Principal Global Insights

Global Insights Outlook 2022

PAST THE PEAK

Last year, this outlook painted a resoundingly upbeat and optimistic picture of the investment environment ahead. We wrote: "Primed by continued global monetary stimulus and exuberant global fiscal spending, and further boosted by the fading of the tail risks… capital markets are facing one of their best backdrops in years." For investors in U.S. and developed market equities, 2021 broadly delivered. Supported by accelerated vaccination rates keeping the worst of COVID-19 seemingly in the rear-view mirror, risk assets rallied, and offered investors impressive returns.

Heading into 2022, investors face an entirely new set of challenges. Global growth has likely plateaued, central banks are starting to remove stimulative support, and for the first time in nearly three decades, portfolios are facing inflationary pressures brought on by supply shortages. Opportunities do exist, particularly for companies that can lean on resilient consumer spending, strong corporate balance sheets, and gradually improving global supply dynamics—but navigating an investment environment "past the peak" will likely require a much more discerning approach from investors.

That approach, the subject of this year's outlook, can be framed by five critical questions as investors consider opportunities within global markets in 2022.

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WILL COVID-19 REMAIN A THREAT TO MARKETS IN 2022?

In 2022, with global vaccinations set to hit key thresholds, the pandemic should no longer monopolize headlines. Even so, while not significantly impacting global demand, continued progress toward COVID-19 vaccination will be vital in resolving supply-chain bottlenecks and, in turn, unwinding elevated price pressures.

Just as the market plunge in early 2020 was driven by the COVID-19 outbreak and ensuing global shutdown, the formidable rally throughout 2021 had its seeds sown in the reopening of developed economies. Aggressive vaccine rollouts across both Europe and the United States enabled governments to end lockdowns and loosen restrictions, allowing for a sharp rise in activity across sectors.

Vaccinations now sit at substantial levels. Additional boosts from that momentum—and the subsequent surge in reopening demand—is unlikely next year. From this perspective, it's doubtful that COVID will dominate the developed-markets (DM) narrative in 2022.

COVID-19 isn't just a demand consideration

There's an additional angle for investors to consider. While global demand patterns have been closely tied to the evolution of COVID-19, the impact of repeated virus outbreaks and COVID-driven shutdowns stoked the supply-chain bottlenecks now causing widespread disruptions.

In Southeast Asia, for example, as many governments have had a zero-COVID policy: factories temporarily close if a worker tests positive; ships quarantine outside the port when a single crew member contracts COVID; and entire towns lock down for even a small outbreak. These disruptions extend along entire multinational supply chains, pushing them to their limits. Delivery times extend to record lengths and input costs soar, resulting in an extraordinary surge in global inflation. COVID-19's impact on global supply and inflation has been quite evidently severe.

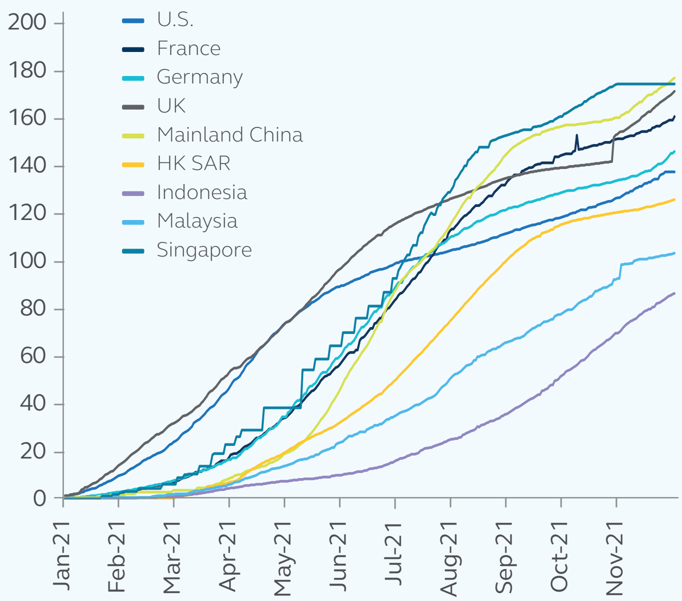
Higher vaccinations hold the key to easing supply constraints in 2022

In 2022, governments in emerging market (EM) countries accelerating the pace of vaccination should become more tolerant of COVID and ease strict containment policies. This means some COVID-driven activity surges for EM still lie ahead, providing a promising opportunity to extend the reopening trade. It also likely implies less frequent factory and port closures. Combined with an expected shift in global consumer demand from goods to services as COVID-confidence rises, supply-chain bottlenecks should gradually loosen. Relief won't be immediate—it may take well into next year to fully normalize, particularly as the Omicron variant may slow supply resolution but at least the most acute upward price pressures should unwind.

A supply-constrained economy has direct implications for profit margins and earnings. In this way, though COVID-19 may no longer pose an obvious disruptive threat, it will continue to influence global supply dynamics, global inflation pressures, and the path forward for global markets.

COVID-19 vaccination rollout

Total vaccine doses administered per hundred people, January 2021 – present



Source: Bloomberg, Principal Global Investors. Data as of November 30, 2021.

HOW PATIENT WILL THE U.S. FEDERAL RESERVE BE IN THE FACE OF EXTENDED "TRANSITORY" INFLATION?

The immediate inflation threat argues for minimal Fed patience. However, provided long-term inflation expectations remain consistent with the Fed's inflation target, the Fed can afford to tighten policy only gradually—particularly if it ensures a full labor market recovery.

While developed market central banks have touted data-dependence and patience, many seem to be preparing for monetary policy normalization. The United States Federal Reserve (Fed) will finish winding down asset purchases in early 2022, followed by a seamless transition into the start of rate hikes. Although the immediate inflation threat argues for a prompt start to rate tightening, easing price pressures in 2022 coupled with the Fed's focus on sustaining a long expansion, argue for only a gradual hiking cycle.

Don't retire "transitory" too hastily

Although the global economy has broadly recovered from the pandemic, scars remain. The reopening-driven demand surge coincided with COVID-related production disruptions, creating a deep supply/demand imbalance, ultimately fueling a sharp increase in price pressures across sectors. Although "transitory" was the buzzword in 2021, central banks now appear keen to retire it, finally recognizing that inflation pressures will likely stay elevated for longer.

Yet, price pressures should at least peak in the first half of 2022 with some elements of the inflation spike, such as reopening novelty, proving unsustainable. Supply chains are certainly complex, and relief will not be immediate, but the most acute supply-driven price pressures should also start to unwind soon enough.

Nonetheless, the Fed is understandably concerned about the broadening of inflation pressures to include items largely untouched by either reopening or supply chains, suggesting that above-target inflation will likely outlast the duration of the pandemic, only fading to 2.5% in 2023.

There are also concerns that prolonged elevated inflation will leave a permanent mark on inflation expectations. However, U.S. breakeven inflation pricing still implies that longer- run inflation expectations beyond the five-year horizon are still well-anchored around the Fed's inflation target. Central banks have not lost the inflation fight.

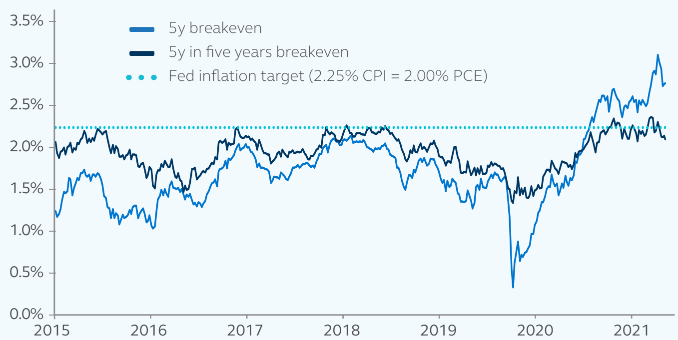
The Fed needs a long expansion, not a hot expansion

During the pandemic recovery, the Fed was focused on achieving maximum employment, aimed at a broader improvement in labor market conditions. But now, despite demand having recovered sharply, almost three million workers who left the labor force during the pandemic still have not returned. Increasingly, it has become apparent that a full labor market recovery requires a long expansion, not a hot expansion.

While the immediate inflation threat argues for a prompt response—thus rate hikes in 2022—achieving a full jobs market recovery also argues for a very gradual hiking cycle that doesn't bring a premature end to the expansion.

U.S. breakeven inflation

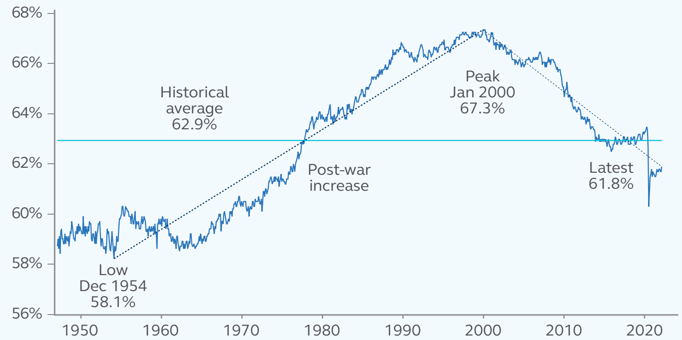
5-year breakeven and 5-year in five years breakeven, 2015 – present



Source: Bloomberg, Principal Global Asset Allocation. Data as of December 13, 2021.

Labor force participation rate

Percentage of the population working or actively seeking work divided by the working-age population, 1945 – present



Source: Clearnomics, Bureau of Labor Statistics, Principal Global Investors. Data as of December 3, 2021.

DO ELEVATED EQUITY VALUATIONS IMPLY AN IMMINENT MARKET CORRECTION?

Given historically lofty equity market valuations, as the recovery shifts to a slower gear, it's reasonable for investors to worry that a market correction is imminent. However, provided earnings growth remains solid and central bank tightening is gradual and measured, equity markets can continue to hit new highs in the period ahead.

After an almost relentless rally since April 2020, equity market valuations are at historically high levels and, for investors, alarm bells are ringing. While some pockets of value remain, by and large, most major global indices are trading at multiples significantly more than their 15-year average. In many markets, such as the S&P 500, valuations have rarely been more expensive.

Investor concern is perhaps understandable—long-term valuation signals are instructive. But in the short-term, valuations don't exhibit much predictive power. As seen in recent years, expensive markets can just become more expensive. Today's stretched valuations don't necessarily imply imminent correction—but the current bull market's sustainability does require a solid earnings trajectory to continue.

A solid, but weaker, earnings trajectory

For equity investors, expect a positive, but meaningfully slower, earnings profile in 2022. After swift recovery from the pandemic, not only is another reopening-driven surge in demand unlikely, but supply chain constraints and labor shortages are putting pressure on corporate margins. With peak earnings growth likely behind us, the slowdown means that equities will also require low and anchored bond yields to underpin stretched valuations.

An upward, but gentle, path for rates

Inflation is proving to be a bit more than transitory. As such, the outlook for interest rates is perhaps the part of the equities equation that concerns investors most. However, while the immediate inflation threat argues for a prompt start to policy rate lift-off, the United States Federal Reserve's additional focus on sustaining the economic expansion in order to achieve a broader improvement in labor market conditions means that investors shouldn't anticipate a very sharp hiking cycle.

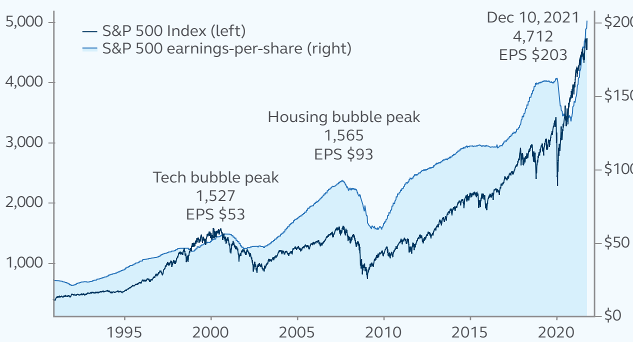
Compared to the 2004 to 2006 period when the Fed hiked rates 17 consecutive times, the 4-6 hikes we anticipate in 2022-23 will be a considerably more gentle tightening. As such, while rates are biased upwards, the path to higher bond yields will be neither sharp nor disruptive and should continue to support higher equity valuations.

Stocks aren't entirely immune to disappointment. Stretched valuations suggest that even small shocks have the potential to undermine equity markets. Amid a backdrop of prolonged supply chain disruptions, elevated inflation pressures, the first Fed rate hike since 2018, and China's wave of regulations and policy changes, equities will be more volatile in 2022.

However, provided earnings growth remains resilient and the Fed doesn't surprise with early and aggressive tightening, elevated valuations alone don't imply an imminent market correction.

The equity market and earnings

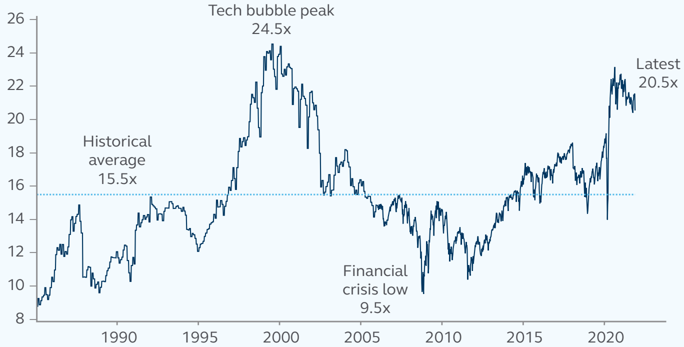
S&P 500 Index price and trailing earnings-per-share, 1990 - present



Source: Clearnomics, Principal Global Investors. Data as of December 10, 2021.

U.S. equity market valuations

S&P 500 forward P/E ratio using earnings estimates over the next twelve months, 1985 - present



Source: Clearnomics, Principal Global Investors. Data as of December 10, 2021.

IS CHINA STILL A VIABLE LONG-TERM INVESTMENT OPPORTUNITY?

Achieving long-term policy goals could prove prosperous for China. But its short-term growing pains can't be ignored, as investors adjust to new regulations and size up the extent of a policy regime shift.

By mid-2021, a solid growth recovery, aided by significant export strength, provided Chinese policymakers space to focus on structural issues and roll out waves of new regulations. Often hastily executed, these regulations damaged corporate profitability and valuations, resulting in the underperformance of Chinese stocks. Concerned that China is trending back to its communist roots, many global investors have reconsidered the long-term attractiveness of its assets.

While China's priority has clearly shifted from strong growth to greater income equality, these policy regime shifts should also help ensure more sustainable growth in the long-term.

Roadmap to long-term sustainable growth

The widely unpopular policy regime shifts in China are the result of the Chinese leadership's recognition that, as its population ages, the country's long-term growth drivers had to shift from labor expansion to productivity increases and capital deepening. The government rolled out supportive industrial policies and refinancing tools that rewarded innovation and green transformation. While intensified regulations did hurt some large digital platform companies' near-term outlook, the end goal was to encourage more competition and stimulate innovation across the industry.

In addition, Chinese government finally accepted that it's investment-driven growth model of the past two decades caused dangerous levels of leverage. To counter, amid a challenging international environment, consumption is becoming a more important growth pillar, focused on growing the middle class.

Short-term pain to last longer

China faces cyclical economic challenges in the year ahead. While the worst of the policy storm seems to have passed, and the country likely will make the regulatory tightening more institutionalized, there is no reversing the tight regulations. As such, disruption to the investment backdrop in China could linger throughout 2022.

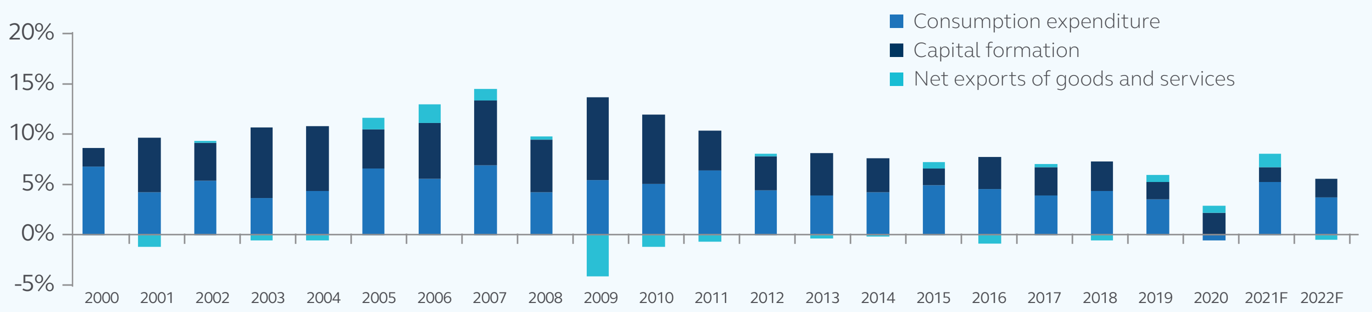
For example, as global demand peaks and trade flows back to emerging economies that have recovered from COVID-19 disruptions, Chinese export tailwinds may become headwinds. While policymakers would likely help ensure the economic slowdown doesn't threaten social stability, a full-blown dovish turn could reenergize leverage. Fine-tuned counter cyclical measures such as targeted relending by People's Bank of China and carryforward of unused fiscal quota are likely the preferred policy choices.

Long-term gains

Even in the face of this challenging environment, China's long-term attractiveness as an investment still stands. Over time, Chinese companies will find ways to reposition their strategies and improve earnings. In fact, current market stress could create a good entry point for long-term investors who can endure some volatility as China transitions its economy for the decades ahead.

Sources of Chinese GDP

Yearly, 2000 - present, 2021 and 2022 are forecasts



Source: Bloomberg, Principal Global Asset Allocation. 2021 and 2022 are PGAA forecasts. Data as of November 30, 2021.

HAS THE CURRENT ENVIRONMENT CHANGED HOW INVESTORS SHOULD APPROACH RETIREMENT PORTFOLIOS?

Last year, this outlook painted a resoundingly upbeat and optimistic picture of the investment environment ahead. Broadly, it was right. And while 2022 appears to be a bit more challenging, diversification and active asset allocation remain key to weathering market volatility and achieving retirement goals.

Over the past decade, the classic "60/40" portfolio (60% equities/40% fixed income) has been a widely utilized long-term allocation for retirement investors looking to earn stable growth and steady income. Amid a backdrop of strong economic growth, declining yields, low inflation, and negative correlations between traditional equities and fixed income, this strategy has traditionally generated robust returns for investors.

Today, with equity valuations at or near all-time highs, rates near all-time lows, and credit spreads near all-time tights, investors are seeking approaches to help protect their retirement accounts. With the current low-yield environment and inflation pressures, applying three core principles may improve the likelihood of a successful retirement.

"Diversification is the only free lunch"

Given current traditional equity and fixed-income valuations, and the increasing correlations between them, seeking exposure to alternative asset classes with the goal of maximizing diversification potential may allow for a more efficient portfolio—higher expected returns for equivalent risk levels or equivalent expected returns with lower risk levels. Furthermore, in the current environment of record low yields and surging inflation, including real assets such as infrastructure, real estate, natural resources, and commodities, can provide diversification through lower correlations to traditional asset classes. Additionally, real assets can offer greater inflation sensitivity and higher income potential.

Increasingly, institutional investors seek private asset classes such as farmland, timber, and commercial real estate within real assets, as well as private equity and private credit—attractive for their greater income potential and lower volatility. More recently, these less liquid asset classes are available to retail investors through various structures, allowing for further diversification benefits. This "modernization" of the "60/40" has increased the prominence of "55/35/10" or "50/30/20" portfolios.

Active asset allocation

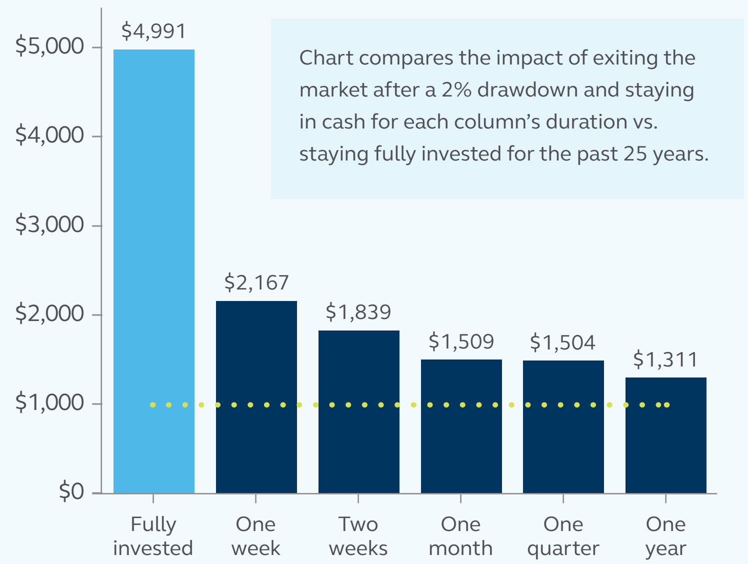
Even with stretched valuations, solid economic fundamentals, strong corporate balance sheets and bolstered household savings should be supportive of risk assets. However, in an environment dominated by unprecedented macro events (global pandemic, record-setting inflation, climate change, etc.), the nuances of investing across different asset classes, regions, sectors and styles, are ever more important to drive returns. For long-term investors, remaining nimble in asset allocation decisions can help to avoid some of today's risks, while taking advantage of opportunities.

Time IN the market, not TIMING the market

Over the past 25 years, investors who exited the market the day after a 2% drawdown have been rarely rewarded. Now, it's ever more crucial for retirement investors to stay invested during times of market volatility—this continues to remain key to generating successful retirement outcomes.

Effect of exiting the market the day after a 2% drawdown, last 25 years

Based on an initial $1,000 investment using S&P 500 returns before transaction costs



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