Treasury Trends

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Signing off the year, planning for 2022

It's that time of year again where we dust off the old crystal ball and read the tea leaves to look for signs of what might capture the markets' interest in 2022. There are plenty of risks to be mindful of as we head into the new year.

Treasurers need not only be experts at cash management and understand global market dynamics, but must be virologists, geopolitical experts, climatologists, and a multitude of other ologists to understand what drives risks to their business.

Key Points

- Treasurers' skill sets forever growing
- Uncertainty and risks of shocks to dominate 2022
- Inflation and central bank response to be key
- Plan for the worst. Hope for the best ...

Uncertainty a certainty

The long shadow of 2020 is still hanging over us at the end of 2021 and looks set to darken the outlook for 2022 as well with COVID-19 still dominating headlines, particularly with the emergence of the Omicron strain. The vaccines have certainly had a positive effect so far, allowing people to return to some sort of normal, but uncertainty around the likes of ongoing efficacy of vaccines, new strains of the virus, impact of border restrictions on health, business and general trade seem likely to dominate headlines for some, if not all, of next year.

Cases are beginning to rise again around the world, particularly in Europe, with many western European countries recording their highest case levels to date. Further lockdowns have been put in place in Austria, with restrictions also being brought into force in Germany and the Netherlands to name but a few. This is only the start of the northern hemisphere 'flu season'. The early part of 2022 could see similar spikes in cases around the world as in 2021.

Risk on or off

The impact on markets however is likely to be more muted as markets become desensitised to COVID-19 related risks. Outbreaks are not good for economic growth, and the IMF's 4.9% global growth estimate for 2022 is under threat from further waves of cases, or more mutations leading to further lockdowns - well into 2022. The emergence of the Omicron strain at the start of December saw safe haven assets, particularly bond markets, in demand as investors shy away from risk in the face of darkening outlooks. That being said, viruses tend to become more mild as pandemics progress so that they spread more easily. Four of the viruses that cause the common cold were once pandemics, offering a glimmer of hope that COVID-19 may tend this way and the world can move beyond it.

Inflation – here to stay?

Inflation has become a pertinent theme in the back half of 2021 and certainly looks like it will be a mainstay of market discussions in 2022.

The US Federal Reserve ("Fed") has just amended its narrative from 'definitely transitory' to 'definitely not transitory.' However, the details in the US and around the world show that the largest rises in CPI are driven by things like used cars, transport, and fuel. These rises are caused by supply chain bottlenecks, the rising commodity prices and oil prices remaining well above $50 per barrel. The problem, and what the Fed is acknowledging, is that those transitory inflation factors are driving more broad-based inflation and wage inflation, which in turn will make inflation more permanent.

Demand has returned to somewhat normal levels although supply chains have not and they look set to remain disrupted well into 2022. With more lockdowns in China — likely thanks to its elimination

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policy, and interruptions in other manufacturing countries — disruptions will continue to ripple up and down supply chains, causing prices to rise. One sliver of hope is that shipping costs are beginning to come down, with the Baltic Dry Index down nearly 50% from its October peak.

Commodity prices too look to be drifting back from their elevated levels, although the recent fall in oil has been driven by demand fears rather than increases in supply. It may take some years, but commodity supply will inevitably respond to the increase in prices, which will certainly take some of the heat out of inflation.

Interest rate markets have been quick to price in policy responses from central banks to curtail some of the highest levels of inflation seen in decades. 2022 looks set to be a year of rising cash rates after years of falling rates. If inflation persists and becomes more broad-based, or indeed wage inflation starts to pick up, interest rate markets will price in further responses.

Markets have already fully priced in the hiking cycle for the Reserve Bank of New Zealand ("RBNZ"), so any upside risk may be limited for New Zealand interest rates, but other global central banks are seemingly well behind. The Fed looks set to make its first hike since 2018, as do the central banks of Canada and England. The Reserve Bank of Australia ("RBA") has been explicit about its desire to hold off until 2023 or 2024 although markets are questioning the timing for the need to lift rates. Interest rate markets around the world have room to price faster hiking cycles if inflation persists, so we could see the shorter end of rate curves balloon out like the NZ curve has over the last six months.

Markets to remain on edge

Higher interest rates would lead to softer stock market returns, albeit a sharp stock sell off is unlikely. The major western economies could be more fragile than the data suggests, and certainly all the fiscal and household borrowing will make them more sensitive to interest rates. Removing the sugar rush of low interest rates and massive fiscal deficits could lead to some rather painful withdrawal symptoms.

All the money in the system, the Fed's Reverse Repo operations are consistently seeing USD1.5 trillion deposited with it overnight, and ultra low interest rates have served to create a debt bubble that has inflated assets such as every property market around the world. Higher interest rates could pop that bubble, causing turmoil. China's property market is a prime case in point, with several major developers struggling to pay debts. The Chinese have never known property prices to fall, so there could be some major panicking if they do — with ramifications for debt and equity markets around the globe.

Climate change is an ever present and growing risk and severe storms can cause ripples in global stock and commodity markets. The world is never far away from a major natural disaster, and if an earthquake, solar flare, or a meteor strikes, global markets will be the fastest to respond.

Commodity prices could crash, taking certain sectors of the economy with them, and political tensions are building raising the risk of war. China and the US are the obvious adversaries with Taiwan the piggy-in-the-middle, but there are tensions (still) in the Middle East, between NATO and Russia, and in the Kashmir region, to name a few.

Keep alert

Our Partnership Plan model with clients will support keeping attention on upcoming issues, both real and potential.

Whatever 2022 throws at us, we know that focusing on the basics will still provide the most robust basis to work from. Plan for the worst, and hope for the best. Happy new year!

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