Prepare for re-entry: the challenges of normalisation

Markets could get bumpy as monetary policy normalises, and as the pandemic's destabilising impacts continue to ripple through the global economy. Philip Saunders, Co-Head of Multi-Asset Growth at Ninety One, explores the investment outlook across asset classes and regions.

As every astronaut knows, re-entry can be the most dangerous part of a mission. Financial 'normalisation' – central banks' return to conventional monetary policy after years of abnormally accommodative stances – may be a similarly difficult transition, potentially exposing markets to significant stresses in 2022.

But it was business as usual in 2021 from a policy perspective, with Western central banks sticking with super-easy policies. This was accompanied by a continuation of the 'V-shaped' recovery in markets and economies, despite some setbacks caused by new variants of COVID-19.

However, the dramatic recovery in demand has not been accompanied by an ability to supply it. Supply-chain disruptions have led to bottlenecks and sharply rising prices in many areas. Indeed, concern about inflation intensified, with market participants beginning to doubt that the surge in prices would prove as 'transitory' as the US Federal Reserve (Fed) and other central banks had suggested.

Inflation matters

Why the concern? The path of inflation matters because valuations across the asset-class spectrum assume a continuation of low real and nominal interest rates. After the Global Financial Crisis (GFC) in 2008, central banks were able to inject huge amounts of liquidity – often via unorthodox policies – without an inflationary backlash. The monetary and fiscal response to the COVID crisis has been on an altogether larger scale, and the impact in terms of asset-price inflation and cryptocurrencies is plain to see. But will central banks avoid having to tighten policy materially, deliberately weakening growth and causing asset prices to fall sharply, to prevent inflation expectations from becoming unanchored?

Vaccines may provide a shot in the arm

That's not yet clear. At least we now have much better visibility on the process of social normalisation after the pandemic. We understand the disease now. And whereas zero-interest-rate policies persisted in 2021, 'zero-COVID' policies have been jettisoned – China being a notable hold-out – as it has become apparent that we are going to have to live with COVID and put our faith in mass vaccination. As immunisation programmes are rolled out more broadly, the world is opening up. This should underpin growth in 2022, especially in developing economies, many of which have so far lacked access to vaccines.

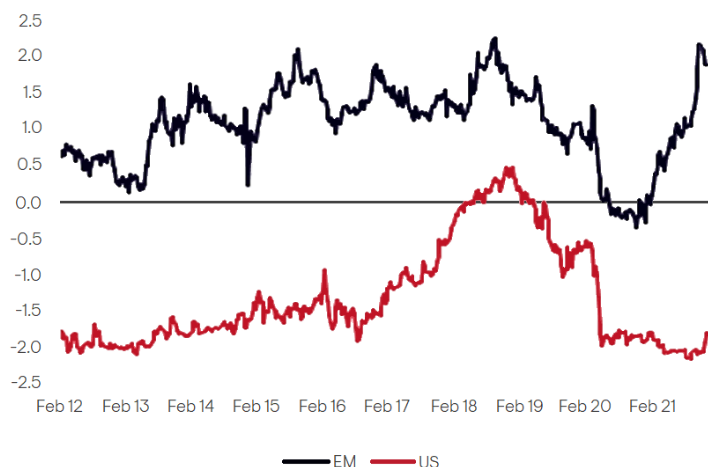
Monetary normalisation

The normalisation of monetary conditions, and the move away from zero-interest-rate policies, are yet to begin in earnest in the developed world. This is likely to add significant uncertainty throughout 2022. The Fed has begun tapering its asset-purchase programme and scheduled to end it in March. It remains to be seen how other major developed-economy central banks will act.

In much of the emerging world, short-term interest rates have already begun to rise. But China has pursued a different course. It didn't suffer as much from COVID-19 as other economies, due to its aggressive lockdown policy. So rather than quantitative easing, it deployed more conventional monetary, credit and fiscal measures. This mirrored the mini-cycles of Chinese policy loosening and tightening that characterised the post-GFC period.

A difference on this occasion is that policy tightening was initiated quicker and accompanied by more assertive macro-prudential policies, particularly in the property market. Chinese policymakers have evidently chosen to 'fix the roof while the sun is shining', using a positive growth environment and a surge in exports to introduce some potentially very significant policy adjustments.

1Y forward real policy rates in EM vs DM



Source: Bloomberg, Ninety One, January 2022

US growth will set the tone for tighter liquidity conditions globally

The US is well positioned to sustain above-trend growth over 2022, even as growth in China and the eurozone slows. The US economy is relatively self-contained; consumers and corporates are flush with cash; banks are 'under-lent'; and supply constraints should gradually ease. Monetary conditions are also set to diverge, with the US finally moving to normalise monetary conditions while Europe remains stuck on hold and China eases.

In aggregate, given the continued dominance of the US in the global financial system, financial conditions overall will tighten, representing a material headwind for international markets. Financial normalisation – against a background of growth and policy divergence, and the distinct possibility of US inflation pressures persisting – is unlikely to be without bumps in the road, especially given elevated valuations across the asset-class spectrum.

Conclusions

It is possible that inflation fears will subside relatively quickly as actual and artificial shortages moderate – the cure for high prices is, after all, high prices. This would provide central banks with greater room for manoeuvre. But if inflation pressures prove to be more persistent, the risk of the Fed being exposed as 'behind the curve' (i.e., as raising rates more slowly than prices are rising) is considerable.

The good news is that the current growth and profits cycle has probably not run its course; the pool of unengaged liquidity on private-sector balance sheets is substantial; and the willingness of governments to increase fiscal spending, despite high debt levels, has undergone a notable transformation in response to the COVID shock. Spending on the energy transition and to address inequality are the common themes here.

What should investors do? We suggest the following:

- There is a strong case for rebalancing strategic allocations away from parts of the market that have done well since the Global Financial Crisis, like growth equities.
- The equities of companies with pricing power, and that start with reasonable valuations, are best placed if prices continue rising. Duration should be kept short.
- There is a high probability that volatility will provide the chance to add exposure to longer-term thematic opportunities.
- While hedging against more negative inflation outcomes makes sense, it should be remembered that the prices of many real assets are a function of the same forces that have driven conventional financial assets to their current levels.

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