

DEC
08
2021



Outlook for 2022: Economic Whiplash?

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Macroeconomic Outlook:

Francis A. Scotland »

The defining characteristics of the economic outlook for 2022 could be more about the composition of global growth than its trend. As long as the threat persists, a return to normalcy from pandemic trauma still seems off in the future rather than around the corner. However, some of 2021's more anomalous economic developments look set to ease, which is encouraging for an extension of the global expansion into 2022. If these anomalies were to reverse completely, which is not impossible, the outlook might even start to look like a case of economic whiplash.

The biggest anomaly of 2021 was inflation. Global in nature, the extraordinary surge in prices was caused by supply chain disruptions and strong policy stimulus measures in the developed world. American programs supporting income and demand were the most aggressive in the world. Correspondingly, the U.S. was the only major economy to see nominal personal consumption eclipse its pre-pandemic trend with inflation reaching 30-year highs. In contrast, the rebound in European nominal spending remained short of its pre-pandemic trend, and core European inflation moved relatively modestly to about 2.5% from 1%. Marching to a completely different drummer, China's economy decelerated all throughout 2021 as its policymakers took advantage of the U.S.-led global rebound to crack down on domestic property sector leverage. How the economic giants reacted to the ebb and flow of viral infections only seemed to exacerbate the extremes: China's tendency to shut down factories and production colliding with government-supported U.S. spending.

A number of factors suggest 2022 could be very different. The worst of the supply disruptions may be over. Order backlogs are improving, inventories are growing again, and executives of key supply-compromised industries are sounding more optimistic. U.S. households may be shifting their consumption back to services after a nearly two-year hiatus, supplanting the online binge of consumer durable goods that—along with higher food and energy prices—drove the bulk of the spike in inflation. Rising prices have slowed real consumption and energy costs remain a headwind. Asset inflation supports consumption, but U.S. monetary policy is turning hawkish. On the other side of the world, Chinese macroeconomic policy is only starting to turn dovish.

What do these trends imply for 2022?

- Based on surveys, many investors expect to see U.S. inflation retreat next year but only to a level that remains well above the Federal Reserve's (Fed) inflation targets. The surprise could be a bigger drop. If so, global *nominal* gross domestic product (GDP) would slow significantly while *real* GDP growth remains firm or even edges higher, bolstered by continued re-openings and stabilization in China.
- The composition of global growth could shift as well—less U.S. and more rest of the world. Domestically, the pivot would be from goods to services.
- Instead of fretting about the Fed being too stimulative, the risk in this scenario is the U.S. central bank putting on the brakes too hard just as inflation retreats. Alternately, the Chinese authorities might not stimulate hard enough in order to ease through the country's property market setback.

The U.S. mid-term elections and geopolitical hot spots are all added risk factors. In particular, determined compliance with ESG goals on the part of countries and companies could sustain upward pressure on oil and gas prices, leading to another version of 2021's supply shock. However, Omicron's arrival as the latest mutation in the COVID pandemic is another reminder that the biggest uncertainties in the outlook are the virus itself and how people and policymakers react. Embedded in the base case is the assumption that the pandemic evolves into more of an endemic that the world learns to live with.

Global Fixed Income Outlook:

Jack P. McIntyre, CFA »

Coming into 2022, it appears that from a valuation standpoint, developed market bonds are going to have more of an undervalued bias. It is not an extreme undervaluation that would indicate a need to aggressively buy developed market bonds. Instead, it is a lower-conviction undervalued anomaly. However, it is more pronounced as you move down the yield curve. This anomaly makes sense given that there has been a generalized shift by developed market central banks to remove monetary stimulus and potentially embark on a tightening cycle in 2022. Some central banks already have acted while others are still contemplating tightening, but this will clearly be the trend for 2022. Going forward, monetary policy will no longer be the stimulative tailwind it was in 2020 and 2021. This monetary policy shift certainly makes sense given that inflation has surged and has become "less transitory" along with the number one storyline for the markets and a major concern for investors.

Meanwhile, the latest pandemic headlines are regaining market influence given the uncertainty associated with the new Omicron variant. The Delta variant was already expected to make a wintertime resurgence in the Northern Hemisphere, so Omicron adds to the pandemic concerns. I suspect in early 2022 we are going to have more clarity on Omicron regarding how contagious it is, the severity of its symptoms, and the efficacy of vaccines. The bond market will continue to adapt accordingly. Providing the new variant does not derail the "learning to live with COVID-19" theme, we expect supply chain bottlenecks to dissipate during the first half of 2022, putting some downward pressure on goods inflation. More shutdowns would clearly prolong the re-opening of the global economy. Even with Omicron, the uncertainty is more along the lines of how governments will react to it as opposed to the variant itself. We see bigger risk in governments overreacting and shutting down certain parts of the economy or that the recovery in the supply chain gets pushed out. The latter is not our base case view, but it is something that we need to watch as it likely would lead to stagflation.

We are still of the mindset that the pandemic is a global natural disaster and not an economic crisis. However, the fiscal and monetary policy responses have been more in line with an economic crisis given their magnitude and duration. Part of the risk market's recent angst has to do with the impending removal of monetary stimulus combined with the withdrawal of fiscal stimulus, i.e., the fiscal cliff. Economic recovery tends to be much faster post the end of a natural disaster than for an economic recession.

Developed Markets

If we extend our view for developed market bonds for all of 2022, we cannot get away from the perspective that yields in the long end of the curve should be range bound. We can blame it on two major forces colliding during

the year. Amid the re-opening of the economy, waning COVID-19, diminished fiscal stimulus, and dissipating supply bottlenecks, goods inflation should subside. However, service inflation, which is more labor intensive, should rise. We expect the Fed to accelerate its tapering of asset purchases, but rate hikes likely will not happen until the back end of 2022, if at all.

Emerging Markets

If we are right about developed market bonds trading in a range in 2022, the real opportunity in global bonds could be in emerging markets, which have lagged for several years. Unlike developed markets, many central banks in developing markets are in mature tightening cycles, and inflation expectations are elevated, which makes their high real yields look attractive. If goods inflation comes down in the first half of 2022 as we expect, the Fed may abstain from hiking rates or, at the very least, the gap from the end of tapering to the beginning of tightening increases. Since many emerging market central banks have been tightening for an extended period, their bond yields have moved up sharply, resulting in very positive real or inflation-adjusted yields. Therefore, lower inflation in that part of the global economy is good for emerging market assets, including bonds and currencies. Our valuation models for emerging market bonds, unlike developed market bonds, are in the range of “significant” undervalued anomalies. The presence of this significant anomaly does not mean that emerging market bonds are poised to rally in the early portion of 2022, but it highlights that they have “discounted” a tremendous amount of negative information. When this valuation disconnect occurs, the catalyst to change the markets’ views of emerging market bonds can be minor. For example, a shift could be triggered by inflation coming in slightly below expectations.

We expect that investors will be adequately compensated for taking an outsized position in duration exposure in emerging market bonds in 2022. Brandywine Global is acting on this view.

Global Currencies Outlook:

Anujeet Sareen, CFA »

After trading in a range for the first half of 2021, the U.S. dollar appreciated more broadly in the second half of the year. There were two key shifts for the dollar in the second half. The main shift was a more hawkish turn from the Federal Reserve (Fed) relative to most major central banks. The Fed has a dual mandate of full employment and price stability. U.S. inflation is running well above expectations, lifting longer-term averages of inflation above the Fed’s target. While employment levels remain below pre-COVID levels, the Fed has acknowledged that its estimates of full employment are in flux. The current strength in wage growth is consistent with a much stronger underlying labor market—as flagged by small businesses—than headline employment data alone would suggest. Additionally, the overall economy is nearly back to trend growth and hence the need for monetary policy to run well below equilibrium has diminished considerably. In this context, the Fed has started to reduce the pace of asset purchases and has even signaled the possibility of accelerating the tapering schedule. Interest rate increases would follow at some stage after asset purchases have ceased altogether (see [Chart 1](#)). Meanwhile, the European Central Bank has expressed less concern about persistent inflation pressures. Economic output in Europe is still well below trend levels, and core inflation, while currently elevated, is not as extreme as U.S. core inflation. This divergence in monetary policy pressure has been a strong contributor toward U.S. dollar strength.

December 2023 3M U.S. Interest Rate Expectations*

%, As of 12/7/2021



*Proxy for the U.S. federal funds rate based off the 3-month LIBOR rate implied by the Dec. 2023 Eurodollars futures contract.

Source: Bloomberg (© 2021, Bloomberg Finance LP), Brandywine Global

The second shift driving the dollar has been the resurgence of growth equity outperformance over value equity. Global growth has decelerated from its first half growth rate. The weakness in Chinese growth—notably in the property sector, the resurgence of COVID case growth in Europe, and the more recent concerns around the Omicron strain have all called into question the attractiveness of the very cyclical value sectors, such as commodities, travel, and tourism, that outperformed earlier in the year. Growth equities, led by large-cap U.S. technology companies, have outperformed in this context. Portfolio inflows into U.S. equities have supported U.S. dollar performance.

The U.S. dollar, in broad trade-weighted terms, is now well above pre-COVID levels, approaching the highs last seen in early 2017 (see [Chart 2](#)). On a medium-term basis, the dollar is moderately expensive. Looking forward, the dollar may strengthen somewhat further against core developed currencies, such as the euro and yen, as the Fed moves ahead in tightening monetary policy. However, we anticipate a bottoming of economic activity in China as the authorities have started to ease monetary and fiscal policy (see [Chart 3](#)). We also expect economic growth in Europe will improve as COVID case growth is expected to moderate. Lastly, an increasing number of emerging market central banks are raising interest rates far more aggressively than the Fed and now offer more attractive carry in support of their exchange rates (see [Chart 4](#)). Accordingly, we anticipate the dollar's performance will become more bifurcated, still outperforming core developed market currencies but weakening against select emerging market currencies with attractive valuations and fundamentals.

2

Real Federal Reserve Board Broad Trade-Weighted Dollar Index

Index level (January 2006=100), As of 12/7/2021

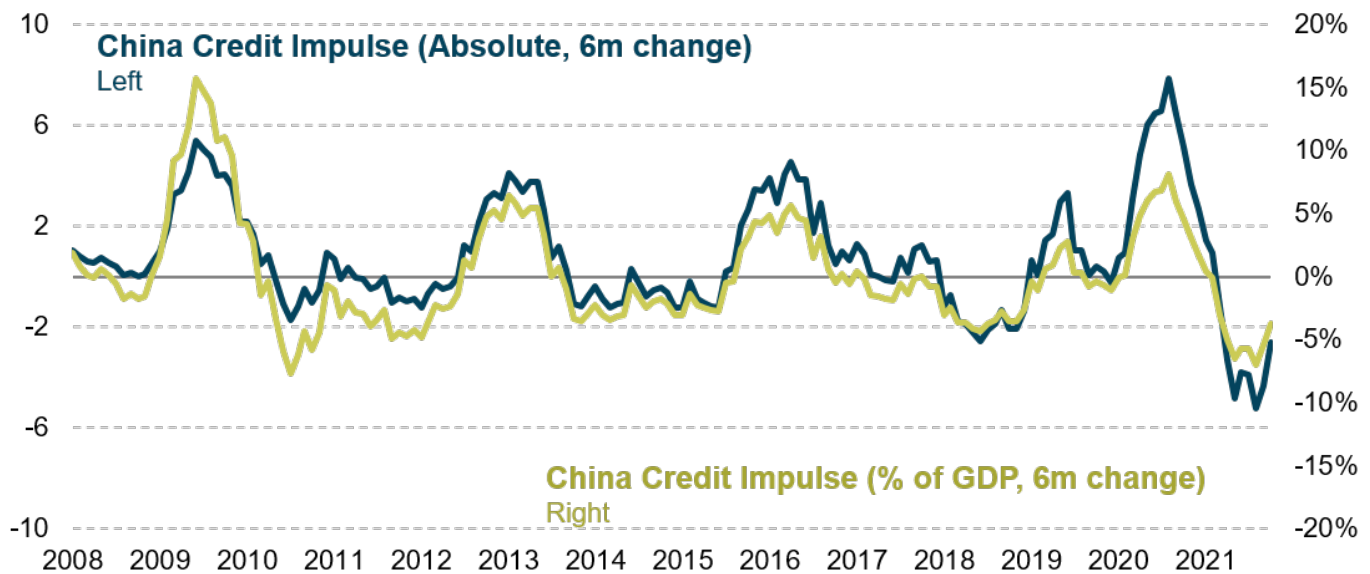


Source: Federal Reserve Board, Haver Analytics, Brandywine Global

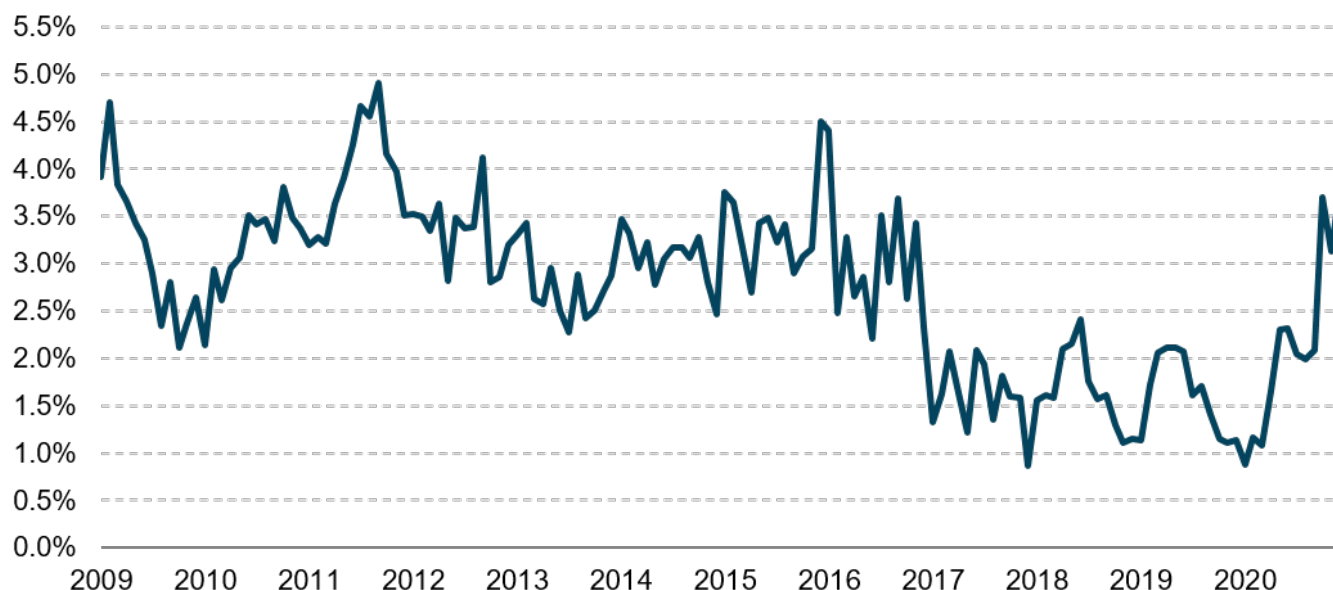
3

China: Credit Impulse

% (right), RMB trillions (left), As of 11/30/2021



Source: Bloomberg (© 2021, Bloomberg Finance LP), Brandywine Global



Source: Bloomberg (© 2021, Bloomberg Finance LP), Brandywine Global

Global Credit Outlook:

Brian L. Kloss, JD, CPA »

“Given expectations for a vaccine and the tremendous policy responses at work, we see a very high likelihood of a cyclical recovery” was how we started this commentary a year ago in December of 2020. It does feel as if we could start this year’s commentary with a similar outlook. That being said, looking out to 2022, one can expect some events to be similar while others are going to be quite different. Vaccines, therapeutics, Delta, Omicron, Pfizer, Moderna—the list of pandemic nomenclature goes on, and all these terms will continue to be focal points for markets as we as a global community continue to deal with that virus we all wish we could forget—COVID-19. As we move into the third calendar year managing and living with COVID, markets continue to adjust and adapt as scientists and policymakers continue to make significant inroads, all while the virus eventually moves from a pandemic to endemic.

However, the unprecedented monetary and fiscal policies we discussed last year are now transitioning to the next stages as the role they played during the pandemic begins to revert back to a more “normal” or conventional policy. Fiscal policy will be expansionary but nowhere near what the markets saw in the previous two years. Meanwhile, regulatory and tax burdens will be increasing. Most importantly, monetary policy will become more restrictive as the U.S. Federal Reserve embarks on ending its quantitative easing program, possibly on an accelerated basis. Embarking on tapering first will allow Fed policymakers to assess market conditions before they move to raise the federal funds rate. These tightening conditions should arrest the spread tightening that we have seen in corporate credit over the last eighteen months. However, economic conditions should remain supportive of credit spreads, and we anticipate minimal defaults across global credit assets.

While they may not rise to the extent of 2021’s record-breaking year, corporate profits in 2022 should continue to surprise to the upside, especially in the first half of the year. There are two strong tailwinds working in their

favor and supporting the market heading into the new year. First, supply constraints may have peaked, which should relieve cost pressures across multiple sectors. Second, companies continue to exhibit a high degree of pricing power due to strong demand from consumers. Consumers, in aggregate, possess an enormous amount of savings ready to deploy as the economy continues to renormalize. The second half of the year becomes a bit murkier as global central banks may become less accommodating if inflation persists.

Therefore, we remain constructive on risk assets, expressing that view across corporate credit markets by utilizing our strong, proprietary underwriting model and deploying a very nuanced allocation to select credit instruments. Our focus continues to be on basic industries, capital goods, energy, and other cyclical sectors in both developed and emerging markets. We favor those industries that have a more cyclical tilt, like autos and mining, which should see marked improvement as the economy rebounds from the lockdowns but will be very mindful to the risks we discussed above around tightening monetary and fiscal conditions. Similar to last year, we believe higher-quality assets offer the best risk/return profile and should remain supported even if there is risk around monetary policy. We are generally avoiding both ends of the credit-quality spectrum, with high quality offering limited total return potential, and lower-quality bonds still susceptible to hiccups in the global economic recovery.

Structured Credit Outlook:

Tracy Chen, CFA, CAIA »

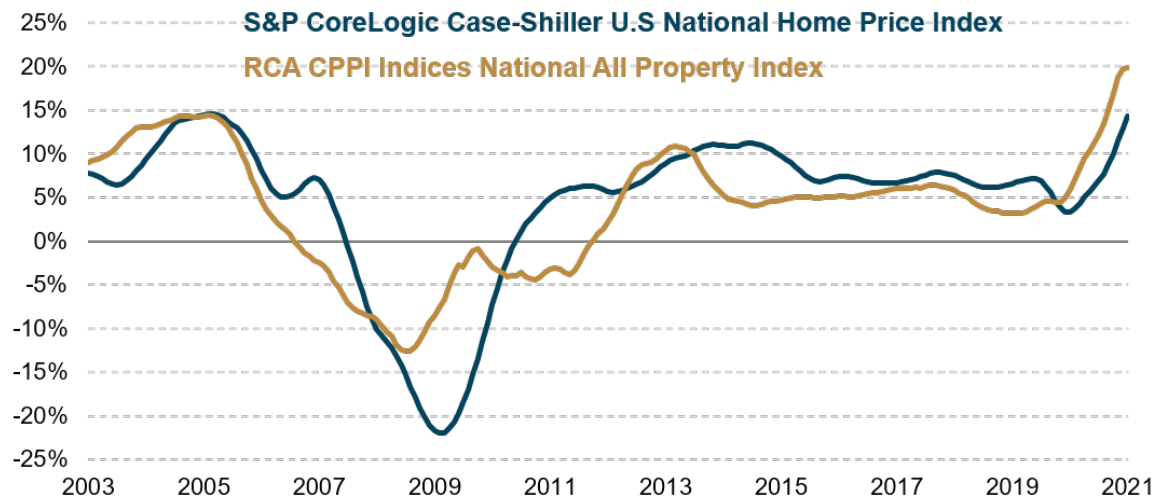
Year 2022 will be marked by the Fed's tapering and fading fiscal stimulus. Fed tapering will pose technical headwinds to the agency mortgage-backed securities (MBS) market, which will likely underperform the broader structured credit market. However, higher issuance across structured credit markets in the second half of 2021 triggered spread widening, providing good entry points for investors. As uncertainty around inflation, moderating growth, tapering, and mid-year elections in the U.S. pervades 2022, we believe the structured credit market provides several attractive carry and unique alpha opportunities from the perspectives of fundamental, valuation, and market technicals.

Credit Fundamentals

- **Bullish residential housing market:** Key drivers that have been propelling the heated housing market include historically low mortgage rates, housing supply shortage, and strong demand for housing, the latter fueled by homebuying from millennials and lifestyle changes post COVID. While housing affordability started to pose challenges on housing demand, lowering buying intentions, affordability is still reasonable given payment burdens remain low. Lending standards started to loosen slightly along with Biden's push to increase affordable housing. We believe the housing bull market will continue with the annual Home Price Appreciation (HPA) remaining strong in the high single digits in 2022.
- **Strong Commercial Real Estate (CRE) market:** CRE fundamentals improved sharply over the past year, boosted by the vaccine rollout and acceleration in economic growth. The performance bifurcation between the "haves" and "have nots" properties remains, especially in the retail, office, and hotel sectors. CRE prices mirrored the HPA at double-digit appreciation (see [Chart 5](#)). We believe CRE prices should continue with high-single-digit growth in 2022, led by multi-family, industrial, and even the hotel sector while office and retail lag comparatively. The macro and fundamental drivers can continue to support strong rent and property price growth in 2022. Capitalization rates are still attractive with considerable dry powder on the sideline, including room for property value and operating income appreciation.

Strong U.S. Residential Housing and Commercial Real Estate Markets

%, Seasonally Adjusted, 12-Month Change, As of 8/31/2021



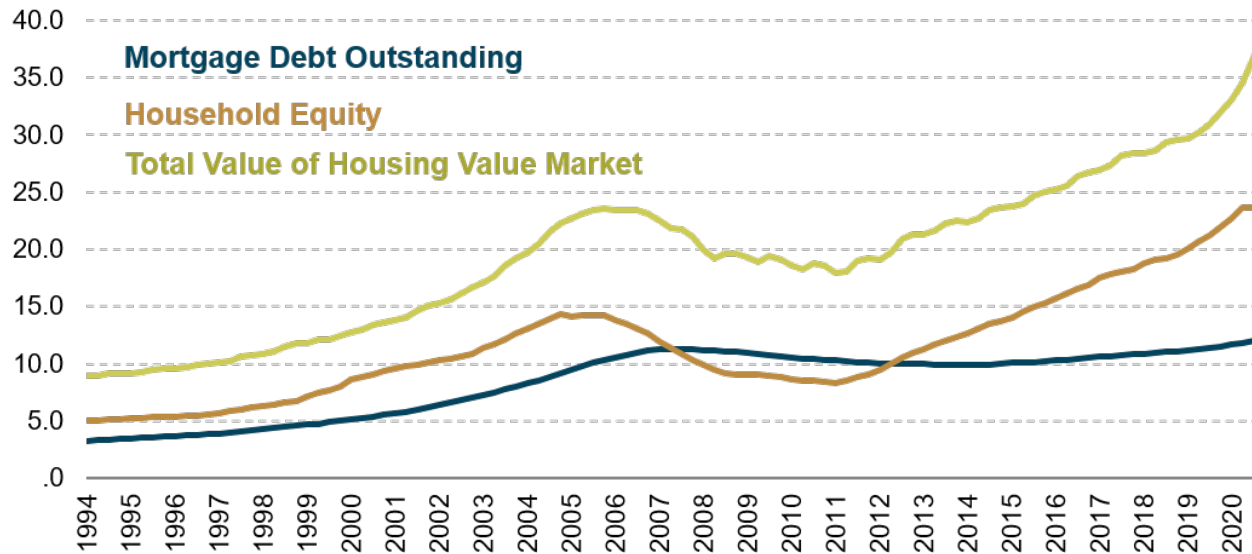
Source: Bloomberg (© 2021, Bloomberg Finance LP), Brandywine Global

- ▣ **Healthy household balance sheets:** Credit fundamentals improved during COVID-19 as consumers boosted savings thanks to generous stimulus packages, improved household balance sheets, and large wealth effects from rising asset prices. Strong HPA since the global financial crisis (GFC) has boosted accumulated home equity to the magnitude of \$25 trillion. Meanwhile, mortgage debt has been growing more slowly (see [Chart 6](#)), which implies a much lower loan-to-value ratio on an aggregate basis (see [Chart 7](#)). This trend signifies the great deleveraging that has occurred in the mortgage sector over the past decade and its strong housing market. In addition, consumers have accumulated \$2.2 trillion in excess savings in aggregate since March 2020, per Morgan Stanley's estimate. The mortgage debt service ratio has declined to a historical low due to low interest rates and deleveraging.

6

U.S. Household Owners' Equity Nears \$25 Trillion

\$ Trillions, As of 6/30/2021

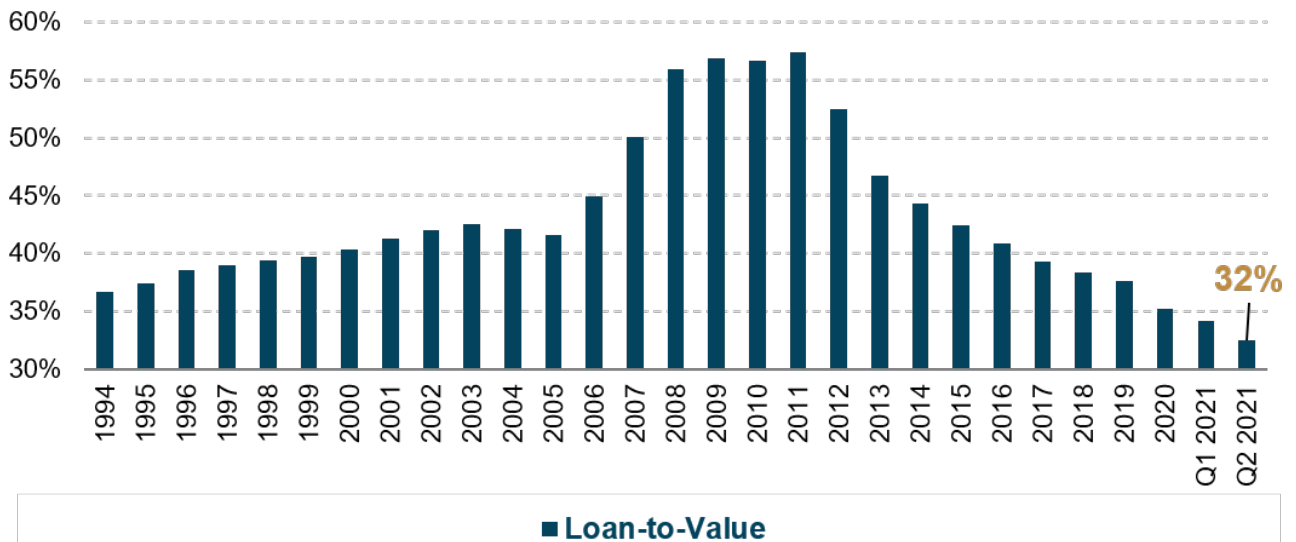


Source: Bloomberg (© 2021, Bloomberg Finance LP), Federal Reserve Bank of St. Louis (FRED),
Haver Analytics, Brandywine Global

7

Loan-to-Value Ratio of the Total U.S. Housing Market

%, As of 6/30/2021



Source: Bloomberg (© 2021, Bloomberg Finance LP), Haver Analytics, Brandywine Global

- **Securitization collateral as inflation hedge:** High wage inflation, home prices, and rents will support securitization collateral as a decent inflation hedge. Supply chain disruptions boost the prices of housing, equipment, and used cars, providing a tailwind for higher recovery value in residential mortgage-backed securities (RMBS) and asset-backed securities (ABS). Wage growth due to labor shortages should be constructive for RMBS and consumer ABS borrowers.

- ▣ **Solid corporate/CLO fundamentals:** Collateralized Loan Obligations (CLO) have become the largest credit sector within the structured credit market. CLO credit fundamentals improved with the reduction of the CCC basket, increase in the market value of overcollateralization (MVOC), and upgrades in credit ratings. Default rates and distressed rates are both at historical lows. We expect 2022 default rates to continue to be below 2%.
- ▣ **CLO: BBB/BB CLOs and middle market CLOs** can benefit from an early credit cycle rotation.
- ▣ **European RMBS:** Spanish and U.K. RMBS mezzanine tranches provide attractive value given the ECB's very accommodative stance. However, capital appreciation is key as carry is minimal due to the floater nature.

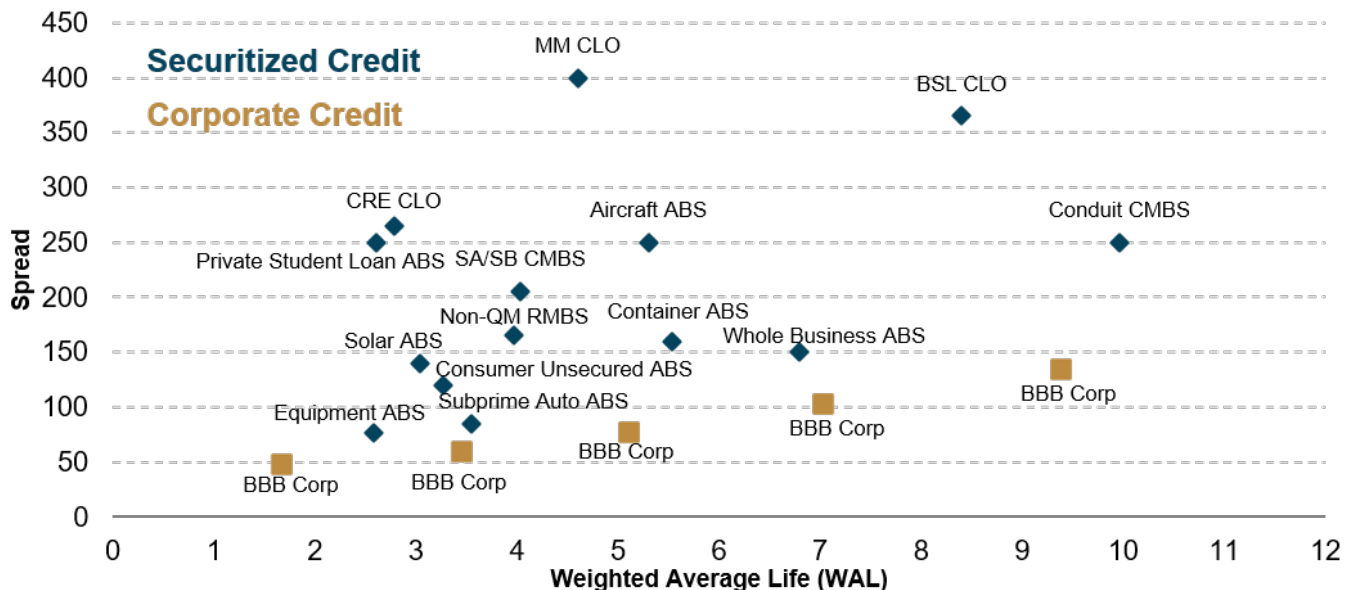
Valuations

The potential for spread pick-up and ratings boosts in the structured credit market is attractive in the ongoing low and negative real yield environment. We believe structured credit still offers good relative value and potential diversification benefits. Comparing structured credit bonds to corporate bonds with the same credit rating and duration, structured credit offers wider spreads with more attractive valuations (see [Chart 8](#)).

8

Securitized Credit Offers Wide Spreads vs. Comparable Corporate Bonds

WAL (Years), Spread (Basis Points), BBB-Rated Credit, As of 10/31/2021



Source: Goldman Sachs Research

Market Technical

The market technical for structured credit is still favorable with limited net new issuance and high demand. Spreads widened in 2021, primarily due to technical characteristics, which should improve with lower supply in 2022.

Where We See the Best Value in 2022

Given these favorable factors, we see opportunities in the following structured credit sectors:

- ▣ In RMBS, we believe Freddie Mac's GSE Credit Risk Transfer (CRT) mezzanine bonds offer a high carry profile and generous spread pick-up opportunity. They are backed by GSE underwriting and servicing guidelines and offer a scalable opportunity to gain leveraged exposure to the housing boom. Mortgage Insurance (MI) CRT mezzanine bonds offer a higher spread pick-up and benefit from limited exposure to defaults from natural disaster losses. CRT are floating-rate instruments and should experience increased investor demand in a rising rate cycle.

- ▣ In commercial mortgage-backed securities (CMBS), we like BBB tranches of seasoned vintages of fixed-rate conduit CMBS/CMBX with embedded price appreciation and amortization, spread pick-up from HY CDX, recovery potential, and shorter duration. We are also constructive on Single-Asset, Single-Borrower (SASB) CMBS loans and senior tranches of CRE CLOs for their higher-quality collateral and floating-rate nature.
- ▣ In ABS, we prefer higher-yielding securities, including those rated B to BBB, of subprime auto, equipment, private student loan, aircraft, container, railcar, and franchise ABS. The fundamentals should be supportive of positive returns.
- ▣ CLOs have one of the widest spreads across fixed income products. Backed by benign credit fundamentals, CLO mezzanine and equity tranches offer some of the most attractive opportunities in floating-rate bonds, and may serve as a good hedge against rate hikes. However, the transition to the Secured Overnight Financing Rate (SOFR) from LIBOR may likely be a challenge in 2022 due to potential operational and basis risk. BB-rated CLOs also offer wider spreads versus corporate bonds. We believe they should outperform in 2022.

The structured credit market, while offering some unique return and diversification opportunities, faces the same major risks as the broader financial market. These risks include more severe COVID waves, a Fed policy mistake, and a hard landing for the Chinese economy.

Equities Outlook:

Patrick S. Kaser, CFA »

Celia Rodgers, CFA »

U.S. equity markets saw a strong year in 2021. However, the big surprise was that large-cap growth style stocks again outpaced value, driven by sizable outperformance in the latter part of the year as COVID fears re-emerged.

Here are some of the major themes we anticipate in 2022:

1. **Fed Boost for Financials:** We expect the Fed to raise rates over the next 12 months. This view makes us positive on financials. At the same time, as stimulus pulls back, we expect loan growth to return, which should favor our bank holdings. The longer inflation continues without moderating, the more aggressive the Fed will need to be in its reactions. Our base case is that inflation will continue above the Fed's 2% target through the entire year, suggesting the backdrop is now more structural for inflation than simply transitory.
2. **U.S. Growth Continues:** We expect the U.S. economy to show solid growth, driven by continued "reopening", strong auto production, inventory rebuilding across a number of industries, infrastructure spending, and pent-up demand generally. Consumer and commercial balance sheets are in great shape.
3. **Supply Chain Bumps Even Out:** Near term, the ongoing progression of the COVID pandemic continues to be impossible to predict, and we believe flare-ups globally will lead to intermittent government responses that drag on local economies, mostly outside of the U.S. Antiviral pills should help in the coming months. Impacts will likely linger with the supply chain issues improving over time, albeit with bumps. Hopefully, normalization will be visible by the second half of the year.
4. **Equity Valuations Flash Warnings—and Opportunities:** The equity market, broadly speaking, looks overvalued with faster-growing companies appearing expensive. In particular, there are many companies with good-sized market capitalization but without earnings or positive cash flows. These companies offer inflated valuations based on unconventional metrics and promises of earnings in the longer term. Furthermore, these stocks represent a significant share of core index weights, which suggests a challenging year might be in store for broad market indices. Value and small-cap stocks do not have the same hurdles to overcome since cyclicals and companies positively correlated with higher rates are

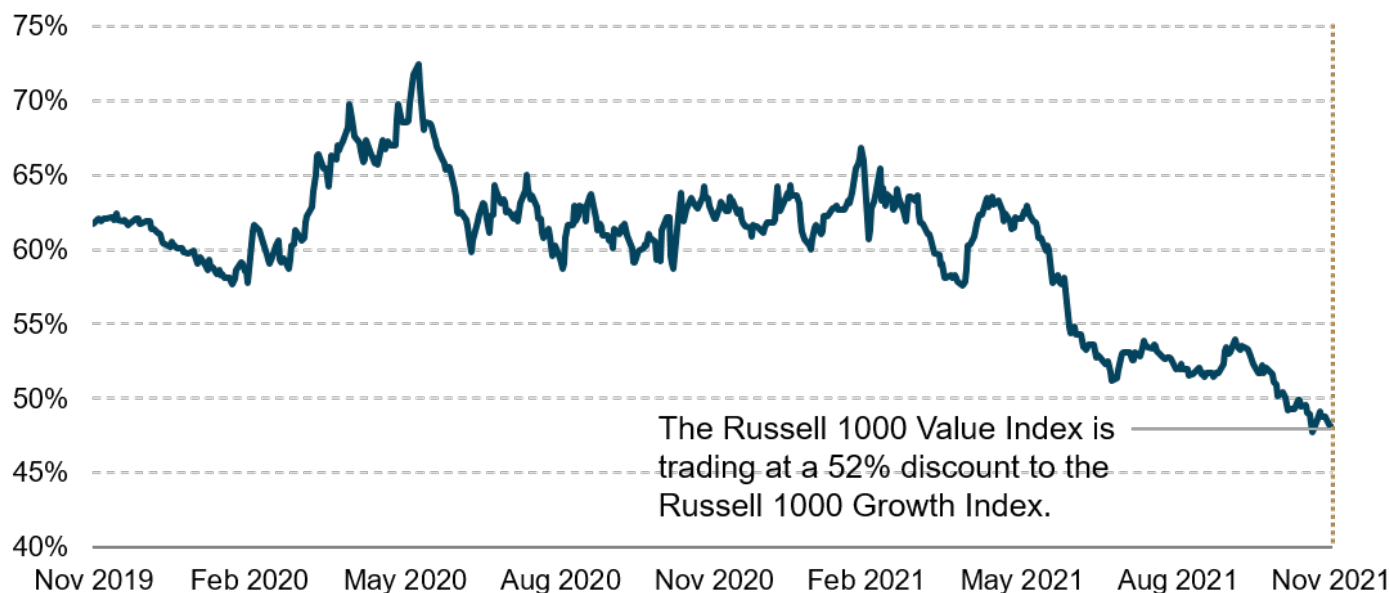
generally trading with much lower expectations and valuations.

On a forward earnings basis, the Russell 1000 Value Index is trading at a steeper discount to the Russell 1000 Growth than it did at the peak of the pandemic (see [Chart 9](#)). We believe this sharp discrepancy in valuations makes a strong case for value stocks in 2022.

9

Russell 1000 Value Index P/E relative to Russell 1000 Growth Index

%, Based on price to next fiscal year's earnings estimate, As of 11/30/2021



Source: FactSet, Brandywine Global

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