

ECONOMICS & MARKETS

What's the market outlook for 2022?

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By Dr Shane Oliver
Head of Investment Strategy and Economics and Chief Economist,
AMP Sydney, Australia

Despite the rough and uncertain start to the year there is reason to be optimistic about the share market in 2022. Economies are recording solid economic growth, profits are rising and monetary policy, notwithstanding increases in interest rates this year, will remain easy.

But 2022 is unlikely to replicate last year's very strong investment returns and low volatility. And that's partly because 2021 was a great year for diversified investors, with average balanced growth super funds returning around 14 per cent, compared to around 3.6 per cent in 2020.

Global Economic Growth

Growth is crucial to the outlook for financial markets, and there's reason for optimism.

COVID could finally be moving from a pandemic to being endemic.

Vaccines, especially when booster shots are administered, are providing protection against serious illness and new treatments are on the way. Past COVID exposure is also providing a degree of protection against serious illness. And while Omicron is more transmissible, it's less harmful than

Delta was (and the same appears to apply to the latest Omicron sub-variant). That's good news for continued reopening and ultimately economic growth.

Another reason for optimism on economic growth is the excess savings of around US\$2.3 trillion in the United States, and US\$250 billion in Australia, which will boost spending. Also, while the US Federal Reserve and Reserve Bank of Australia (RBA) will tighten this year, policy will still be easy. It's usually only when policy becomes tight that economic cycles and bull markets tend to end. And that's a fair way off.

Inventories are low and will need to be rebuilt which will provide a boost to production, and in turn, help growth. Positive wealth effects from the rise in share and home prices will help boost consumer spending. China is likely to ease policy to boost growth. And while business surveys are down from their highs, they remain strong and consistent with good growth.

Global growth is likely to slow this year but to a still-strong 4.55 per cent, with Australian growth of around 4 per cent, despite the Omicron wave resulting in a brief set back in the March quarter.

Financial Markets Outlook

Global shares are expected to return around 8 per cent this year but investors will likely see a rotation away from growth and tech heavy US shares to more cyclical markets.

Australian shares could start to outperform. That will be helped by leverage to the global cyclical recovery and the search for yield. Relative to near zero deposit rates, a grossed-up dividend yield of around 5 per cent looks attractive.

Still very low yields, and a potential capital loss from a rise in yields, are likely to again result in negative returns from bonds. There could be some weakness in unlisted retail and office property, but industrial property and unlisted infrastructure is likely to be strong.

Australian home price gains are likely to slow with prices falling later in the year as poor affordability, rising fixed rates, higher interest rate serviceability buffers, reduced home buyer incentives and higher listings impact borrowers.

Cash and bank deposits are likely to provide very poor returns, given the ultra-low cash rate of just 0.1 per cent. While the Australian dollar could fall further in response to COVID and the Federal Reserve tightening cycle, a rising trend is likely over the next 12 months, helped by still strong commodity prices and a decline in the US dollar. We expect the local unit to hit \$US0.80 later in the year.

Volatility

One attribute of all financial markets over the next year will be greater volatility. There are several reasons for that. While inflation is likely to

moderate this year as production rises and goods demand subsides, there is a risk that it stays higher for longer.

Also, the start of US Federal Reserve and RBA rate hike cycles and quantitative tightening could cause volatility. But it's unlikely that the tightening will be severe enough to threaten the economic recovery and cyclical bull market.

The US mid-term elections could also trigger volatility. Mid-term election years normally see below average returns in US shares, and since 1950 have seen an average drawdown of 17 per cent, albeit with an average 33 per cent gain over the subsequent 12 months¹.

Geopolitical tensions involving China, Russia and Iran could also be another trigger. A partial Russian invasion of Ukraine could lead to even higher European gas prices.

And finally, shares are no longer cheap. The easy gains are behind us and calmer years like 2021 tend to be followed by volatile years.

As always in financial markets, there are plenty of unknowns. Heading the list this year, again is COVID. Any new variants could set back the recovery.

If inflation continues to increase, and long-term inflation expectations rise, central banks will have to tighten aggressively putting pressure on asset valuations. Political polarisation is likely to return to the fore in the US, posing the risk of a deeper than normal mid-term election year correction in

shares. China issues are likely to continue with the main risks around its property sector and Taiwan. And an invasion of the Ukraine by Russia could add to European Union energy issues.

The Australian election, due before the middle of May is another unknown.

But if the policy differences remain minor a change in government would have little impact.

Important notes

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