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Around THE Curve

The Yin and Yang of 2022

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The inflation shock that characterized 2021 saw many emerging market (EM) countries and some developed market countries already on the path of interest rate hikes. However, last year the two largest economies remained on hold. That status quo could change, and 2022 could become an interesting year of policy divergence between these two nations as China refocuses on growth stabilization while the U.S. Federal Reserve (Fed) potentially moves quickly from tapering to tightening through rate hikes. In addition to the policy front, politics will also dominate. China will be front and center, hosting the Winter Olympics in February and the 20th Party Congress later this year when President Xi transitions power to…President Xi. Meanwhile, the U.S. faces a potentially tumultuous mid-year election. As the two most significant economies prepare to move in opposite directions, investors should position for this potential policy divergence.

China's policy pivot to growth stabilization will be the dominant policy theme in 2022.

China's Central Economic Work Conference (CEWC) concluded on December 10, 2021, and signified an important shift in policy focus to stabilizing growth from derisking and deleveraging. The important conference set the accommodative tone and growth focus for 2022, which were delineated in the CEWC communique:

1. **Acknowledging challenges and downward pressures: Policymakers admitted that China faces a trio of growth challenges from demand contraction, supply shocks, and weakening expectations. Specifically, China faces large downward pressure from the property market downturn, persistent COVID-19 pandemic, the Fed's looming policy normalization, weakening export momentum, and worsening geopolitical environment.**
2. **Refocusing on "stability" and "growth": The CEWC stressed the importance of *"economic development as the central task for the party"*, with emphasis on both *quality* and *quantity* of growth. Stabilization is the top priority, indicating more modest property easing to come. Furthermore, all levels of governments and agencies are charged with the responsibility to support growth with more front-loaded policy easing early in 2022. A synergy between *counter-cyclical policy* and *cross-cycle measures* and enhanced coordination between fiscal and monetary policy will be stressed. Additionally, several specific areas were highlighted:**
    a. **Property sector evolution: The CEWC maintained *"housing for living, not for speculation"* to avoid an entire reversal of its property sector regulations. That said, it emphasized the need to better meet the healthy demands of home buyers. Local governments will be allowed to "use city-specific measures" as needed. Goals were set to accelerate social housing construction and expand the long-term rental housing market. Policymakers will further fine tune the existing property financing restrictions to prevent a hard landing, but it is unlikely that curbs will be revoked completely.**
    b. **Proactive fiscal policy: The government called for faster front-loaded fiscal spending on tax and fee reductions for small and medium-sized enterprises (SME), innovative manufacturing, and green infrastructure. We expect a moderately larger fiscal deficit, new special local government bond quotas, and larger infrastructure investment.**
    c. **Prudent monetary policy: Monetary policy will be aimed at providing ample liquidity to support**

SMEs, innovation, and green development through relending facilities offering lower borrowing costs. More reserve requirement ratio (RRR) cuts are likely, but a significant rate cut is more difficult if other central banks hike more aggressively.

   d. Less radical decarbonization: Another area of divergence may be in the race to net zero carbon emissions. The CEWC signaled a more moderate pace of decarbonization to balance the economic growth and green targets. It calls for *"investment before divestment"*, boosting investment in renewable energy with more incentives while keeping traditional fossil fuel-based energy as a reliable resource in the interim; energy security should be maintained. The conference promoted cleaner and more efficient use of coal, optimizing the combined utilization of coal and new energy, and excluding renewable energy from total energy consumption control.

3. More pragmatic on "common prosperity": The CEWC clarified that China needs to *"get the pie bigger first"* and then *"distribute the pie more equally"* to achieve common prosperity gradually. Policymakers will emphasize sustaining economic and household income growth and supporting employment rather than major radical income distribution. To some extent, the U.S. is facing similar challenges on addressing social inequalities.
4. Growth-enhancing structural reforms to continue: In 2022, China will implement growth-enhancing reforms while cautioning against reforms that may hamper near-term growth. The momentum of regulatory tightening on housing, the internet, and education may moderate in 2022; regulations will be carried out in a more gradual and transparent way. The CEWC called for structural reforms aimed at boosting growth and the confidence of market participants, promoting fair competition, enhancing the anti-monopoly campaign, strengthening intellectual property rights (IPR) protection, and acknowledging the principal role of enterprises in innovation. These are the growth drivers that will remain the focus: industrial upgrading, technology innovation, and green development.

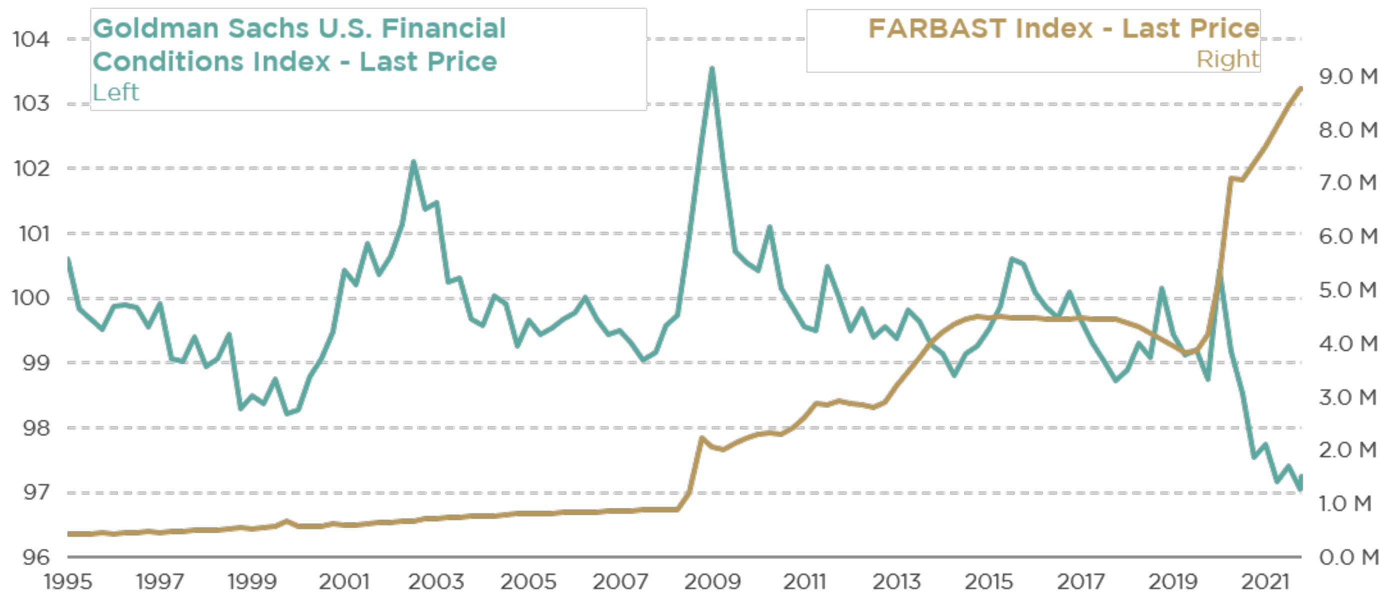
The gross domestic product (GDP) target will be announced at the National People's Congress in March 2022. While it will probably be between 5% to 6%, this target will likely be exceeded in a year of political reshuffling. Given the shift in focus to growth and easing, we believe that China's credit impulse has already bottomed and should rebound early in 2022. However, the near-term, downward pressure on growth is still here, and it remains to be seen how the unwinding of Evergrande and other defaulting developers will play out.

The Fed's pivot to renormalization will be another major theme in 2022.

At the same time, we have the Fed indicating that its ultra-easy monetary policy since the beginning of the pandemic is not only ending but reverting to aggressive policy moves in response to rising inflation. The Fed decided in mid-December to double the pace of tapering to $30 billion every month, hence completing tapering in March of 2022. Then, the Fed expects to start raising interest rates with as many as four or five hikes in 2022, two in 2023, and two more in 2024. At any time the Fed may also start reducing its balance sheet by allowing its current holdings to run off. To put this policy normalization into perspective, the Fed's balance sheet increased significantly from its pre-COVID level to $8.8 trillion. Financial conditions are ultraloose, with interest rates still near historical lows around the zero-bound (see Figure 1). It takes time to normalize such ultra-easy monetary policy, and risk assets are still benefiting from massive liquidity and easy financial conditions. A strong economic recovery combined with both households and corporations flush with cash means that the Fed is behind the curve and should have normalized policy already, in our view. On the fiscal side, the Build Back Better Act is still pending, but most of the fiscal stimulus is already behind us.

1 **U.S. Federal Reserve Balance Sheet and Financial Conditions**

Index (left), $ MM (right), Chart Units/Description, As of 1/7/2022



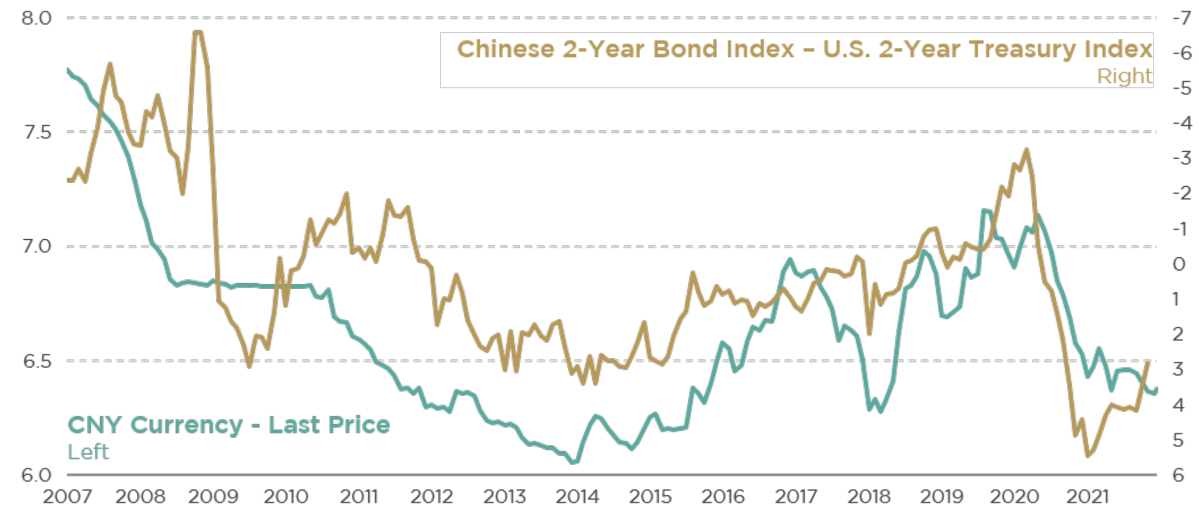
Source: Bloomberg (© 2022, Bloomberg Finance LP)

Investment Implications

The yin and yang of the divergence between Chinese and U.S. monetary and fiscal policies could have significant implications for investments.

1. **Potential impacts on assets in China and the U.S.**
    a. **Chinese yuan (CNY), rates, and risk assets: The narrowing interest rate differential will exert downward pressure on CNY, all things being equal (see Figure 2). However, the currency is still supported by robust balance of payments and investment flows. Easing policies should result in a bull steepening of the yield curve and support for risk assets in China, including equities and distressed credit. Green investment—solar and wind power, power grid upgrades, power storage, efficiency upgrades in various industries, and so on—will likely become a new growth driver in 2022 and beyond and should benefit from policy easing.**

2 | **Chinese Yuan vs. Real 2-Year Interest Rate Differential between China and U.S.**
¥ (Left), % (Right), As of 1/10/2022



Source: Bloomberg (© 2022, Bloomberg Finance LP)

b. U.S. dollar, rates, and risk assets: The relative tightening of U.S. monetary policy should support the dollar. A stronger U.S. dollar will not bode well for other low-carry developed market and EM currencies. The Treasury yield curve should see a bear flattening, depending on the degree of aggressiveness of rate hikes. Quantitative tightening may also steepen the curve. Cyclical inflationary forces could temporarily pull interest rates higher despite the longer-term structural deflationary forces, including aging demographics, technology, and mountains of debts. Risk assets in the U.S. will likely be more volatile, with carry dominating the return.

2. Potential impacts on EM: China's easing policy should marginally support demand for commodities and benefit commodity-exporting EMs. With valuations less expensive after recent years' selloffs, some higher-yielding EM assets may present opportunities. However, the Fed's policy normalization would be a significant headwind for EM assets if we are in for further interest rate shocks, depending on how contained inflation turns out to be.

Wild Cards Could Change How 2022 Plays Out

There are a few wild cards for 2022 that make forecasting a daunting task, and which could result in drastically different outcomes.

1. COVID: Year 2022 will still be haunted by the uncertainties of COVID, which is not yet over. The pandemic can still wreak havoc on the global economy, both on the supply side and the demand side. More tools, like vaccines and treatments, are available, but more variants are also very likely. The severity, transmission potency, and our reaction function will determine the path of economic growth. With over $34 trillion in global stimulus already shelled out, the bar for more stimulus is much higher. China's zero-COVID policy is still the dominant risk for its economy—and this risk could be significant if Omicron gets out of control and nationwide lockdowns result.
2. Policy mistakes: Policy errors are another risk. In China, the property sector slowdown is both cyclical and structural, facing both declining demand from aging demographics and a reckoning of the debt largess of the past decade. Hence, we do not see a complete policy reversal, and policy may disappoint. In the U.S., if the latest COVID wave turns out to be more severe, negatively impacting growth and confidence, the Fed will probably have to adjust the pace of policy renormalization. And while it may currently be behind the curve, the Fed could also misstep in the other direction by hiking too aggressively and triggering a

material selloff in risk assets or impairing growth.

3. **Other risks: Other wild cards include runaway inflation risks, geopolitical risks, and social instabilities triggered by COVID disruptions and restrictions.**

While the U.S. and China may follow divergent paths this year (see Figure 3), they also could share one thing in common: They both may face the "show me the money" test. Is China's policy shift too little or too late to arrest the slowdown? How serious is the Fed in containing inflation, and how high can the federal funds rate go without derailing the fragile recovery, given the excessive debt increase post-COVID? Investors will have to be nimble in adjusting their investments accordingly by watching which policymakers can walk the talk better.

3 Yin and Yang: U.S. and China Set to Diverge in 2022 on Multiple Fronts

	U.S.	China
Monetary Policy	The Fed is reversing its ultra-easy policy in response to rapidly rising inflation. After doubling the pace of tapering, which now will conclude in March 2022, the Fed could move quickly to multiple rate hikes.	Policymakers recently acknowledged challenges to growth. China is pivoting its policy and has outlined a host of measures aimed at stabilizing growth.
Fiscal Policy	The Build Back Better Act is still pending, but most of the fiscal stimulus likely is already behind us.	Faster fiscal spending will be front-loaded early in 2022, focusing on tax cuts for SMEs, innovative manufacturing, and green infrastructure. We expect a moderately larger fiscal deficit, new special local government bond quotas, and larger infrastructure investment.
Growth	Growth is expected to slow but remain strong. Healthy consumer balance sheets, corporate earnings, and financial conditions that are still easy will continue to support growth.	China faces a trio of growth challenges: ▪ Demand contraction from weakening property sector ▪ Supply shocks from rising commodity prices, zero-COVID policy, and decarbonization efforts ▪ Weakening expectations from pains of structural transition of growth model
Inflation	Inflation has hit new highs, potentially putting the Fed behind the curve.	Inflation is not currently a concern.
Politics	If Democrats lose control of Congress after the mid-term election, aggressive fiscal expenditures likely will be held up by gridlock over the next two years.	The extension of President Xi's leadership to a new term will provide continuity, but China faces social and political pressures at home and abroad.
Property Market	While fundamentals remain strong, rising interest rates and deteriorating housing affordability will decelerate housing price appreciation. But the shortage of housing supply and favorable household formation from millennials will be tailwinds to housing.	Property market slowdown is cyclical *and* structural due to lower housing demand and aging demographics. Focus will be on meeting "healthy" demands of home buyers by developing affordable and rental housing. Existing property financing restrictions may be adjusted to prevent a hard landing, but it is unlikely that curbs will be revoked completely.
Infrastructure and Green Initiatives	Infrastructure and "green economy" initiatives are dependent on the passage and funding of the Build Back Better Act.	Green infrastructure should remain a longer-term growth driver, but policymakers are shifting to a more rationalized pace of decarbonization.
Risks	▪ Inflation ▪ COVID ▪ Policy errors ▪ Mid-term election ▪ Social instabilities	▪ COVID ▪ Policy errors ▪ Property sector fallout ▪ Geopolitical pressures ▪ Social instabilities