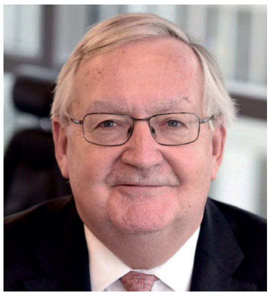
After the recovery: What threats are looming over growth in 2022?



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Even as a consensus growth forecasts for 2022 remain strong (more than 4%), a number of OECD countries still are faced with looming threats that could, derail their growth.
These threats include supply chain issues (especially for raw materials) difficulties linked to the transportation of goods, a drop in real wages on the back of the accelerating inflation in Europe and the US, changes in labour market behaviour, and ultimately, a fiscal hangover amid an ineviable "normalisation" of growth. While the outlook still looks benign, these risks are worth considering.

Supply chain difficulties & energy transition

The main concern, of course, remains supply difficulties and value chain functions, a persistent problem that has boosted inflation and hampered growth in the last year. It's no secret that the Covid crisis has had a strong negative impact on the demand for services, at the expense of services (since the start of 2019, the consumption of goods in OECD countries has increased (in volume) by 27%, while consumption of services has fallen by 1%).

Mostly this is the result of working from home, on-line consumption amid record stimulus (at least in the US). But investment in the energy transition, and consequently the demand for raw materials, energy, semi-conductors, transport, has also played its part, which in turn has resulted in ongoing bottlenecks and inflation.

It's worth noting that much of the nascent energy transition is based more on reducing investment in the production of fossil fuels, than reducing the demand for fossil fuels, which continues to climb. The banks and asset managers are indeed strongly discouraged from financing investments in petrol, natural gas, coal, whilst the price of CO2 or the regulations are insufficient to greatly discourage demand for these energies.

With renewables unable to substitute fossil fuels, this divestment could see supply challenges and put upward pressure on prices, particularly as demand recovers to pre-Covid levels and is set to rise in the coming years.

Meanwhile, the transition will also get raw materials, that are needed like copper, nickel, aluminium, lithium, cobalt etc..., under a great deal of pressure.

We may therefore be concerned about the emergence of a lasting situation of supply difficulties, inflation and production losses, which go hand in hand.

What goes up…

It's worth noting too that higher energy prices and inflation causes growth to slow down. But it's unlikely that Central Banks react aggressively: even if they react to inflation, they will react half-heartedly, long-term interest rates are going to increase a little (the 10-year interest rate in the United States may climb to 2.5%, up to 1% in the Euro zone), real interest rates should remain negative and therefore will not slow down activity.

The Central Banks have no other choice than to exercise this caution to avoid a public or private debt crisis, to support employment, in particular of those people facing difficulty amid the energy transition and soaring gas and utility prices. In contrast, inflation means the buying power of wages is reduced: nominal wages are only imperfectly price-indexed which is one of the forms of the loss of the employee's negotiating power.

Despite the recent fanfare over salary increases, real wages (wages minus inflation) are actually falling. In the US, for instance, real wages at the end of 2021 were roughly -2.8%, while they were -2.5% in the Eurozone. This decline in the buying power amid persistent and sticky inflation (real wages) will obviously slow down household and business demand, and we are already seeing this in a range of sentiment surveys, especially the US consumer (which makes up 70% of the economy)

Saving our jobs

The third area of concern is the evolution of the labour markets. In the United States and the United Kingdom, the level of participation (i.e. the proportion of a working age who are in the labour market and job-seeking) has fallen considerably (by 1.5%) since the start of the Covid crisis. This creates a shortage of workforce and significant hiring problems which slows down business.

In the Euro zone, meanwhile, there is no overall decline in the level of participation, but there is strong disruption to the labour market in specific sectors. Employees are increasingly turning down arduous jobs, jobs with atypical schedules or temporary roles, and business sectors where these jobs are primarily found (hotels, catering, restaurants, sales, cleaning, and construction etc.) are experiencing recruitment problems. This hiring problem, whether due to the global decline in the supply of work, or due to the "mismatch" between supply and demand for work in specific sectors will have an impact on business.

There is no such thing as free money

Our final concern is that budgetary policies which were very expansionary in 2020 and 2021, will become more restrictive. This is the case to a certain degree in Europe, but it is very much strongly the case in the United States, where the public deficit will fall from 16% of the GDP in 2021 to 8% of the GDP in 2022, and the structural deficit (corrected by the cyclical economic situation) will fall by 7%. This considerable reduction in public deficit, or fiscal overhang, is not corrected by household savings, and thus will act as a significant brake on the US economy.

When supply and transportation difficulties, which look set to continue in certain areas, are added to the mix, this presents a difficult combination: higher structural inflation, falling real wages, a weaker consumer, lower labour force participation, and a notable fiscal drag (at least in the US).

These issues show few signs of abating this year, so it's necessary to remain cautious on the growth prospects of 2022, and it's no surprise that the IMF recently cut its global growth forecast to 4.4%.

And some of these issues are likely to linger in the medium term too, since the energy transition is likely to trigger sustained higher energy prices and a lasting scarcity of the raw materials, necessary for the transition.

Conclusion

What are the consequences of slowing growth for the financial markets and asset allocation? In our view, this will incite the Central Banks to be cautious, and err on the side of caution, which will limit any interest rate hikes and be favourable for the stock markets and property markets – despite the current bearish consensus when it comes to Central Banks. While central banks may sound hawkish on inflation now, the reality is that they can ill-afford to pursue aggressive monetary tightening given the already-slowing global economy. This should support risk assets in the long-term, even if hawkish sounding central banks and a growth slowdown increase volatility.

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INT61-0222