospects of tighter global financial conditions, we expect the widening to continue in 2022. However, this would be limited, reflecting deteriorating financial conditions rather than the onset of a debt

crisis. The movements in the US will not be the only cause. Most countries have followed a traditional path of monetary and fiscal normalization of policies but continued virus uncertainties together with poor economic growth could re-open (or even worsen) longstanding structural gaps and political chal-

lenges. If countries manage to bring inflation back to comfortable levels – not everything is in their hands as supply chain constraints or global commodity prices play a role – the real rates would be well above those in advanced economies, offering an interesting trade.

Figure 51: Selected EM countries: Sovereign spreads movements in 2021



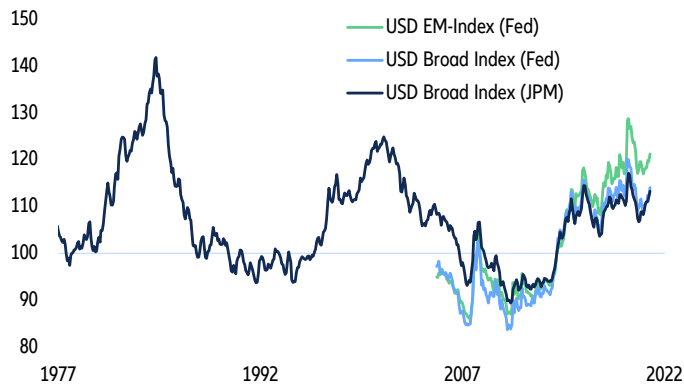
Sources: Refinitiv, Euler Hermes, Allianz Research

But every interesting trade needs of a predictable and stable exchange rate. After losing some of the Covid-19 gains between November 2020 and May 2021, the USD started to strengthen again in June (Figure 52). The prospects of anticipated policy normalization pushed the currency, a trend that we expect to continue in 2022, especially against EM currencies. The

Chinese Yuan, Taiwanese Dollar and Philippines Peso have been the only currencies appreciating against the USD in our sample, while Latin America has been the region most affected. The bulk of currencies have lost between -6% and -20% in the last two years, including the Thailand Baht, the only Asian currency in the range. Looking at the year ahead, the trend is set to con-

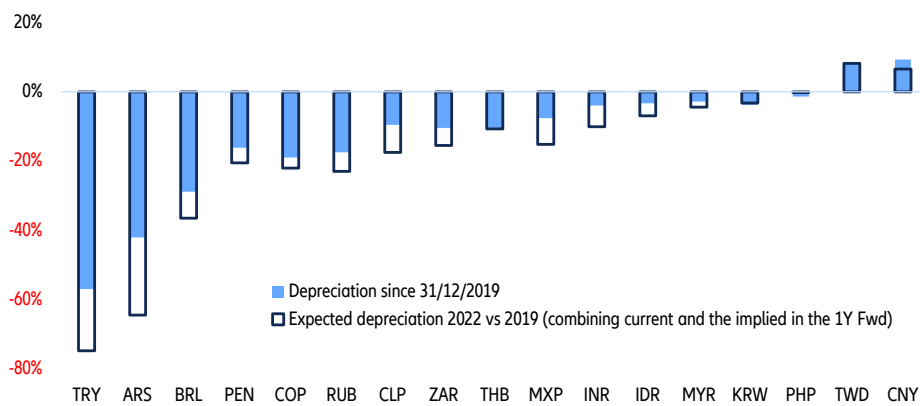
tinue (especially where inflation pressures are not contained). In the case of the Chinese Yuan, we could see how the appreciation in recent years is halted as China has shown a predisposition to loosen monetary policy and support the economy (Figures 52 and 53).

Figure 52: Evolution of different USD indexes
(100 = 31/12/2014)



Sources: Federal Reserve, JP Morgan, Refinitiv, Allianz Research. Fed indexes are based on nominal exchange rates weighted by trade relevance. JP Morgan index is based on real effective exchange rates (adjusted with CPI).

Figure 53: EM currencies movements since 31.12.2019 vs. the USD: depreciation to date, and the compounded depreciation implied by the 1Y Forward.



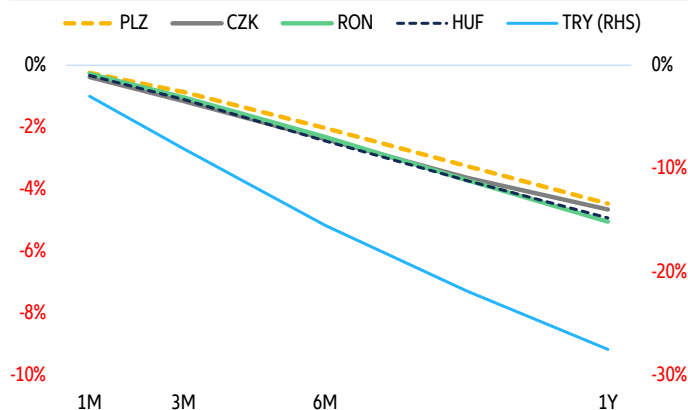
Sources: Refinitiv, Euler Hermes, Allianz Research.

On the European side (except for the Turkish Lira), the situation is less acute. The Hungarian Forint and the Polish Zloty have been the currencies that have fallen the most against the Euro, in part affected by tensions in the relationship with the EU. Overall, central

banks have been proactive in raising interest rates and fighting inflation, which in the case of Poland and Hungary has meant the first hikes since 2012. It is worth highlighting the case of the Czech Koruna, which performed especially well in 2021 and that in

2022 could even cross the 25 CZK per EUR barrier. Notwithstanding, the forward curves indicate timid depreciations in 2022, which could be larger in Hungary and Romania than in Poland and Czechia (Figure 54).

Figure 54: Selected European currencies: implied depreciation vs. EUR (as of end-2021)



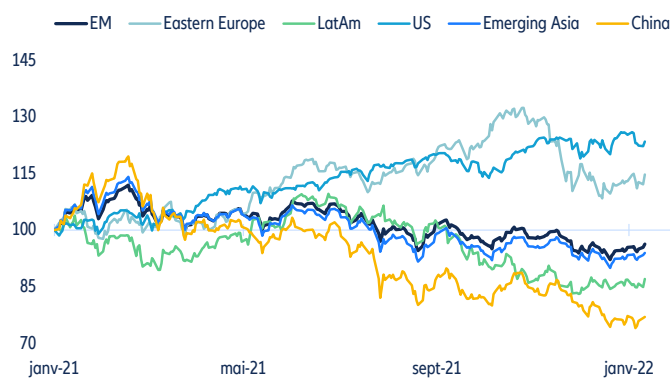
Sources: Refinitiv, Euler Hermes, Allianz Research

EM equities in the largest markets continue to lag those in advanced economies (Figure 55). We do not expect the trend of relative underperformance to

change materially at the index level. Furthermore, export- and raw-materials-driven companies – quite important in EM indices – would be

disproportionately more affected by global slowdown in aggregate demand.

Figure 55: MSCI-EM 2021 compared performance by region (31/12/2020 = 100)



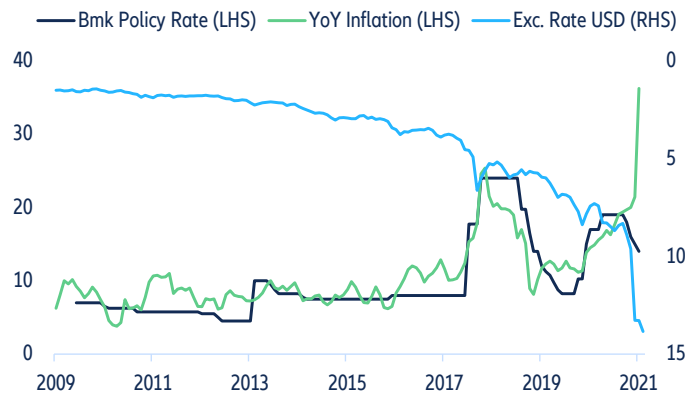
Sources: Refinitiv, Euler Hermes, Allianz Research

The evolving (and largely self-inflicted) currency crisis in Turkey illustrates the rising potential of policy mistakes in EMs amid tighter global financial conditions; however, spillover effects have not occurred thus far. Most EMs have

made further progress in normalizing their monetary stance to contain FX pressures (while supply-side-driven inflationary forces remain difficult to contain). Turkey has chosen an unorthodox path of lowering policy rates in

the attempt to counteract inflation. Unsurprisingly, the Turkish lira has dramatically declined in Q4, with strong inflationary pass-through (and little remedial impact of current account rebalancing) (Figure 56).

Figure 56: Case study: Turkey's peculiar approach to FX pressures



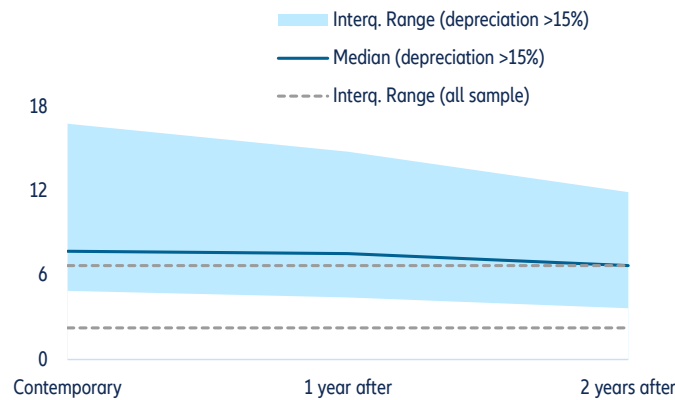
Sources: Refinitiv, Euler Hermes, Allianz Research

Historically, we have seen a significant impact of a deteriorating external balance and the related FX depreciation

on inflation in EMs. Our preliminary analysis shows that effects on inflation remain larger even two years after a

severe depreciation (>15% Y/Y) has taken place (Figure 57).

Figure 57: Currency depreciation and long lasting inflation



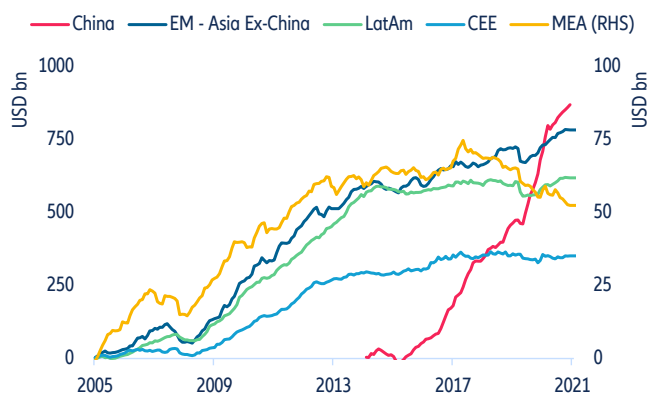
Sources: Refinitiv, Euler Hermes, Allianz Research

There are early signs of rising capital outflows from EMs, which could pick up if external pressures were to increase. Net capital flows (equity and debt) have generally plateaued during the

crisis except for Asia. The non-resident flows into China experienced an enormous increase since April 2020⁹. A visible exception to this pattern is South Africa, where flows have dropped pre-

cipitously and where the trend since 2017 has been quite negative (Figure 58).

Figure 58: EM capital flows (equity and debt), cumulative (2005-21)



Sources: IIF, Euler Hermes, Allianz Research.

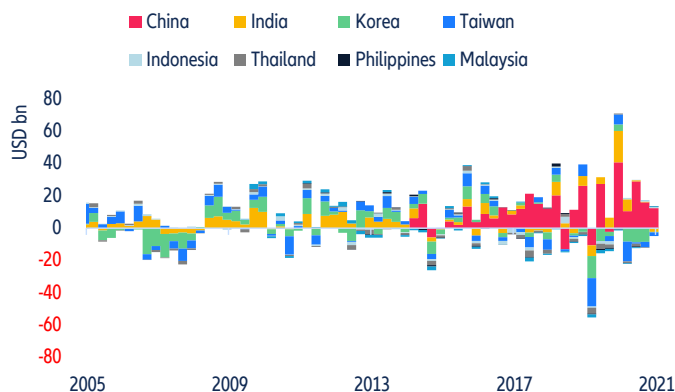
Note: EM-Asia Ex-China includes: IND, KOR, IDN, THA, PHL, PHL and MYS. LatAm includes: BRA, CHL, MEX and COL. CEE includes: POL, CZE, HUN, TUR and ROU. MEA only includes ZAF.

In terms of capital inflows into EM-Asia equities, China and India have led the post-Covid-19 recovery, while two other important markets such as Taiwan and South Korea have had a second tough year (Figure 59). How to reconcile the increasing foreign presence of

foreigners in Chinese equities (which is not only confirmed by IIF data, but also by quarterly PBOC data), and at the same time their poor performance? In the first place, this picture is one-sided as it only shows non-residents flows, while at the same time there have

been resident outflows. A second reason is that the entities leading the decline are the overseas-listed, which have a big share in international indexes such the MSCI EM and which have underperformed onshore-listed entities.

Figure 59: EM capital flows (equity and debt), cumulative (2005-21)



Sources: IIF, Refinitiv, Euler Hermes, Allianz Research.

⁹ As we reported in our China-specific report: [Chinese capital markets, the panda in the room](#) (using PBOC data).

Table 4: 2021 performance by asset class

	Value as of 31.12.2021	Change since 31.12.2020	Total Return since 31.12.2020
EMU			
Government Debt			
Policy rate (ECB deposit rate)	-0.50	0	
10y yield sovereign (Bunds)	-0.18	40	-3.3%
10y swap rate	0.28	53	-3.3%
Italy 10y sovereign spread	1.19	66	-4.1%
France 10y sovereign spread	0.19	54	-3.6%
Spain 10y sovereign spread	0.60	54	-3.3%
Corporate Debt			
Investment grade credit spreads	98	5	-1.0%
High-yield credit spreads	331	-24	3.3%
Equity			
Eurostoxx	479		23.4%
US			
Government Debt			
Policy rate (mid-rate)	0.13	0	
10y yield sovereign (Treasuries)	1.50	59	-3.1%
Corporate Debt			
Investment grade credit spreads	98	-5	-1.0%
High-yield credit spreads	310	-76	5.4%
Equity			
S&P 500	4766		28.7%
UK			
Government Debt			
Policy rate	0.25	15	
10y yield sovereign	0.97	78	-5.7%
Corporate Debt			
Investment grade credit spreads	115	2	-3.3%
High-yield credit spreads	390	-73	3.8%
Equity			
FTSE 100	7385		14.3%
Emerging Markets			
Government Debt			
Hard currency spread (vs USD)	297	16	-1.8%
Local currency yield	4.83	63	-4.7%
Equity			
MSCI EM (\$)	2984		-2.2%

Sources: IIF, Refinitiv, Euler Hermes, Allianz Research.

Table 5: Selected asset class performance forecast (2022-23)

year-end figures	Value as of 31.12.2021	Unit	Old Scenario		New Scenario	
			2021	2022	2022	2023
EMU						
Government Debt						
Policy rate (ECB deposit rate)	-0.5	%	-0.5	-0.5	-0.50	-0.25
10y yield (Bunds)	-0.18	%	-0.3	-0.1	-0.2	0.1
10y swap rate	0.28	%	0	0.2	0.1	0.4
Italy 10y sovereign spread	136	bps	90	90	120	140
France 10y sovereign spread	37	bps	20	30	30	40
Spain 10y sovereign spread	77	bps	55	60	65	75
Corporate Debt						
Investment grade credit spreads	98	bps	90	110	110	125
High-yield credit spreads	331	bps	325	375	360	380
Equity						
Eurostoxx	20.4 (ytd)	%	15-20	6	7	9
US						
Government Debt						
Policy rate (mid-rate)	0.125	%	0.125	0.375	0.75	1.875
10y yield (Treasuries)	1.5	%	1.5	1.8	2.0	2.3
Corporate Debt						
Investment grade credit spreads	98	bps	100	110	115	135
High-yield credit spreads	310	bps	350	400	370	400
Equity						
S&P 500	26.9 (ytd)	%	15-20	6	6	8
UK						
Government Debt						
Policy rate	0.25	%	0.1	0.35	0.75	1.25
10y yield sovereign	0.97	%	0.7	0.9	1.3	1.6
Corporate Debt						
Investment grade credit spreads	115	bps	130	140	130	150
High-yield credit spreads	390	bps			460	500
Equity						
FTSE 100	14.3 (ytd)	%	10	8	5	6
Emerging Markets						
Government Debt						
Hard currency spread (vs USD)	297	bps	300	330	380	350
Local currency yield	4.9	%	4.8	5.3	5.3	5.0
Equity						
MSCI EM: total return p.a. in USD	-4.6 (ytd)	%	5-10	7	2	5

Sources: IIF, Refinitiv, Euler Hermes, Allianz Research.

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