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Fitch Solutions Global Macro Key Themes For 2022: Mid-Year Review

17 Jun 2022 | Global | Economy

In November 2021, we outlined some of our key themes for 2022. As we reach the mid-point of 2022, we take this opportunity to assess how well our themes have played out. On aggregate, several of our views have been playing out as we expected, but we also got some of them wrong. The global outlook has become even more complex than we originally expected, particularly as Russia's invasion of Ukraine has intensified inflation, monetary tightening and global economic uncertainty. Below, we assess how our 10 key themes have fared thus far in 2022.

HIT OR MISS? 10 KEY GLOBAL THEMES FOR 2022

Theme	Hit Or Miss?	Thoughts
Almost Full Economic Normalisation And Covid-19 Policy Pivot	Hit	Most economies are now treating Covid-19 as endemic and have re-opened their economies. The key exception that we identified was Mainland China, which remains committed to its dynamic zero-covid policy.
Another Year Of Above-Trend Growth, But A Cyclical Slowdown Nonetheless	Mixed/miss	The global economy is seeing a sharp cyclical slowdown from 2021, but it is slowing much more quickly than we expected given multiple headwinds. Our forecast for global growth stands at 3.0%, which is below the pre-pandemic trend of 3.1%.
Tourism Will See An Uneven Recovery	Hit	Developed and emerging markets are opening up their tourism sectors, but this is uneven globally, with Asia lagging behind significantly.
Inflation Will Peak As Rebalancing Occurs	Too early to tell	Inflation has not yet peaked, and it is stickier than we expected. We expect it to peak in H222 and only slowly come down. The rebalancing story has also been slow, but we are seeing a steady pick-up in demand for services.

Source: Fitch Solutions

Developed Markets Will Start To Tighten Policy, But Not As Much As Rate Markets Suggest	Mixed/miss	We underestimated the pace of hikes in 2022. Not only were we more dovish than the market, but the markets have also become significantly more hawkish in recent months, as inflation remains elevated.
A Tough Landscape For Emerging Market Policymakers	Hit	Emerging markets are facing several challenges including rising food and energy cost pressures, slowing growth as monetary policy tightens, political risk due to election cycles, as well as external pressures as the dollar strengthens. As a result, some economies are facing balance of payments stresses. Moreover, Chinese policymakers are in a very difficult spot as they try to balance their zero-Covid policy with growth.
Financial Markets Not A One-Way Bet In 2022	Hit	Financial markets have been under substantial pressure in 2022, with global equity, bond and currency markets all selling off in unison. As of mid-June, the US equity market was officially in a bear market, having lost 20% of its value since the start of the year.
Rising Polarisation And Divergent Reform Momentum	Hit	In 2022, we are seeing evidence of political polarisation as voters move away from the centre. At the same time, fiscal consolidation will be slow given the decision by policymakers to provide greater subsidies to offset the burden of rising fuel and food costs.
Old Opportunities And Risks In Geopolitics	Mixed/too early to tell	We believe the Iran nuclear deal will be agreed on, although downside risks to this view have become more pronounced. At the same time, tensions between the US and China have remained stable as the US focuses more on Ukraine.
Risks Will Remain Top Of Mind	Hit	We believed that 2022 would be a year with significant risks. While we did not anticipate Russia's invasion of Ukraine, we had flagged the risks of a hard landing in China, as well as the risks that inflationary pressures might require a much more aggressive response by central banks. Risks of new Covid variants have not yet been significant.

Source: Fitch Solutions

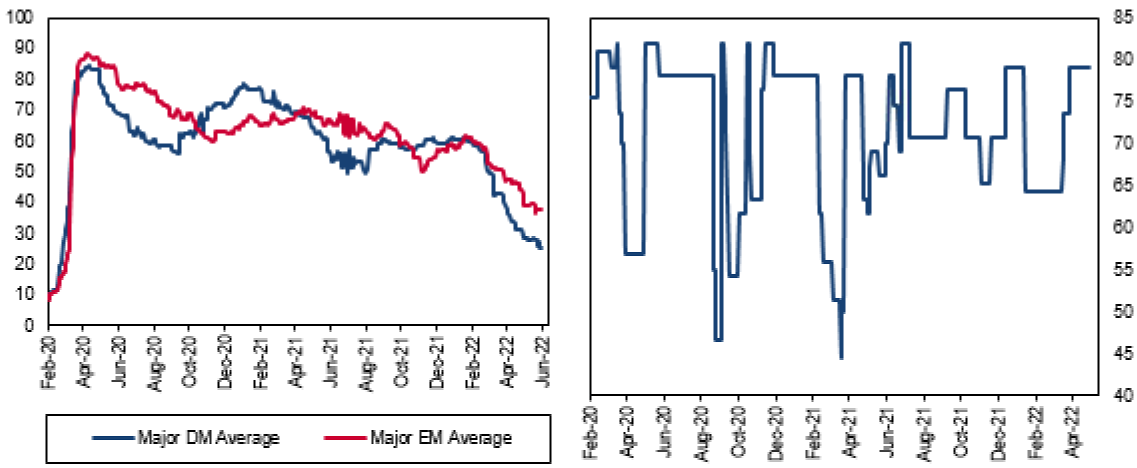
1. Almost Full Economic Normalisation And Covid-19 Policy Pivot

What we said: *'Our Pharmaceuticals & Healthcare team expects the risks from Covid-19 to diminish over the coming quarters, which will allow many developed markets (DMs) and most emerging markets (EMs) to return to 'normal' by mid-2022... However, there are nuances to this view. First, EMs in Africa will continue to lag behind in terms of vaccinations and will thus take longer to normalise... Second, countries that rely on less effective vaccines will take longer to open up fully. A case in point is China.'*

As of June 2022, Covid-19 vaccination rates are now extremely elevated across the world, and as a result, most countries have reduced the number of restrictions across their economies. Indeed, the average stringency of restrictions has dropped rapidly to about 25 for DMs and 37 for EMs. That said, restrictions remain in place across several economies, most notably China, which has adopted a dynamic zero-Covid policy, and continues to implement rolling lockdowns and mass testing in major cities such as Shanghai, Shenzhen and Beijing in response to new outbreaks.

Economies Returning To Normal, With Exceptions

Global - Stringency Index Averages (LHC) & China (RHC)



Source: Our World in Data, Bloomberg, Fitch Solutions

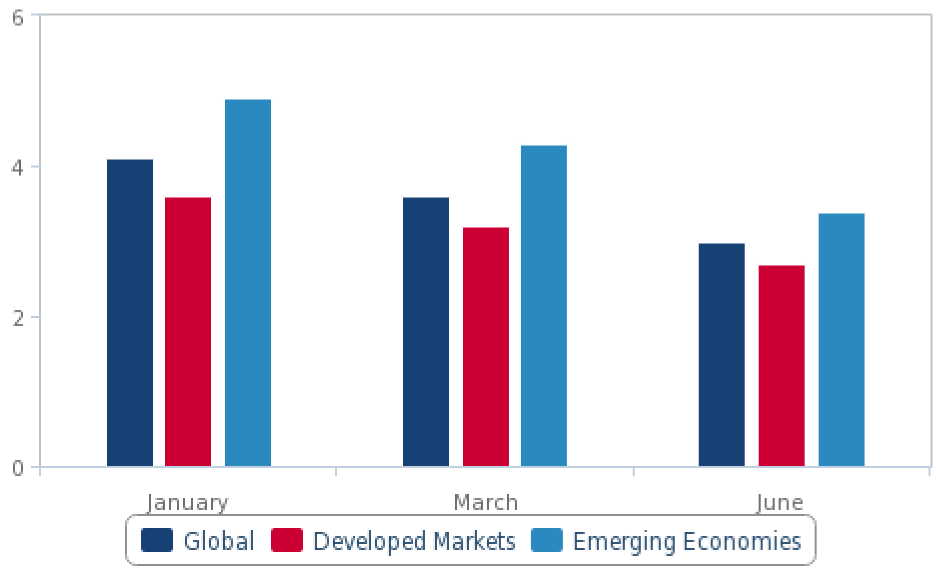
2. Another Year Of Above-Trend Growth, But A Cyclical Slowdown Nonetheless

What we said: *'We forecast that the global economy will grow by 4.1% in 2022, well above the 3.1% average recorded between 2015 and 2019. This still marks a significant cyclical slowdown from the 5.5% we estimate for 2021.'*

Our global growth forecast has now fallen to 3.0% as a combination of headwinds including uncertainty from Russia's invasion of Ukraine, tightening monetary policy, global financial market volatility and lockdowns in China have weighed on growth. Our latest forecasts assume a cyclical slowdown from 2021, but a much faster deceleration in economic activity than we originally expected (4.1%), and suggest that growth will no longer come in above-trend in 2022, particularly as we note slight downside risks to this forecast. Moreover, consensus estimates for growth in 2022 have also been easing since they peaked in late 2021, while financial markets are increasingly becoming concerned about the risk of a recession in the US this year. While this is not our core view, we believe that there is about a 30%-40% probability of a recession in the next 12-18 months.

Global Growth Forecasts Continue To Ease

Global - Real GDP Growth, % (January, March & June 2022)



Source: Bloomberg, Fitch Solutions

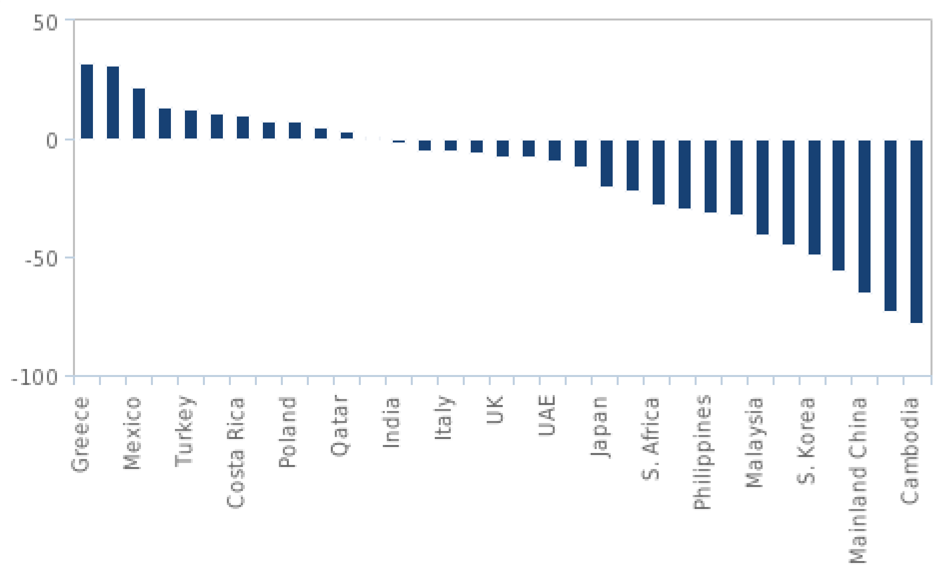
3. Tourism Will See An Uneven Recovery

What we said: *'We expect that most Western consumers' willingness to travel will rise in 2022 as household balance sheets remain strong and as restrictions continue to ease, but we also expect that demand will be focused on short-haul destinations. This will benefit markets in the Caribbean and Southern Europe. In contrast, a slower vaccine rollout across Asia and tight travel restrictions in China as a result of its zero-Covid policy will depress visits to Asian destinations.'*

As of June 2022, the number of flights are close to, or have exceeded levels seen in 2019 in most DMs as well as several EMs. That said, flight numbers in most of Asia remained far below their pre-pandemic levels. In many economies in Asia, flight numbers were about 60% lower than over the same period in 2019. The performance of economies in the Middle East and North Africa and Sub-Saharan Africa was mixed. While we expect that the global tourism market will continue to recover through H222, we note that Asia will continue to lag behind other regions as its economies are slower to normalise.

Some Tourism Sectors Recovering Faster Than Others

Global - Number Of Flights Relative To Same Period In 2019, %



Source: Airportia, Fitch Solutions

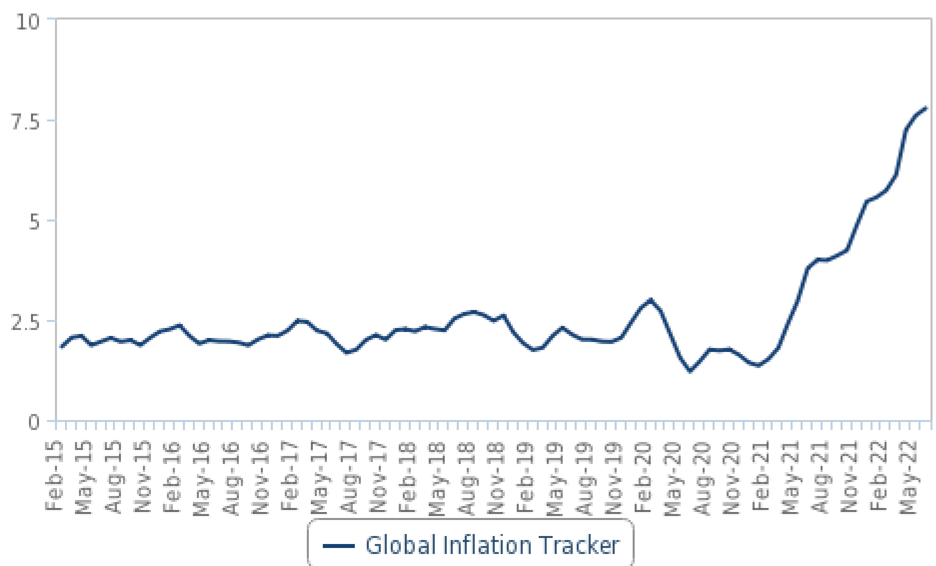
4. Inflation Will Peak As Rebalancing Occurs

What we said: *'As the global economy loses steam and base effects work in reverse, we believe that inflationary pressures will start easing towards central bank target levels in H222, although we note that there will most likely be a slower pace of deceleration than we initially expected.'*

Inflation continues to rise globally (*see chart below*), but we believe that it will peak at some point in Q322. That said, inflation has risen to higher levels than we originally expected and has remained stickier than anticipated, which suggests that the path towards central bank targets will be slower than we originally expected. From a supply side perspective, inflationary pressures have been exacerbated by the sharp rally in commodity prices as a result of Russia's invasion of Ukraine, and reduced Chinese exports due to the lockdowns in China. Moreover, we highlight that the rebalancing story has also been slow to play out, although it has started. Personal consumption of goods remains above trend, particularly in the US, but demand for services is starting to pick up more significantly as well, as economies continue to re-open. As a result, we have seen a sharp rise in restaurant, event and travel activity since the start of 2022, and we expect this trend to continue.

Inflation Keeps Rising

Global - Inflation Index, % y-o-y



Source: Bloomberg, Fitch Solutions

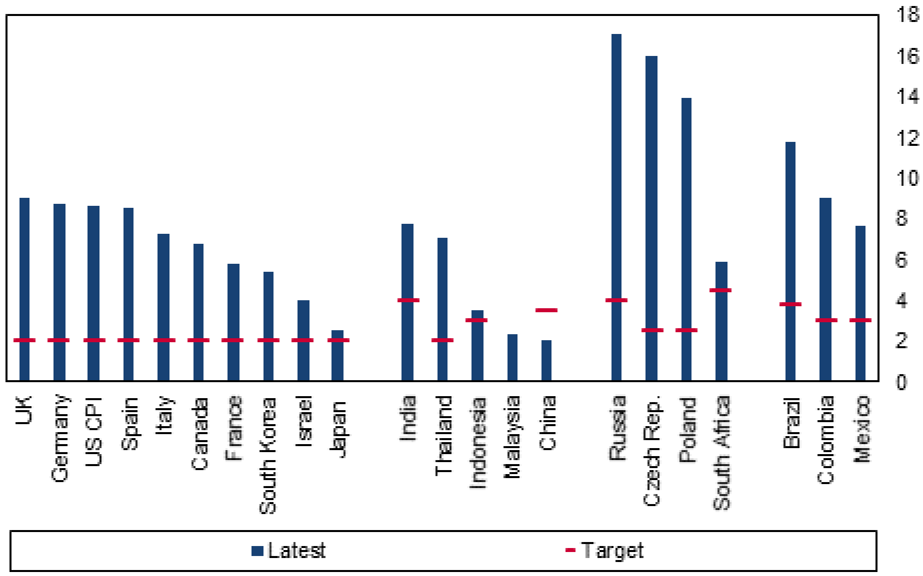
5. Developed Markets Will Start To Tighten Policy, But Not As Much As Rate Markets Suggest

What we said: *'We have long argued that EM policymakers would begin to normalise monetary policy in 2021 and that DMs would follow suit in 2022... Given our expectations for inflation to start coming down in Q222, we do not believe that central banks will hike interest rates as aggressively as markets are pricing in.'*

DMs have tightened policy in 2022; however, the pace of hikes have been more aggressive than we or the market was expecting at the end of 2021. Indeed, at the time of writing, the futures market is pricing interest rates to be 4.1% in the US and 1.6% the eurozone. While the market might be overestimating the pace of hikes, it is clear that we underestimated the pace of hikes for 2022, while at the same time, the market has led central banks on a more hawkish path than they initially anticipated.

Global Inflation Continues To Be A Major Problem For Central Banks

Global - Inflation Vs Central Bank Mid-Target



Source: Bloomberg, Fitch Solutions

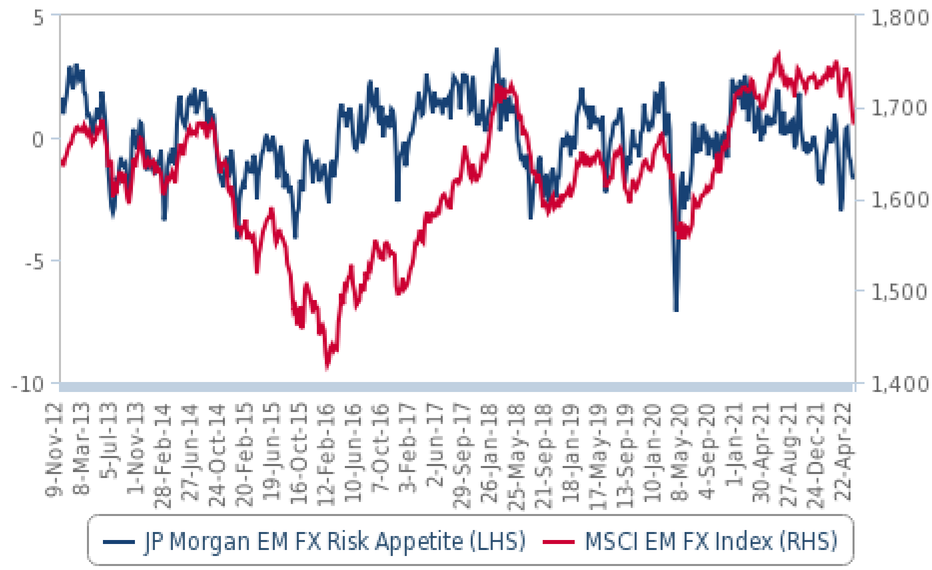
6. A Tough Landscape For EM Policymakers

What we said: *'The macroeconomic environment will remain challenging for EM policymakers in 2022. First, inflation will still be above target in many cases. Several central banks have already hiked interest rates aggressively in 2021, which will drag on growth going into the coming year... At the same time, tapering by the US Federal Reserve and interest rate hikes in 2022 could cause some volatility for EMs... Second, there is the risk that election cycles could result in a shift in the political discourse towards more generous populist economic policies, particularly in Brazil, Colombia and Kenya... Third, China faces yet another set of policy challenges. Beijing has cracked down heavily on multiple industries in order to assert greater control over the economy, rein in the power of tech giants and reduce foreign influence in the education sector. We expect this focus on strengthening government oversight to intensify ahead of the 20th Party Congress in Q422.'*

As inflation has surprised to the upside, many central banks across EMs have been forced to hike by more than they initially expected. For example, the Banco Central do Brasil has hiked by 350 basis points (bps) since the start of 2022, while the National Bank of Poland has also hiked by 425bps over the same period. Moreover, financial market volatility as a result of multiple headwinds has caused currency volatility for EMs, and combined with rising grain and energy prices, has led to a sharp rise in imported food and energy costs. The combination of rising imports and slowing growth has hit several economies hard, with Sri Lanka experiencing a balance of payments crisis, and Pakistan looking vulnerable. At the same time, investors have become more cautious towards Ghana, given the sharp rise in inflation and the widening fiscal deficit.

Emerging Markets Facing Currency Volatility

EM - FX Risk Index & Currency Index



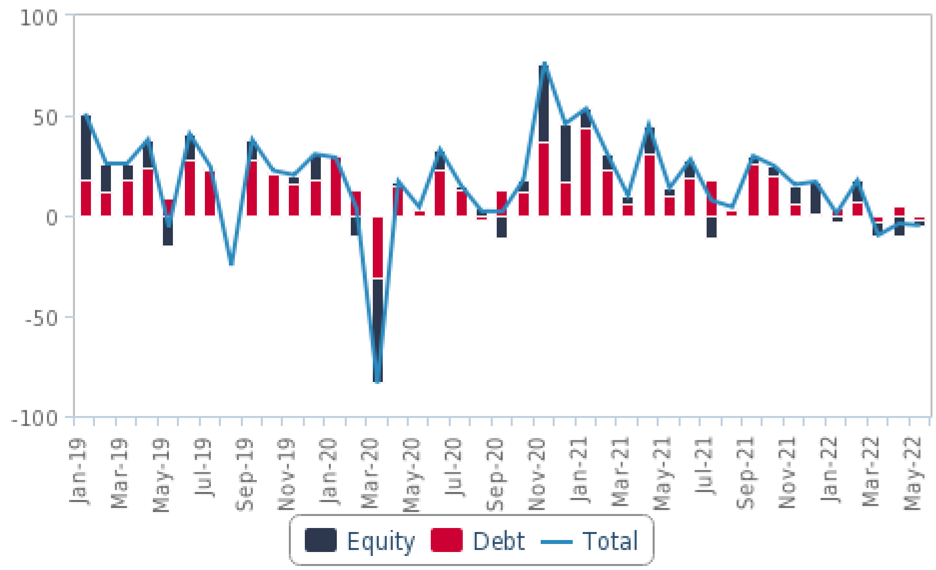
Source: Bloomberg, Fitch Solutions

Although most major elections thus far in 2022 – including in France, Hungary and the Philippines – have been won by incumbents or the ruling bloc, in the case of France, the anti-establishment candidates significantly increased their vote share from 2017. Elsewhere, economic adversities prompted political shifts in South Korea (to the centre-right) and Australia (to the centre-left) following their elections. In Colombia, the anti-establishment left-wing candidate prevailed in the first round of the presidential election on May 29 2022, and while he is likely to be defeated in the June 19 run-off, events there underscore public discontent with establishment candidates, given that the likely victor is also a populist. In H222, Brazil's presidential election in October-November will be a contest between the populist right-wing incumbent Jair Bolsonaro and left-wing former president Lula da Silva, and we anticipate that the latter will win and shift Brazil's economic policies towards a more interventionist stance.

Chinese policymakers are facing a tough set of challenges. First, their dynamic zero-Covid policy has resulted in a sharp slowdown in growth, which means that they will miss their 2022 real GDP growth target of 5.5%. In addition, there have been sporadic incidences of minor unrest in response to the lockdowns, which were severe in Shanghai and Shenzhen. Moreover, risks to the real estate sector remain large and have not been fully resolved, with credit markets still pointing to significant stress for the sector. Lastly, while it is broadly expected that President Xi Jinping will be reappointed for a third term, we believe that there could be some policy uncertainty ahead of the 20th Communist Party of China Congress, which will take place in Q422.

Outflows From EMs But Outflows Continue

EMs - Net Capital Inflows, USDbn



Source: IIF, Fitch Solutions

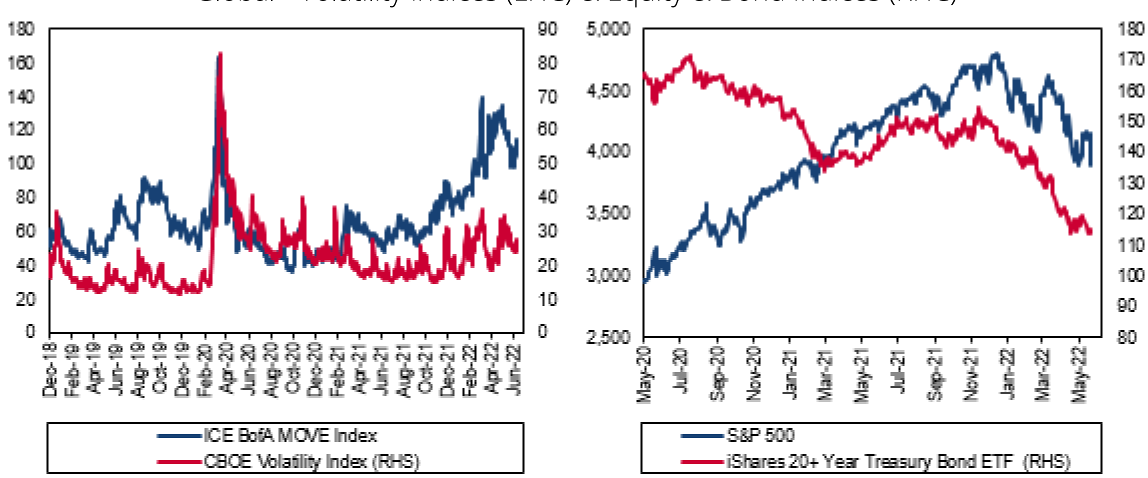
7. Financial Markets Not A One-Way Bet In 2022

What we said: *'We believe that financial markets will face a greater set of challenges as the economic cycle matures and new risks emerge. These include much higher uncertainty regarding the trajectory of monetary policy, rich valuations, slowing economic and earnings growth, as well as political risk emanating from the US midterm elections in November 2022. US equity markets were notably less volatile in 2021 than in recent years, so even a return to the pre-crisis level of volatility could come as a shock.'*

Financial market volatility has been a dominant theme since the start of 2022, with a sell-off in most assets. Indeed, bonds, currencies and equities have all sold off at the same time, which has resulted in significant losses and volatility for investors. We expect continued market volatility as long as inflation remains elevated and central banks maintain a hawkish bias. Moreover, the risks are skewed to the downside as central banks around the world may have to raise interest rates to a level that results in a sharp slowdown, and even recession in certain economies. This, in turn, would lead to greater financial market volatility. In addition, the US midterm elections in November 2022 could also see a rise in financial market volatility, given the likelihood of greater policy deadlock as Republicans could secure a majority in the House and Senate.

Markets Experiencing A Sharp Rise In Volatility

Global - Volatility Indices (LHC) & Equity & Bond Indices (RHC)



Source: Bloomberg, Fitch Solutions

8. Rising Polarisation And Divergent Reform Momentum

What we said: *'In 2022, several elections will take place in a polarised political environment due to uneven economic recoveries, at times exacerbated by elevated levels of corruption and wealth inequality. Moreover, given the uneven economic recoveries, many governments will focus on short-term measures to boost growth, which means that reform momentum will remain slow and patchy in EMs... A polarised political environment will most likely strengthen anti-establishment sentiment in many markets, boosting support for new and/or fringe parties.'*

Polarisation has increased amid economic dissatisfaction, and political pressures ahead of elections in Europe have led governments with some fiscal space to increase social spending. In DMs, such moves have either fallen short of opposition demands (such as in France) or faced criticism for overly high borrowing (such as in Germany and the US). This dissatisfaction has affected election outcomes, most recently in France, where both far-left and far-right parties appear set to make large gains in the French legislative election on June 12 and 19, complicating policymaking. In EMs where governments were unable or unwilling to spend more, such as Brazil and Nigeria, policymaking has stalled as key political actors position themselves ahead of general elections in Q422 and Q123 respectively. Slower policymaking has reduced reform momentum, while greater social spending has led to multiple reform initiatives being watered down and/or postponed. Overall, economic drivers of political polarisation remain unresolved and will likely continue to drive political risk in the longer term.

Russia's invasion of Ukraine and its impact on energy and food prices have exacerbated this polarisation, with governments coming under pressure to relax the pace of fiscal consolidation. Over the longer term, the disruption of virtually all supply chains passing through Russia will further complicate decarbonisation and sustainability initiatives, potentially adding to political discord over climate change. The need to lower energy prices has already derailed a proposed reform of the EU carbon market, which implies delays to other initiatives, such as the bloc's proposed carbon border adjustment mechanism.

Election Cycles Will Shape Policy In Turkey, Argentina And Elsewhere

Selected Countries - Political Pressures For More Fiscal Spending (Higher placement=higher pressure)

	Pressure due to elections / events	Misery Index	Debt Service Costs (%GDP)	Event details
Turkey	High	76.4	2.9	General election, by June 2023
Argentina	Moderate-High	64.3	1.6	General election, 2023
Italy	Moderate-High	14.8	2.9	Legislative election, by June 2023
Brazil	High	21.4	6.7	General election, October 2022
South Africa	Moderate	40.3	4.6	ANC Party Conference, December 2022
Spain	Moderate-High	18.2	1.8	Legislative election, December 2023
Nigeria	High	25.2	1.8	Presidential election, February 2023
Kenya	High	11.6	4.5	General election, August 2022
France	Moderate	12.2	0.8	Legislative election, June 2022
Chile	Moderate-High	16.7	0.6	Constitutional referendum, September 2022
Pakistan	Moderate-High	17.3	5.8	General election, by May 2023
Tunisia	Moderate	27.3	3.6	Constitutional referendum (July 2022), Legislative elections (by December 2022)
Colombia	Moderate-High	19.1	3.0	Presidential election, June 2022
Poland	Moderate	16.8	1.0	Legislative election, by November 2023
US	Moderate-High	10.2	1.3	Mid-term elections, November 2022
Sweden	Moderate-Low	12.6	0.1	Legislative election, September 2022
UK	Moderate	11.4	1.0	Local elections, May 2023
Mexico	Moderate-Low	11.3	3.4	General election, 2024
Japan	Moderate	4.0	0.3	Upper house election, July 2022
Sri Lanka	Moderate-High	22.6	6.8	Presidential election, by 2024
Egypt	Moderate-Low	20.6	8.0	Presidential election, 2024
China	Moderate	7.8	0.9	CPC Party Congress, October 2022
Thailand	Moderate	6.3	0.8	Legislative election, March 2023

Source: Bloomberg, Fitch Solutions

9. Old Opportunities And Risks In Geopolitics

What we said: *'We expect that two major geopolitical relationships will dominate the headlines in 2022. Positively, we expect the US and Iran to once again sign a nuclear deal. Less positively, we expect US-China relations to deteriorate ahead of the US midterms and China's 20th Party Congress in Q422.'*

We still anticipate that the US and Iran will return to the nuclear deal (Joint Comprehensive Plan of Action) in the first half of the current Iranian calendar year (running from March 2022-March 2023), but we see growing downside risks to this view, given that the negotiations have hit obstacles, most notably the US' reluctance to remove the 'terrorist organisation' designation of Iran's powerful Islamic Revolutionary Guards Corps. We also see a risk that President Joe Biden will be less able to focus on talks with Iran as the midterms approach.

While US-China relations have not deteriorated significantly, they have remained lukewarm at best. Russia's unexpected invasion of Ukraine has forced the US to focus on Eastern European security, which means that US-China relations have temporarily taken a slight back seat. While President Biden has attempted to shift his attention to the Indo-Pacific region, we believe that the severity of the Ukraine conflict will keep his focus on Russia. We thus anticipate that US-China relations will remain in a holding pattern over the course of 2022, so long as China does not undertake any major steps to support Russia economically or militarily, or increase pressure on its neighbours over their territorial disputes.

10. Risks Will Remain Top Of Mind

What we said: *'Our final theme highlights several important downside risks for the world economy in 2022. First, credit stress from the property sector in China could spread to the wider economy and result in a sharper economic slowdown than we are currently anticipating. Combined with the potential for more Covid-19 outbreaks, the sector could even prompt a 'hard landing'. Second, there is a risk that, rather than easing as we expect, price pressures could remain strong for the duration of 2022. This could prompt a more aggressive tightening cycle, resulting in a significant re-pricing of markets, causing volatility and depressing growth as investors and consumers retrench, particularly for EMs. Third, we should not discount the risk of new Covid-19 variants, particularly as large sections of the global population remain unvaccinated.'*

Despite expecting a strong recovery, we still believed that the global economy would face significant risks. However, it is our view that the global economy has experienced enough risks to last several years, despite being only six months into 2022 at the time of writing. Although we did not anticipate Russia's invasion of Ukraine, China's economy is experiencing a sharp slowdown as the lockdowns weigh heavily on growth. Indeed, our newly revised forecast of 3.6% in China is well below the government's target of 5.5% and suggests that China will likely see a 'hard landing' of sorts. Second, sticky inflation has resulted in a more aggressive stance by central banks, which has led to higher levels of volatility than we were originally expecting and poses significant downside risks to growth. In contrast to our expectations, thus far, there have been few risks from new Covid-19 variants.