2022 Outlook

Summary

MACKENZIE
Investments

Contents

Pandemic aftershocks: Challenging, not insurmountable

- Pandemic aftermath playing havoc with inventory cycle
- Equities should outperform bonds as inventory restocks and service sector returns
- Bond yields expected to rise on inflation fears
- Central bankers tread lightly, balancing recovery and inflation
- China growth to buoy the global economy

As the world continues to navigate the COVID-19 pandemic, the risk of variant outbreaks remains. However, we believe that the world is better equipped to handle outbreaks through effective and highly adaptable vaccines, expanding vaccine adoption and approval for children, booster shots, and an expanding range of therapeutics. Continued rollout of these measures beyond the developed world to developing nations remains critical – it is increasingly clear that COVID knows no boundaries.

We believe that each successive variant outbreak will have a diminishing impact on capital markets. The fear of the unknown is now greatly diminished. Markets will need to reprice expectations and the timing of a reopening depending on the severity of the variant's impact. However, if the economy stumbles, we now know what fiscal and monetary authorities are prepared to do in response.

If a return to normal stokes investors' fears of tighter financial conditions and higher inflation, a COVID setback removes the tighter financial risk and should dampen inflation fears, even if it doesn't eliminate them. COVID variants and the attendant government restrictions will weigh on economic activity, but that weight and the market's response should be smaller and more selective.

Lesley Marks, MBA, CFA
Chief Investment Officer, Equities

Brent Joyce, CFA
Investment Strategist

Steve Locke, MBA, CFA
Chief Investment Officer, Fixed Income & Multi-Asset Strategies

Our asset class expertise

William Aldridge , MBA, CFA

Konstantin Boehmer, MBA

Katherine Owen, MBA, CFA

Dan Cooper, CFA

Martin Fahey, MBA, CFA

Todd Mattina, Ph.D

Nick Scott

Jules Boudreau, MA

Wenjie Ding, Ph.D.

Benoit Gervais, MSc, CFA

Arup Datta, MBA, CFA

US inventory cycle: Orders are at a historical high, and supply is unpredictable

ISM manufacturing new orders less customers' inventory

Source: Bloomberg November 2021

As the risks ebb and flow, capital markets will experience gyrations as they always do, especially given pockets of extended valuations. As the world adapts to living with COVID, we see capital markets driven more by the fundamentals of earnings, inflation, interest rates and sentiment, versus a singular focus on case counts and R0 stats of the past.

The pandemic has created a historic shake-up in most global economic systems, causing distortions to the business cycle. What will become more important for investors in 2022 and beyond is how capital markets respond to these reverberating shocks. The collision of excess demand and restrained supply has triggered an outsized wave of inventory restocking. The timing and unwinding of supply and demand imbalances are challenging to forecast, but the pattern should prove to be typical of an inventory cycle, which has three stages – excess demand (production ramp-up, inventory upcycle), supply catches up to demand (inventory cycle peaks), and overshoot, supply exceeds demand (inventory cycle bottoms).

Until mid-2022, we expect we will see elevated production activity while manufacturers scramble to meet elevated demand. Equities do well at this stage, embracing the strong production and robust sales environment, while bond markets fret about inflation, sending yields higher.

Mid- to late-2022, or later, we expect production to remain high, while PMIs* slow, and sales lose momentum. At this point, equities may begin to discount a future slowdown.

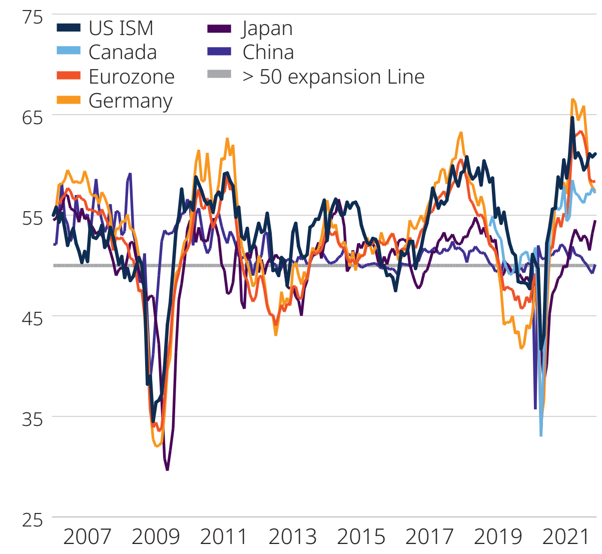
In early 2023, we expect the inventory cycle to overshoot. The outsized price signals and supply challenges of today eventually lead businesses to over-order/over-produce, resulting in full inventories. Meanwhile, pent-up consumer demand and excess savings have run their course. Fiscal and monetary stimulus (despite sizeable fiscal spending continuing) are shrinking from the massive pandemic response of 2020-21.

The overshoot stage typically triggers a slowdown, and that may eventually ensue. But, for our forecast horizon, we see the broader economic backdrop having enough momentum – with the resurgence of the services side of the economy – not only to stave off recession but to deliver reasonable growth.

A key assumption in this scenario is that central banks take a light-handed approach, such that financial conditions do not tighten to the point of causing a recession.

Boom-times at factories should stretch into mid-2022

Global manufacturing Purchasing Manager Indices

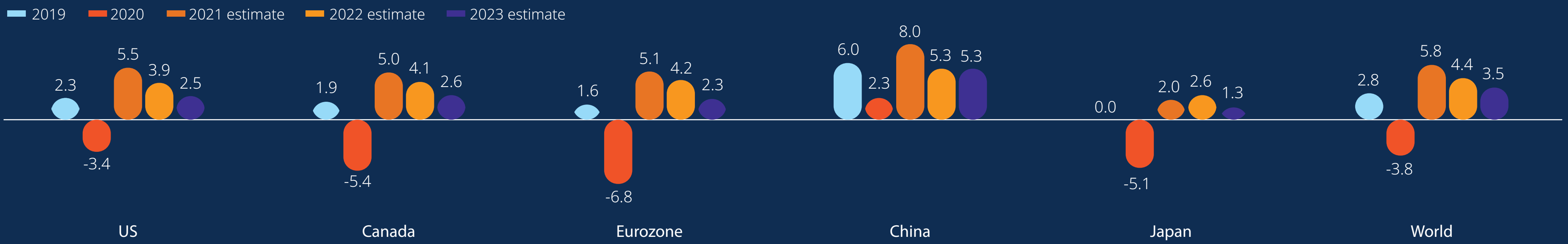


Source: Bloomberg November 2021. For US, ISM. For Canada, Eurozone and Germany, Markit Economics. For Japan, Jibun Bank. For China, China Federation of Logistic and Purchasing

*PMI – Purchasing Managers Index – a survey of hundreds of manufacturers designed to capture a forward-looking view of business conditions.

China and the return of the service sector will fuel positive global GDP growth

Real GDP growth (y/y % change)



Source: Bloomberg November 2021

In addition, the economic cycle in China is asynchronous with the rest of the world. We anticipate mid-to-late 2022 should see the Chinese economy exiting the current slowdown, providing timely ballast to the global economy and equity markets.

Equities expected to remain buoyant, while rising bond yields weigh.

We see equity markets remaining buoyant but with much shallower gains through the first half of 2022. This period would correspond with rising bond yields.

Equity markets could begin discounting a future slowdown in the mid to back half of next year. We feel this timing could be conservative. If anything, we see pandemic disruptions elongating the period of inventory restocking and thus extending the cycle.

In the past decade, equity markets had slowdowns coinciding with inventory cycle bottoms in 2012, 2015 and 2019. These periods typically featured increased volatility and a sideways trading pattern. Valuations absorbed much of the slowdown in earnings, waiting patiently for profits to resume their uptrend.

Our macro view: Medium-term, we see the environment as constructive, but some risks make us cautious enough to warrant a neutral stance.

A policy error by central bankers is a risk as they begin to remove accommodative policies. Equity valuations are generally elevated, with Canada and emerging markets the exceptions. Rising costs also present a headwind for corporate earnings in 2022.

However, many positives remain. Monetary policy is only beginning to tighten. New fiscal spending is expected to flow, although the overall government sector contribution to GDP growth is expected to decline. Unshackled from the pandemic, businesses and households step up. Households have accumulated savings, are seeing rising wages and positive wealth effects. Businesses are flush with cash; tight labour markets and rising costs should be a catalyst for capital investment spending that can unlock productivity gains.

Our base case scenario features upward pressure on bond yields. Equity gains that flatten out into 2022 are accompanied by volatility as recession and stagflation scares swirl, but don't materialize. This environment can present short-term tactical opportunities, but the best approach is, as always, diversification across asset classes and a long-term time horizon to ride out any short-term turbulence.

To read the full version of the 2022 Outlook, click here.

Equities often pause after inventory restocking before resuming climb

MSCI World Equity Index

Source: Bloomberg November 2021

Asset mix recommendations

Equity*

Equity

We hold a constructive outlook but see enough risks to warrant a neutral stance. Equity valuations are generally elevated and face downward pressure on rising bond yields. Solid global growth sees earnings deliver, but that represents a normalization back to single-digit levels. We see equity markets remaining buoyant but with much shallower gains.

Canada

Canadian equities are levered positively to global growth. We anticipate strong capital returns to shareholders through dividends and share buybacks. The value and cyclically oriented sector composition is favourable against a backdrop of rising yields and commodity prices. Valuations are attractive, as is the 2.8% estimated dividend yield.

US

We expect solid S&P 500 earnings reflective of strong GDP growth. Downward pressure on margins is likely from rising input costs and on elevated valuations from rising bond yields. We expect overall US equity returns to be positive but moderating. The 1.4% estimated dividend yield is modest relative to other markets.

International

International developed market equities with more value, cyclical, industrial and global trade-oriented exposure should perform well against a backdrop of solid global economic growth that includes inflation and rising yields. Financial conditions in Europe and Japan remain easier than in North America. Valuations are moderate and the MSCI EAFE Index 3% estimated dividend yield is attractive.

Emerging markets

EM equities are levered to a global expansion scenario along with many exciting new-economy and technology companies. We expect present headwinds to turn into tailwinds, with the US dollar weakening, China's growth stabilizing (with the potential for stimulus) and tempering of regulatory reform. In our opinion, the weak performance in 2021 leaves valuations attractive.

Fixed income

Fixed income

We expect bond yields to rise mildly in 2022. The move higher in 2021 has gone a long way; some further upward adjustment remains – keep duration short. We see yields being restrained by excess global savings, central banks' desire for an orderly move toward normalization and the sheer volume of global debt.

Sovereign bonds

We expect that sovereign yields should move higher as central banks taper asset purchases and raise overnight rates. Nominal yields face upward pressure from rising inflation risk premia, and real yields rising within a solid economic backdrop. Flows from ultra-low yield jurisdictions (Europe and Japan) temper global yield increases. Some exposure is prudent, as a hedge against any short-term bout of risk-off sentiment.

IG corporate bonds

We are constructive on credit markets amid a robust economy delivering solid earnings growth, falling defaults and credit rating upgrades outpacing downgrades. Demand is strong from yield-hungry investors. We acknowledge that credit spreads are tight, providing minimal buffer from rising government bond yields. We see credit positioned to deliver attractive carry.

HY corporate bonds

We expect high yield and leveraged loans to outperform investment grade, given the additional spread buffer to higher rates. However, we expect some flow-through of higher rates to impact high yield bonds and thus currently prefer leveraged loans, which benefit from rising rates and have virtually zero duration.

* All dividend yield estimates are Bloomberg consensus. As of November 30, 2021

Underweight Neutral Overweight