# Market Letter

Fourth Quarter 2021

***Cautious in the short-term, but optimistic beyond Q1. Regime change underway: 2022 a year of transition. The Great Moderation is over. A world with less central bank support.***

Early data shows that 2021 ended on a positive note with **output** continuing to expand. Sentiment, however, is not upbeat. Businesses are understandably worried about Omicron and renewed Covid restrictions leading to moderation in demand, alongside persistent supply related issues. The global inflation shock could last longer than initially expected but will likely be addressed differently across regions.

- The growth bounce following reopening after lockdowns was anticipated, but the inflation surge was a surprise. Even though the recovery remains far from complete, global consumer prices are approaching their fastest increase of the past quarter century. Earlier in 2021 rising inflation was linked to a surge in goods demand, while recent price pressures largely reflect higher energy prices and persistent industry and transportation bottlenecks. With vaccination programs likely to reach their targeted levels by Q2 and macro policies staying largely accommodative, economic losses from Covid waves should continue to decline going forward.

- With these supply shocks, accompanied by a new wave of infections, global expansion is in the midst of its first resiliency test. This test should be overcome and growth sustained in the coming quarters.

- The global business cycle is in consolidation. Massive fiscal and monetary counteraction prevented damage to private household and corporate balance sheets. In light of the COVID-19 pandemic, many central banks have supported their banking sectors in the form of term funding facilities, covered bond purchases programs, and temporary extensions of the list of eligible collateral for central bank repo transactions.


- For 2021, the recovery was uneven, incomplete, and often interrupted by new virus outbreaks and scares. 2022, on the other hand, should mark the end of the pandemic and a return to "normal". This should be achieved by reaching massive population immunity along with the help of human ingenuity, such as the anticipated availability of new therapeutics. This should produce a strong cyclical recovery, return of global mobility, and strong growth in consumer and corporate spending, within the backdrop of still-easy monetary policy.

- 2022 will likely be characterized by **transition**, barring the Omicron variant causing another widespread economic shutdown: The world economy will transition from the recovery boom phase back toward a more normalized rate of growth. Fed policy will transition from hyper-stimulative settings to monetary tightening, while the People's Bank of China is going from monetary austerity to renewed easing. The stability-oriented macro policies and reduced macroeconomic risk of the past few decades known as Great Moderation, which was characterized by low inflation, macro volatility, and massive returns to investors is likely over. The "Washington Consensus" was founded on the principles that policymakers should pursue macroeconomic stability by promoting low and stable inflation as well as budget deficits. Central banks were very successful in controlling inflation, expanding the life span of business cycles and, until the 2008/2009 Global Financial Crisis, keeping recessions shallow. Market opening led to a huge rise in trade that pulled many EM's out of poverty. Deregulation, free trade, and economic stability were each expected to boost economic growth. In DM economies, however, growth slowed during this period, while income and wealth inequality worsened dramatically. Dissatisfaction with weaker DM growth and worsened inequality of the last 2-3 decades are prime drivers for the pursuit of faster growth. Policy frameworks for most EM countries are not changing fundamentally, but China's policy regime is also responding to increased inequality by lowering the importance of GDP growth and balancing it out with Common Prosperity policies. Greater **macro volatility** should raise risk premia depressing asset prices, but will not affect total nominal return over the next decade as higher inflation boosts asset income. Real returns over 10 years will be proportionally lower. The return to active management, such as pursued by hedge funds, should improve over time.

- EM policymakers have not shown any intention to fundamentally alter their policy frameworks, beyond adapting to changing policies by DM countries, in particular by the US. However, ongoing asset purchases by central banks are a regime change that is here to stay and with no exit strategy, including by EM central banks. The hope is that the threshold for central banks to take action should be moved further out rather than eliminated.

- Widespread reports of the **dollar's** death in 2021 turn out to have been exaggerated. A bumpier global recovery, US economic exceptionalism that fed into rate support, and a more responsive Fed were all components of what actually turned out to be a strong year for the dollar.

- The Federal Reserve is likely to start to raise **interest rates** by the 2nd quarter, while it could take up to the end of 2023 for the European Central Bank to be fully prepared to raise them. Emerging market central banks have already started to hike rates and most of these policy actions will mature in 2022. Real yields will move up in 2022, pushing nominal rates higher as well. The long end of the curve should be more anchored in the process, which may flatten the term structure of interest rates. **Excess liquidity** is distorting financial market signals. Markets are indeed pushing short-term interest rates up in expectation of the imminent rate-hiking cycle by advanced economy central banks. At the same time, they are holding down long-term interest rates. Normally, this would imply markets expect both long-term inflation and growth to remain subdued. And judging by inflation break-even rates, they indeed appear to be expecting inflation to come under control. Interbank interest rate spreads have crept up in the past two months in anticipation of rate hikes, whereas bank excess reserves remain extremely high.

- **Normalization**, but not as we know it. The pandemic, high inflation, and the very unusual behavior of labor markets are among the challenges facing major central banks as they start to normalize policy adding to the trepidation in large parts of EM. Supply chain bottlenecks, higher energy and food prices, surging consumer demand, and higher wages have combined to send inflation in the US and Europe to multi-decade highs. A year ago, the assumption was that inflation was "transitory", but now the Fed chairman has suggested it might be a good time to retire the word. Labor markets have also changed since the pandemic with many advanced economies facing worker shortages and low labor market participation.

- So far Omicron appears far less severe than any of the prior waves. A study comparing **Omicron** to previous variants in the first 25 days showed that Omicron was far less fatal. The fatality rate is lower irrespective of age. Don't expect the CDC to spread this good news. The Omicron wave in South Africa has resulted in a record spike in cases to a new high, but COVID deaths have barely increased. England has experienced a surge in COVID cases that is twice as high as January 2021 but COVID deaths are down 92% from January 2021. Clearly there is a difference in how Omicron invades the body compared to the Delta variant that explains why Omicron is less severe. A University of Hong Kong study found that Omicron is less than one-tenth as infective in lung cells compared with the Delta variant. This may explain why Omicron patients report far fewer cough and fever symptoms. Instead, they report common cold-symptoms, similar to the four known seasonal coronaviruses that have circulated for decades. It is early yet but this data is very encouraging. Cases and hospitalizations in the US are going to continue to climb due to Delta and Omicron. If the data from South Africa holds up, concern about Omicron in the US may be overblown. The stock market would breathe a sigh of relief if true.

- The social consequences of the pandemic in Latin America have polarized political debate during a busy electoral calendar (Chile and Brazil). **Inflation** in EM was visible early in the cycle. Many started raising rates early in 2021 and are continuing to tighten monetary policy to preserve the hard-won credibility in inflation targeting. This is critical for current account deficit countries that rely on foreign capital to finance their external imbalances. Central European countries started late but are now accelerating the **tightening**. The trend is now starting in Asia, with the exception of China. This has less to do with the trend in consumer prices than financial stability concerns, such as in South Korea. The good news is that the largest CADs have improved by a couple of percentage points in GDP terms over the past two years. For commodity exporters, the improvement in terms of trade contributed to the CA improvement, others benefited from the pandemic-induced weakness in domestic demand. The other good news is that the rise in nominal GDP has largely limited the deterioration of the indebtedness ratio (government debt on GDP). This helped to stabilize sovereign ratings despite wider fiscal deficits. US rate tightening and the US dollar's trend are important for the external debt of EM countries. So far, the rise of the US dollar in 2021 has been manageable, because it started from a very low base. Should the Fed be late in raising interest rates (or inflation be too high versus current projections), they will have no choice but to accelerate their policy rate adjustment.

- <u>Supply-chain pressures continue to bite, with the Omicron variant a significant near-term downside risk. The recovery in global industrial production will gain considerable momentum later in the year as component shortages and cost pressures ease and will once again lead growth into the medium-term. Lingering semiconductor shortages and supply chain disruptions means the recovery will be gradual. Shipping disruptions are expected to ease over the course of the year. As labor supply problems throughout logistics supply chains abate and shortages in warehousing space are addressed, seaborne freight looks set to recover in H2 2022. High-tech manufacturing will continue to lead growth in both advanced and emerging economies, as industries move towards greater digitalization and automation.</u>

- **EM current accounts** will continue to unwind their crisis-year improvements, but EM external vulnerability is not a 2013-type risk. An easing terms of trade boost for commodity exporters and recovery in domestic demand (especially investment) for the others should push the number of EM CAs (e.g. India, Indonesia, Philippines, SA, Thailand, CEE and Peru) into deficit over 2021-22. However, the high-yielders should still maintain deficits below pre-pandemic and 2013 levels. The rise in EM policy rates well ahead of the Fed's expected liftoff in 2Q22 should help mitigate financial stability concerns except where country risks are acute. Moreover, EM excess savings remain above the 2015-19 average through 2023, suggesting the EM private sector can fund a much stronger increase in domestic demand (especially investment) without exerting pressures on domestic bond yields or CA balances. <u>With economies dependent on bond purchases from the developed world, their wiggle room is much more limited. And the U.S. advantage from its Treasury market and global reserve currency, described 50 years ago by French president Valery Giscard D'Estaing as "exorbitant privilege," is now even more exorbitant. The U.S. can set rates four whole percentage points below the core inflation rate and get away with it. Turkey can't. And neither can anyone else in the emerging world. This explains why emerging markets are in trouble and shines a light on just how privileged the U.S. has become.</u>

- Regime change in the transition to the ESG world is facing a test with the first energy crisis of the decarbonization era. COP26 ambitions are facing an implementation gap as fossil fuels remain the key source of supply through the decade while hurdles to switching to clean energy remain. The pandemic has brought increased demand for alternative assets and record retail flows, and transformed market structure, while liquidity in traditional markets has declined even as central banks have massively expanded asset purchases.

## Global Drivers

- ***Global growth:*** *global growth remains above trend given the magnitude of stimulus.*

The ten-to-two-year bond yield spread, a traditional financial predictor of the business cycle, has retreated substantially in the past couple of months, raising concerns over a substantial growth slowdown.

The world economy remains regionally out of sync today: the U.S. economic recovery has been the strongest among the G7, and the U.S. output gap is closing quickly. Economic activity in both Europe and Japan is still far below potential. The Chinese economy was the first to fall into the pandemic-induced recession, but also the first to recover. Nonetheless, since the beginning of this year, China has been growing much more slowly than its historical trend. Regardless, the strongest thrust of the economic recovery is already behind most major economic blocks. This means that after the reopening surge, growth in each region will now resettle back to pre-pandemic highs. The cyclical backdrop for emerging world economies, excluding China, will continue to be heterogeneous. Many EM countries deployed significantly less fiscal and monetary support for their economies compared with most G7 nations, but EM economies and financial markets were hit much harder than their high-income counterparts. Mexico only spent 2% of GDP supporting its economy, but the MXN dropped 25% between February and April of 2020. This has stoked inflation, forcing the central bank to raise rates. The story for Brazil is an acute case of a government being forced to pay back pandemic stimulus largesse. President Jair Bolsonaro doled out subsidies equivalent to 10% of Brazil's GDP to shore up the economy and political support. Asian governments needed less fiscal stimulus. Moreover, Asian economies have larger cumulative assets, having run sustained current account surpluses over the years, endowing those governments with a higher cushion of much-needed resources. Overall, the Latin American economic recovery will likely resume on renewed currency market stability and falling inflation in 2022, while Asia will continue to normalize on the back of export-led economic growth, as the rest of the world economy moves back to a more normal state. The global manufacturing PMI is already rolling over, along with world industrial production. This confirms that the world economy will likely transition from a recovery boom to a more normal, much-reduced rate of growth in 2022.

- ***Monetary policy outlook:*** *the hiking cycle is already in motion as inflation pressures have led many central banks to hike policy rates. US Core inflation to stabilize this quarter with both headline and core CPI rising at a still-elevated 3.5%ar. A more hawkish message delivered as FOMC projects four 25bp rate hikes in 2022, plus three more in 2023.*

Rapid labor market tightening amid elevated inflation is likely to prompt a significant early-cycle recalibration from the Fed and other DM central banks starting in 2022. Fed thinking will likely shift gradually as it remains hopeful that a positive labor supply impulse will materialize. But, unemployment may fall faster and inflation may run hotter than current FOMC forecasts.

**Global CPI inflation** accelerated sharply last quarter to an estimated 5.9% annualized, approaching its fastest pace over the past quarter century. This acceleration was accompanied by a notable broadening of price pressures as service price inflation rose materially above its pre-pandemic pace for the first time during this expansion and moved sharply higher in regions (Western Europe and EM Asia ex. China) where pressure was limited through much of last year. A natural gas supply shock accounts for a large portion of this pickup and last quarter's service price inflation acceleration reflects a broad fading of a Delta drag that delayed normalization of depressed services activity and prices. In 1Q22 inflation should decelerate as the natural gas price shock is already starting to fade. Forecasting the trajectory of core inflation is more complicated as goods and services prices face different COVID -related cross-currents. Evidence suggests that goods sector activity is picking up following a midyear stall. But the current acceleration is promoted by an easing of supply constraints that is facilitating a rebuilding of depleted inventories.

FOMC's decision at the November 3rd meeting to taper by $15 billion a month was timid. FOMC left the funds rate target range unchanged at 0–0.25% at the December meeting. Then, citing elevated inflation pressures and further improvement in the labor market, the Committee announced that it will double the pace of tapering to $30bn per month in January. The dot plot showed a baseline of 3 hikes in 2022, 3 hikes in 2023, and 2 hikes in 2024. As expected, the statement dropped any reference to transitory factors in its characterization of inflation, and instead noted that supply and demand imbalances "continued to contribute to elevated levels of inflation". The FOMC revised the statement to acknowledge that inflation has "exceeded 2% for some time".

Monetary policy is effectively impotent in unwinding supply chain disruptions, increasing computer chips, lessening the labor shortage, or increasing the supply of oil and gas. Members of the FOMC understand this, which is why Powell & Co. maintained the inflation will be transitory mantra so long. By their nature, each of these problems are transitory but the timing of any improvement has extended due to the demand shock created by fiscal stimulus and lingering COVID disruptions globally. There is one issue the FOMC believes it can influence and that's inflation expectations which have been rising and are well above the range of the last decade. Members of the FOMC have made clear that it won't taper and hike rates at the same time.

**Treasury Yields:** Treasury yields are expected to rise as supply increases (Congress has increased the debt ceiling), core inflation moves up, and the amount of QE purchases by the Fed drops to $60 billion in January and $30 billion in February. The amount of supply will far exceed the Fed's purchases for the first time since March 2021.

**EM:** The strength in the Dollar has pushed many EM currencies lower so the cost of imports has increased even more depending on how much the local currency has depreciated. Central Banks have responded to higher inflation by increasing their policy rates, with some enacting multiple increases. These economies are more exposed to the rising cost of food and energy.

- **Commodities:** *We are set to enter 2022 with inventories at depleted levels across nearly all commodity sectors. Commodities are on pace to deliver the strongest year of returns since the early 2000s. A constructive economic outlook, depleted inventory levels, and supplies still struggling to respond to resurgent demand-point to continued strong returns. Oil is set to remain a major beneficiary of a continued economic reopening over the course of 2022.*

Commodity prices should soften on a weak Chinese economy, persistent strength in the dollar, and concerns of new Covid variants. Nevertheless, supply disruptions have supported prices, as bottlenecks helped deplete commodity inventories. China has cut industrial metal production to conserve electricity in the face of coal shortages. All of this has offset some commodity market headwinds, cushioning price declines. Nevertheless, with the dollar continuing to strengthen and the Chinese economy struggling, it is hard to project an imminent bullish trend for most industrial metals and materials. Into 2022, an inflection point for commodity prices may be at hand: if the dollar indeed begins to soften and the Chinese economy starts to accelerate anew, commodity prices could experience another cyclical bull run, but before this inflection point is reached.

The fossil fuel sector has been depressed by the green movement, government policies, and proliferating ESG divestment practices. All of this has jacked up capital costs for the sector and limited exploration and production, leading to supply constraints. However, global demand for oil and natural gas has continued to grow. Until Omicron fears hit the oil market, crude prices had continued to creep higher even though the dollar remained strong. Therefore, the recent selloff in oil may have created another buying opportunity for those who want to play the energy crunch theme.

Oil inventories have drawn rapidly this year with OECD commercial oil stocks falling below the 5-year range in summer, prompting an extraordinary coordinated SPR release late this year. In natural gas, a lack of increased supply from Russia to Europe has placed Northwest Europe's supply and demand balance in an extremely precarious situation heading into the depth of winter. Across base metals, the story is similar with supply curtailments and logistical constraints leading to a steady depletion of stocks across the complex. In agriculture, weather-related production penalties and inelastic food demand have drawn inventories of some grains like wheat and corn to decade lows.

A constructive economic outlook is feeding through the demand numbers across commodities, resulting in record or near-record demand outlooks in the coming years.

The outlook for demand on industrial metals is more clouded by a slowing in Chinese growth, however policy will likely be further fine-tuned to remove downside risk while demand in the rest of the world will remain firm aided by a robust macro-outlook and continued growth from energy transition. Supply is still struggling to respond to resurgent demand and will most likely remain constrained through next year. With spare capacity at a premium, OPEC+ looks set to remain firmly in control. Metals supply chains have been tangled by logistical bottlenecks and disrupted by high energy prices and increasingly stringent decarbonization policies.

In agriculture, fertilizer shortages, and historically high prices present an unprecedented headwind for food production, at a time when the market is seeking supply, and weather appears threatening. The fundamental outlook across agri-commodities remains constructive across the agri-complex.

**INVESTMENT OUTLOOK:** *inflation will remain a recurring theme. Global economic growth is likely to remain robust and provide a solid backdrop for corporate fundamentals. Positive on equities, commodities, and emerging markets. Cyclical assets and value to outperform. China/EM backdrop improving, and normalizing consumer spending habits.*

Fiscal and monetary accommodation has been a big tailwind for global equities and the shift toward less accommodation isn't a death knell but it is a change that investors weren't quite ready to embrace or accept. Growth will remain elevated globally, with EM economies running faster in aggregate than DM economies but with a more positive momentum in the latter. A continuation of above potential growth will help close output gaps and keep inflation distribution risk to the upside for next year. As a result, real rates should rise from excessive negative levels. Uncertainties surrounding Covid-19, inflation, and the reaction function of central banks are factors that could generate high volatility. Overall, the odds are for a rise in real rates which favors credit risk to duration risk. Emerging Market economies are facing a number of fundamental headwinds including higher inflation, EM Central Banks raising policy rates, and COVID disruptions but technically, the outlook is improving.

Financial markets handled the FOMC's decision to increase the tapering of their purchases from $15 billion a month to $30 billion without a hiccup. The prospect that the FOMC expects to increase the federal funds rate 4 times in 2022 was a yawner. The 10-year Treasury yield has been anchored at 1.50% which has supported an overvalued market since many valuation models use the 10-year Treasury yield as the benchmark.

Credit spreads are historically tight in general, with the exception of Asia corporate credit. Higher volatility and the end of central bank liquidity injections may increase the credit spread range for 2022 versus 2021.

Equities should beat bonds this coming decade, and with lower overall real returns, investors will likely move further into risk assets, deciding to hold even more equities. Higher inflation and macro risk should actually have little impact on nominal long-term returns on bonds or equities as initial losses from falling asset prices should be offset by higher income from coupons, earnings, and dividends.

Quarterly growth rates for the global economy will be similar to last year (around 1%). EM and advanced economy (AE) growth will also be similar; but that's disappointing for EMs given their faster trend growth. Global inflation fears will peak but, elevated commodity prices, political uncertainty, and inflation concerns will linger. Markets remain edgy but should reward EMs' generally strong fundamentals by H2 2022. EM current accounts have improved, institutions that delivered a massive fall in macro volatility in the last decade are mostly intact, and government debt can generally be stabilized with limited medium-term fiscal adjustment. Political uncertainty may be more important than bloated public debt as a legacy of this pandemic. EM monetary policies are mostly ahead of the curve.

Central bank policy to remain broadly accommodative despite Fed tapering – an additional ~$1.1T in global DM CB balance sheet expansion through YE22 and a more dovish Fed relative to current market expectations ahead of U.S. midterm elections.

Record corporate liquidity and strong fundamentals should continue to drive capital investment, inventory restocking, shareholder return, and M&A activity. While there have been sporadic setbacks with COVID-19 variants, this needs to be seen in the context of higher natural and vaccine-acquired immunity, significantly lower mortality, and new antiviral treatments.

**Risks:** *The key risk is a hawkish shift in CB policy, especially if post-pandemic dislocations persist.*

The world economy, policy, and financial markets will go through major transitions. As the recovery runs its course, markets will begin adjusting to tighter monetary conditions, a process that will likely inject volatility. There are risks that investors will need to monitor and manage in 2022: increased geopolitical tensions in Europe and Asia, a looming energy crisis, uncertainties around high inflation, and normalization of monetary policy.

Demand growth should remain strong in the absence of unforeseen shocks. But, there are two tensions:

1. Overhangs in China's real estate sector and corporate balance sheets. In contrast to the growth bias elsewhere, China's policy is focused on a set of objectives—deleveraging, de-carbonization, and a reduction in income inequality—in which actions to deliver long-term gains come at the expense of weaker near-term growth.

2. The global economic recovery is moving forward with limited slack in its early stages and particular tightness in the DM.

The **pandemic may leave a negative imprint** on DM labor markets and global immigration flows. Offsetting this is a recognition that sustained strong demand and easy credit access can be a catalyst for rising investment and labor force participation that boost supply performance. For fiscal authorities, the next two years should highlight a growing structural problem. The DM fiscal deficit is expected to run at 5% of GDP next year, even as unemployment rates approach 50-year lows-such a gap is unprecedented.

The increase in Delta cases and the potential of

Omicron causing a spike in cases and hospitalizations that might lead some local and state governments to impose **lockdowns** is a concern. Global travel has become more difficult with two European countries shutting down their economy for the next 4 weeks. Reports that current vaccines may not provide the same level of protection is feeding the surge in fear. At this point many people aren't going to need the government to tell them they need to alter their behavior as many people will curtail their exposure by not venturing out. This change will hurt the US and global economy in the short run.

Although **global liquidity** retreated over 2021, liquidity is still so high that it's **dragging long-term rates down**, even while long-term growth and inflation outlooks are arguing otherwise. As central banks normalize policies and balance sheets, liquidity will inevitably seep out of the system, changing the growth signals. The buds of this change are already appearing in the riskiest global market segments – emerging markets. EMBI rates are creeping up significantly for the riskier EMs, as if markets are ignoring the fact that the EMs are now well into the monetary policy tightening cycle. We're likely to see more turbulence in 2022.

Given the high risk that **inflation will not normalize** by itself, the probability is rising fast that the Fed will at some point over the next 1-2 years have to rapidly slam on the brakes. This should not necessarily lead to the same 5-year long extended EM crises of the 1990s as many EMs have since learned to not rely on foreign short-term capital and have been adding to their FX reserves since. Not all EMs, however, have learned this lesson, making those with sustained current account deficits most vulnerable. Even those with sound external finances will likely be, at least, under some short-term pressure as investors have historically penalized the EM asset class at large when the Fed is moving fast.

## Countries

**Argentina :** *IMF agreement in 1Q22?*

Negotiations for an agreement with the IMF were postponed until 1Q22. The decision to continue paying principal on loans to the IMF is a signal that the government is looking for an agreement. The government unveiled details of the country's proposal. There is disagreement with the IMF on the speed of fiscal adjustment. There are significant hurdles still present towards an agreement, with a late-March deadline fast approaching. The program will need to include accumulation of reserves at the Central Bank. The BCRA accelerated the pace of ARS depreciation and said that it will adjust interest rates towards positive returns in real terms.

In 2021, high agricultural commodity prices allowed a trade balance surplus that peaked at $20b (5.3% of GDP) in the 4-quarter period ending in 3Q2020 and is now down to US$16b (3.6% of estimated GDP). International reserves rose for the third quarter in a row to US$43b. The current account balance posted a US$3.3b surplus in 3Q2021, above the US$1.2b surplus recorded a year earlier.

**Brazil:** *2022 will be a tough year for Brazil's economy. General elections countdown.*

The temptation to increase fiscal spending ahead of the election in Brazil is creating a conflict in policy mix and the central bank is preparing the market for more rate hikes as a result.

Brazil watchers are expecting 2022 to be a lost year, buffeted by stagflation and steep interest rates. Politicians tend to spend when they're campaigning, making it harder for the central bank to control price increases without hurting the economy. A slump in domestic demand would be the main driver of a recession. Wages are depressed too, with real income still 5.5% below pre-pandemic levels.

Annual consumer inflation has been slowing down, but economists still expect it to total 5% in 2022. Since inflation started speeding up, the central bank has found it hard to rein in the market's expectations on price increases. In October, the CB intensified its monetary tightening, bringing the Selic to 9.25%.

Whoever clinches the Presidency will naturally have an impact on the economy's medium-term prospects. So far, the front-runners are current President Jair Bolsonaro and former President “Lula” da Silva. Bolsonaro did well with the business crowd the first time around. Given where the economy is, and where it's likely to be next year, their support is no longer a given.

**China:** *risks are balanced. Xi and the Private Sector. China's Property Market.*

China’s economy slowed down in Q3 2021 but is expected to recover soon. The deceleration will not lead to heavy policy responses from leadership. The management of the property developer crisis shows the strategic targets have shifted from high economic growth to financial stability and fairer income distribution. Global equity portfolios are reducing their secular overweight in Chinese equities, a positive outcome for credit markets, with the government’s rationalization of credit policy forcing issuers to deleverage. China will have to transition to not relying on real estate so much, but in order to do so it will need to find the right balance. High savings and tight political/social control may allow Chinese equities to be supported by domestic fund flows if there is a decrease in investment in real estate (as there should be).

One profound issue is China's clampdown on the private sector. Whether this is the Communist Party rediscovering its true colors, or (more likely) a pragmatic attempt to limit possible centers of opposition, it's bad news for investors in private Chinese companies. While there is always the possibility that investors overreacted, there is still a decent chance that valuations already reflect the new dirigiste reality. The clampdown, in which authorities stopped Alibaba Group Holding Ltd. and others from continuing exclusivity arrangements with retailers, has had a real effect on profits as other companies made inroads. it is just possible that some of Beijing's interventions are for the long-run good of consumers and the economy. They've unquestionably been awful for shareholders of leading companies like Alibaba.

The single biggest reason for emerging market underperformance this year is the Chinese property market. The problems of Evergrande Group sparked fears of a Lehman-style crisis, or "Minsky Moment." Lots of developers have sunk money into a wildly over-extended housing industry. China's real estate market is far more overblown than Japan in 1989 or the U.S. in 2006, which is terrifying. Why should we be calm? Firstly, a critical element in the Lehman crisis is missing- leverage. Property developers' funding has come primarily from pre-selling houses yet to be built. Reliance on loans is far less than it was during China's near crisis of 2015, and inordinately less than in the U.S. housing bubble. Further, contrary to appearances, the primary problem isn't wildly overblown valuations. As a share of disposable incomes, house prices have fallen considerably over the last quarter century.

China's leaders know that the economy is too reliant on housing. Engineering a deflationary move away from property is much easier now, amid signs of accelerating inflation, than it was when China first attempted it in 2014 and 2015. Back then, prices were stagnant, and housing deflation was dangerous.

"Housing is for living in, not for speculation." This was said for the first time at the 2016 Central Economic Work Conference and reiterated at high-level meetings including by President Xi. The property sector won't be used as a short-term tool to stimulate growth. This is a big job but nudging Chinese savers only a little out of property into something riskier could make the economy far more productive. China is trying to turn the housing market around in a way that will help in the long term and probably hurt a lot in the short run. Authorities have made it clear for years that they wish to avoid a "Minsky moment" and it looks as though they will succeed.

**Russia:** *RUB: Geopolitical risk vs. macroeconomic fundamentals.*

The near-term Ruble outlook continues to be driven by geopolitical tensions: on the more positive side, headlines following Biden-Putin summit appear to suggest some desire from the White House to de-escalate tensions in the region, and to seek discussion to explore how Russia's security concerns can potentially be addressed. Still, tension around Ukraine isn't likely to go away anytime soon, and investors will need to remain attentive to upcoming risk events. As Russia's inflationary impulse has broadened, CBR is to deliver a 75bp hike in order to anchor inflation expectations which, in turn, can continue to support Ruble carry.

**Turkey**: *Lira weakness spills over domestically, but not globally. Pressure to remain on the Lira over the short-run.*

The central bank cut its benchmark lending rate. It has already been through enough personnel shifts over the last few years, as Turkey's President Recep Tayyip Erdogan has sought an appointee to concur with his view. These cuts have been made at Erdogan's insistence, despite serious and rising inflation. The impact on the Turkish lira has been predictable. As markets expect rates to rise in the US and Europe, cutting them is bound to damage the currency. This is another fact of post-crisis life for emerging markets. On the financial side, contagion to the European banking system appears limited, given that exposures to Turkey have fallen significantly in recent years. With foreign ownership of Turkish assets now low compared with historical levels and given a broader understanding that policy impulses in Turkey are idiosyncratic in nature, EMFX appears increasingly unaffected by sharp moves in the Lira.

**Venezuela:** *recovers oil production to 1m bpd pre-pandemic level*

Venezuela announced that PDVSA again reached a production of more than 1m barrels per day (bpd), a figure that has not been achieved since 2018 and double the 500,000 bpd it was extracting at the end of 2020. However, the news service said OPEC figures indicated an output of 625,000 bpd for the country on 13 December while a union leader estimated production at around 720,000 bpd. PDVSA's output plummeted in 2020 to its lowest level in decades. The Nicolas Maduro regime blames the US sanctions against the company, while the opposition attributes the crisis to lack of maintenance.

As a consequence of the country's dollarization, which accelerated in 2021, as well as the reduction of monetary liquidity, among other measures, Venezuela's central bank reported that the national consumer price index (INPC) has remained at single digits since September, and has not exceeded 50% since December 2020, when it reached 77.5%.

The National Assembly ratified the continuity of Juan Guaido as interim President of the country for the next 12 months.

**We thank you for your continued support.**


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