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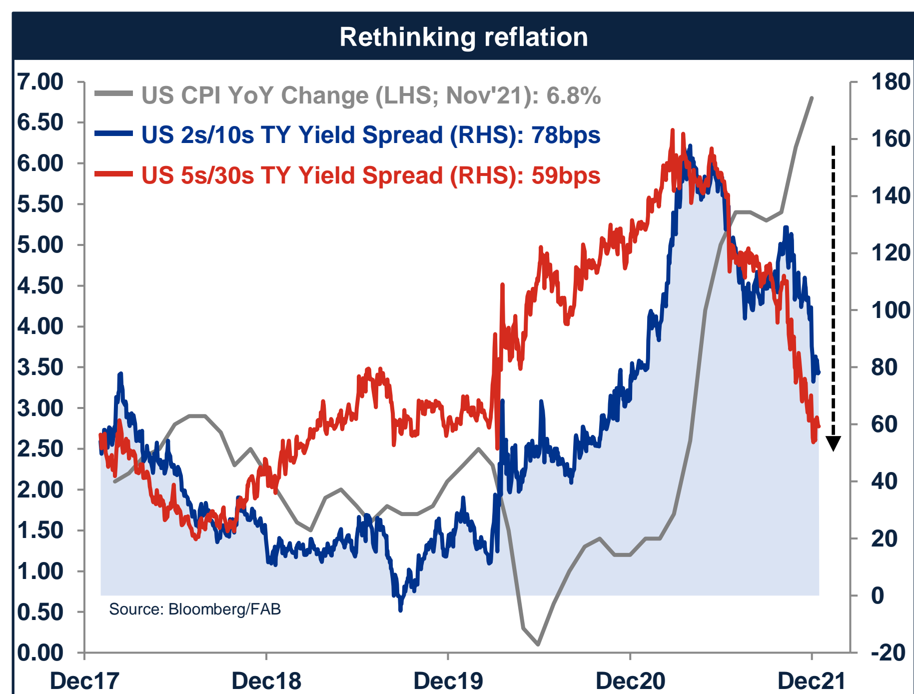
Simon Ballard
Chief Economist

Global rates outlook 2022 - From famine to feast?

- **Rates poised to bounce off the zero bound even as pace of reflation eases**
- **Generic yields should rise, curves modest bear steepen over course of 2022**
- **'Cautious optimism' should be the buzz phrase of macro conditions**
- **When it comes to inflation, 'temporary' is a matter of perception**
- **Fed hawks cohabitating with ECB doves through the coming 12 months**

As we traverse, what we hope will continue to prove to be the post-pandemic terrain, global financial markets will position themselves over the coming year with respect to prospective economic growth and inflation conditions. We have long argued that that the strongest, 'V'-shaped element of the recovery may lie behind us in 2021 and that the trajectory of recovery in the coming quarters may be more shallow-U-shaped in nature. We expect this moderating recovery projection to hold true for growth as well as inflation over the coming year.



This said, even assuming that initial rebound momentum, fuelled by loose monetary and fiscal stimulus as well as the game-changing Covid-19 vaccination programmes around the globe, begins to wane in the months ahead, we do expect robust reflationary growth levels to be maintained overall through 2022, subject to the well-documented caveats. The latter of course may include resurgent virus variants and consequent renewed draconian socio-economic restrictions, or an overly hawkish stance by central

banks. The net result of this is that nominal policy rates across most developed economies do now appear poised to bounce off the zero bound that is still largely priced into the rates market. This will lead to a gradual rise in generic yields and modest bear steepening of yield curves over the course of 2022.

The foundations for reflation are well known – strong and successful Cobvid-19 vaccination programmes, a re-opening up of economic activity and consumption and solid inventory building across most sectors, but so are the risks (virus variants, economic uncertainties, fragile labour market conditions). As such, the inference in this is that the path of least resistance for global rates over the coming quarters should be tentatively higher. 'Cautious optimism' should remain the buzz phrase of the macro rates outlook in 2022.

During H2 2021 it seemed that global investor sentiment was steadily being conditioned by central banks for an impending turn in the monetary policy screws. Elevated inflation rates around the globe – while perceived as 'transitory' by several major central banks, including the Federal Reserve and ECB – continued to fuel bond market fears that monetary authorities' hands would be forced earlier and more acutely than previously anticipated. At the same time, such anxieties have pushed many market participants to the sidelines, thereby draining the market of liquidity and fuelling outsized volatility across risk assets.

Meanwhile though, fiscal stimulus seemed, and still seems, set to remain ultra-loose during 2022, albeit with governments becoming increasingly cognisant of the structural debt pile that is being accumulated as a result of their emergency pandemic rescue packages. Indeed, it was the recognition of this debt position, coupled with current high inflation that lead the Federal Reserve, while leaving underlying interest rates unchanged, to announce the beginning of its asset purchase tapering process at the conclusion of its November 3 2021 FOMC meeting. The Fed aims to have concluded the tapering by mid-2022.

At the same time though, the Fed remains keen to reassure markets that tapering does not predetermine the start of rate tightening, even though it has stressed its readiness to act if appropriate, faced with the current backdrop of macroeconomic risks and conditions. As reflation gathers momentum, the spectre of possible monetary and fiscal policy 'normalisation' during the course of 2022 will now surely cast an increasingly opaque veil of uncertainty across global markets over the coming months.

With markets having learned to live with – and depend on – not only a near-zero interest rate environment for much of the past 2 years, but also deep structural stimulus in the form of quantitative easing, fears have begun to grow over how global markets might survive once tighter conditions prevail. With inflationary pressures seemingly building by the day – albeit what is still expected to be largely transient inflation in our view – it is perhaps a natural question to ask. However, the key error that markets have made in recent months has been the blunt assumption that QE tapering and rate tightening are one and the same. They are not.

While the Federal Reserve has begun the process of tapering its asset purchase program, it has stressed that it does not anticipate an increase in actual interest rates until late 2022 at the earliest. The anchored nature of the underlying treasury yield curve suggests that the market concurs. In the context of fragile reflation and the prospect of easing price pressures over the coming months, we would conjecture that the timeline for Fed tightening may even edge back toward early 2023.

U.S. money market futures in November 2021 saw some 15bps of tightening priced into the U.S. curve by the end of 2022. Indeed, in recent months futures have fluctuated between implying a Q4 2022 or Q1 2023 start date for fed funds tightening. The FAB house view favours the latter.

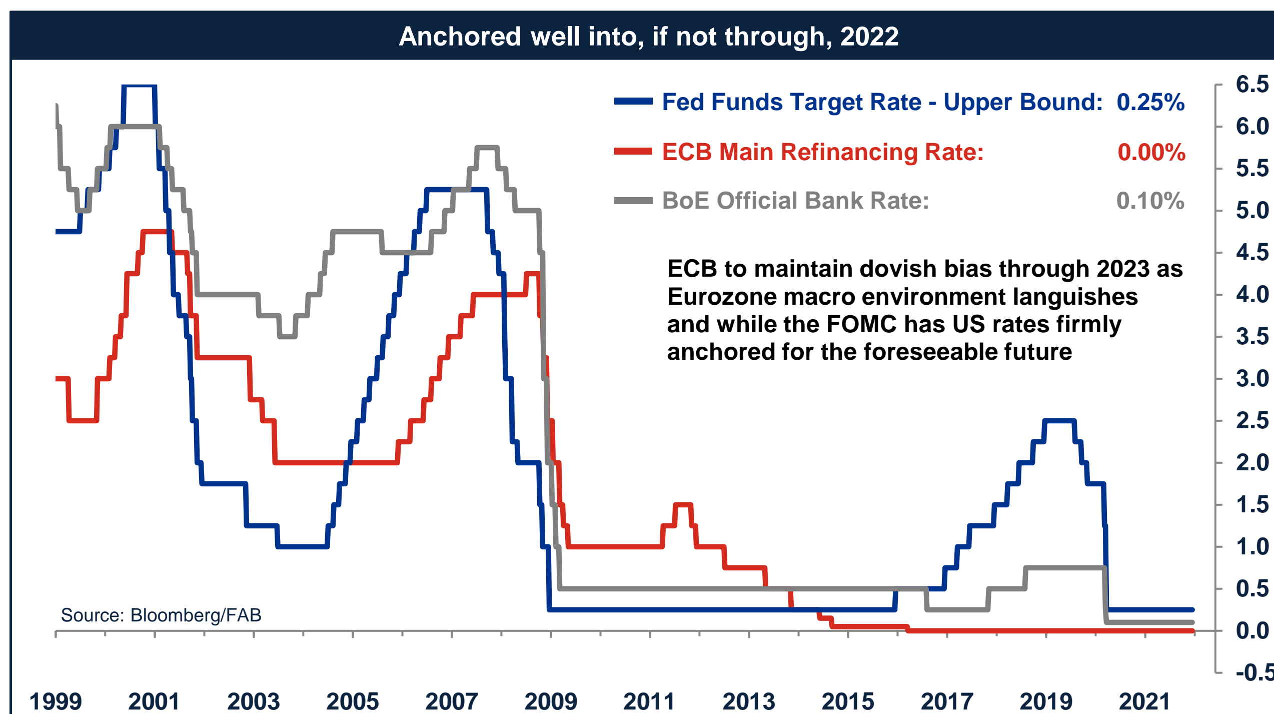
While current inflationary pressures are unarguably elevated and may only peak in 1H 2022, we still subscribe to the view that they will prove to be transient during the course of the coming year as a whole. Nonetheless, in order avoid a more disruptive, hawkish outcome we do believe that it may will be appropriate for the FOMC to maintain a buoyant pace of its taper process in the early months of 2022, in order to send the correct, 'we've got this' message to the markets. Failing to act swiftly enough, after having acted so

swiftly in response to the pandemic, could lead to future claims that Mr Powell has overseen the greatest policy mistake of modern times. Risk markets would not be sympathetic to such a view.

In broader terms though, as we move further away from the nadir of the economic downturn in Q2 2020 – and the low point in terms of price compression – we expect headline year-on-year inflation rates to also recede. Admittedly, the terminal rate of inflation may remain structurally higher than where it was pre-pandemic, but we nonetheless anticipate a gradually less hawkish rhetoric to prevail among G10 central banks over the coming quarters.

Under such a scenario we currently believe that U.S. rates will remain anchored and that the first actual tightening of the fed funds rate may only materialise at the February 2023 FOMC meeting. As generic economic conditions make tentative gains though, the underlying yield curve should edge higher/steeper during the course of 2022 such that the yield on the 10 year treasury may only just break above the 2.00% level by the end of the year.

In this context, and given that we expect the GCC dollar pegs to be maintained for the foreseeable future, UAE and broader GCC interest rates also seem set to remain steady during 2022. Expect rates/yields across the region to continue to largely track their U.S. counterparts, albeit with some modest variation to be expected over time due oil price fluctuations and regional geopolitics.



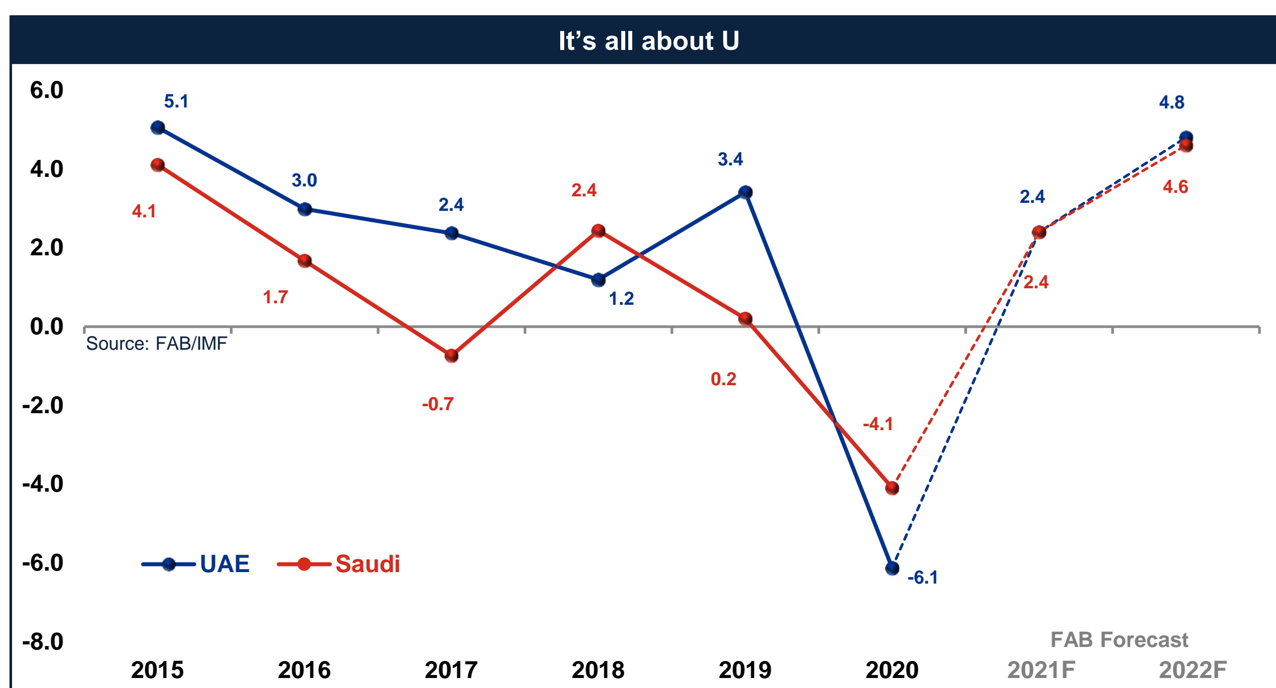
In the Euro area, we expect the overarching tone of monetary conditions to remain far more dovish. The ECB has stated quite categorically that it does not expect macro conditions to be strong enough to support tighter monetary policy any time before 2023. We agree and do not expect the ECB to be in a position to pull the rate tightening trigger until Q4 2023 at the earliest. But this dovish spin is not reflected in market pricing, which we feel has overshot recently with regard to expectations of a more hawkish bias from the ECB. Markets should correct over the coming months therefore to withdraw such hawkish assumptions.

Meanwhile the lack of a coherent communications policy at the Bank of England put investors on alert for a U.K. rate hike at the November 4 2021 meeting, only for the Bank's MPC Committee to then vote with a solid 7-2 majority for leaving its benchmark Bank Rate unchanged at 0.10%. U.K. interest rates will rise in time and government bond yields will react accordingly, but, we believe, not as quickly or as hawkishly as many currently anticipate.

GCC macro outlook 2022: From trough to peak and back to U

- **GCC macro consolidating into sustainable positive growth trend**
- **Governments to maintain expansionary fiscal strategies alongside easing deficits**
- **Varied but contained inflation should leave regional policy rates unchanged with U.S.**
- **Further reforms will remain key to diversification strategies**

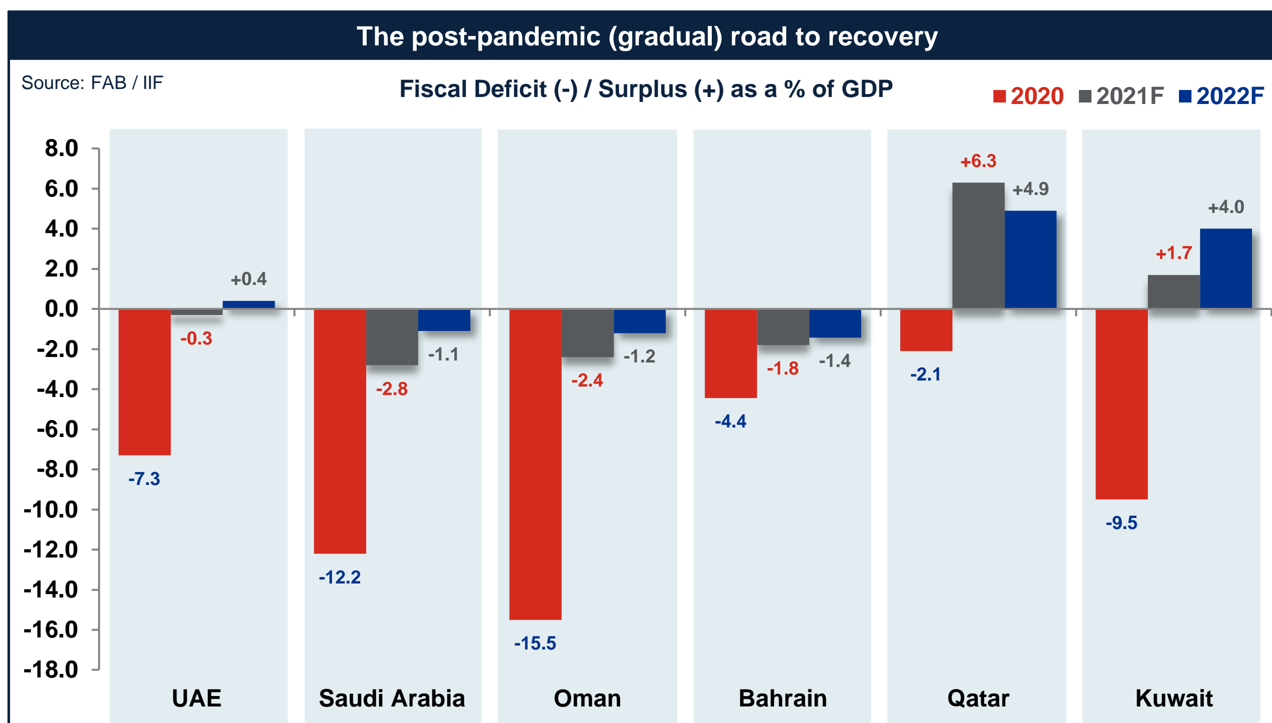
After the anticipated rebound in economic activity seen across the Gulf Cooperation Council (GCC) region in 2021, when growth recovered sharply back into positive territory from the recessionary nadir of the cycle in Q2 2020, the six GCC countries should see economic growth make further positive advances in 2022. Beyond that though we then anticipate an easing in the rate of improvement, such that the trajectory of the medium-term economic advance will be more 'shallow-U-shaped' in nature. We believe that this will be the most sustainable outcome for reflation across the region.



The economic performance across the region is forecast to be strengthened not only by the widespread vaccination programme that has helped to revive domestic activity and consumption and also supported the re-opening up of tourism again (particularly important for the UAE), but economic performance should also stem from the implementation of deeper structural reforms.

On balance, we believe that the aggregate GCC economy expanded by 2.1% during 2021 and that, as global reflation continues to gain cautious momentum over the coming months, GCC economic growth should improve further and settle around a 4.4% growth rate for 2022 as a whole. In the context of OPEC+ oil production cuts perhaps ending by mid-2022, we assume that the private sector will be particularly important to such an overall annual economic growth rate, and within this, particularly in KSA, UAE and Qatar.

At the same, with oil prices remaining buoyant, the fiscal and external sovereign positions in the region are expected to improve substantially over the coming years, with the United Arab Emirates and Saudi Arabia expected to see their fiscal deficit positions of 2021 move back toward balanced / into surplus territory during 2022. In aggregate we believe that while the fiscal balances of Saudi Arabia, Oman, and Bahrain should continue to narrow during 2022, the fiscal positions of the UAE, Qatar and Kuwait should all improve back toward (small) surplus over the coming months.



This said, at least across the major economies of the UAE and KSA, we do expect to see the maintenance of modestly expansionary fiscal strategies, which will be made possible by the respective large financial buffers, spare capacity as well as enhanced government revenues from firm oil prices.

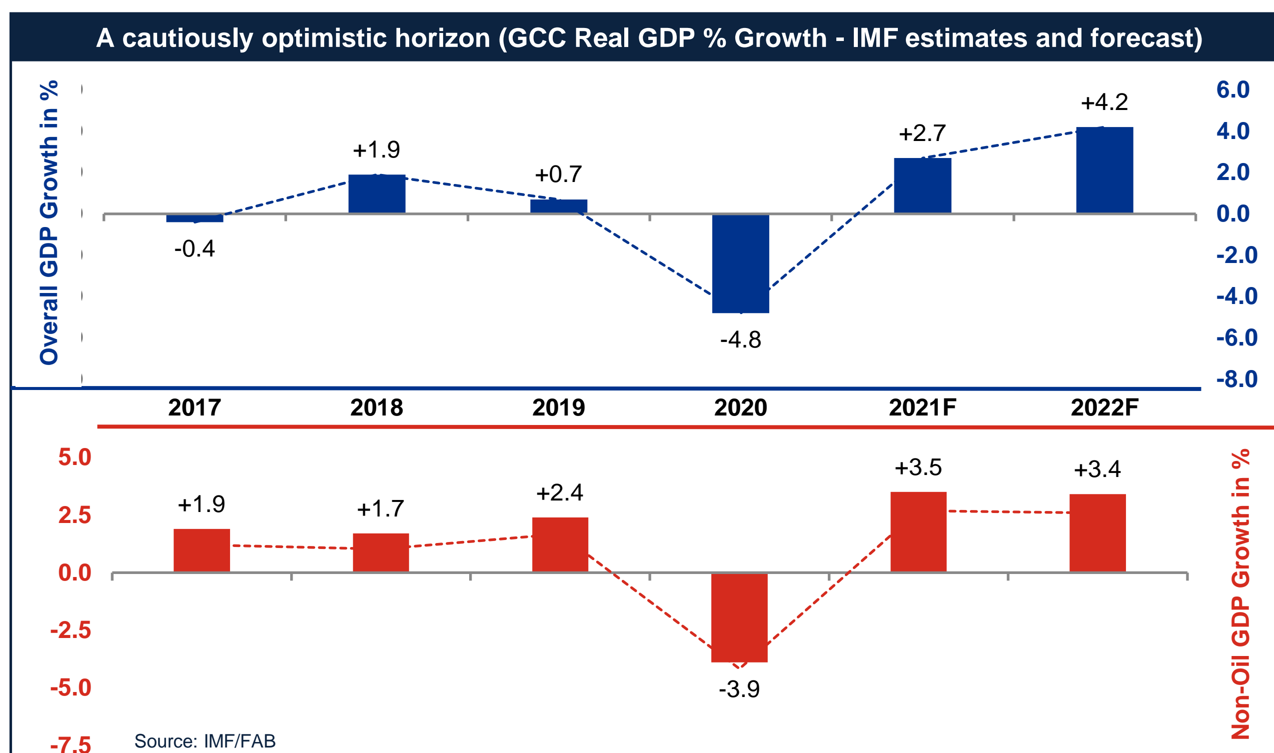
As is the case for many geographies around the world at present, inflation will remain a key threat to the monetary and fiscal status quo across the GCC during much of (early) 2022. However, while elevated commodity valuations will bolster price pressures, we continue to subscribe to the view that the latter will begin to recede as 2022 evolves and we move further away from the inflation low point seen at the end of Q1/early Q2 in 2020.

Moreover, we would conjecture that generic inflation pressures should remain relatively contained over the coming months as a result of pegged exchange rates across the region (with the exception of Kuwait of course). Inflation can vary greatly from member state to member state though, albeit running on average between 2%-3% in 2021 buoyed by the latter strength in the oil price. Consequently, we do not anticipate any change in GCC central banks' policy rates during 2022, which will remain anchored to and continue to track U.S. rates.

Structural reform will remain a key focus for governments across the region – and a key foundation of improving economic fortunes – during the coming year, coming in the wake of what has unarguably been major progress on that front over the past several years. We have seen some major improvements in the business environment, including the promotion of a more favourable regulatory landscape across much of the GCC region in recent years and this, coupled with an acceleration in digital transformation, should help to further bolster the outlook for business and SMEs in the region. Similarly, strategies to promote new investments, including the relaxation of residency rules and longer-term ('Golden') visas for expats, should all help to enhance the UAE's status on the global corporate stage and promote the country as a global hub for business, finance, and attractive tourist destination.

This said, there is a clear need for further reforms across the region, particularly across the non-financial sectors. While the GCC financial environment continues to look robust to us, benefitting from a high-quality asset base, strong capitalization, and adequate liquidity, in the non-financial space reforms will be key to not only achieving individual countries' economic diversification aspirations, but will also serve as the foundations for improving and sustaining economic growth rates over the medium-term.

At the country level, Moody's Investor Service affirmed its A1 long-term issuer and senior unsecured ratings for Saudi Arabia on November 5 2021 and at the same time revised the outlook from negative to stable. To us, this reflects what we have long held as being a positive macro fundamental outlook for the major GCC sovereigns (KSA and UAE) through 2022.



Indeed this structural strength was also reflected in Fitch's affirmation of the United Arab Emirates' 'AA-' credit rating in November 2021, with the agency attributing the rating on the federal government to the country's moderate consolidated public debt, strong net external asset position and high GDP per capita. Recognising the ongoing global macro challenges to the reflation narrative though, while we generally expect GCC sovereign fundamentals to remain robust over the coming years – which in turn will help to drive improving FDI flows into the region – we do anticipate a degree of continuing consolidation in growth rates during these still early stages of rebound from the economic nadir of the pandemic.

And in this respect, we also note the subliminal risk to the outlook that could stem from any weakening of fiscal discipline if higher oil prices were to result in complacency, especially if it were to coincide with a weakening in the pace of economic growth. While unadvisable, this is a pro-cyclical strategy that one might be sympathetic to at the time and one that have seen evidence of before, although (UAE and KSA) governments do seem committed to medium-term fiscal responsibility as they aim to redress the costs of and ballooning public debt incurred during the pandemic.

Simon Ballard
Chief Economist
Market Insight & Strategy
FAB Global Markets
Tel: +971-2-6110012
Mobile: +971-50-9332806
Email: Simon.Ballard@bankfab.com

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