RISKS FOR 2022 AND BEYOND: CENTRAL BANKS, CHINA, AND COVID

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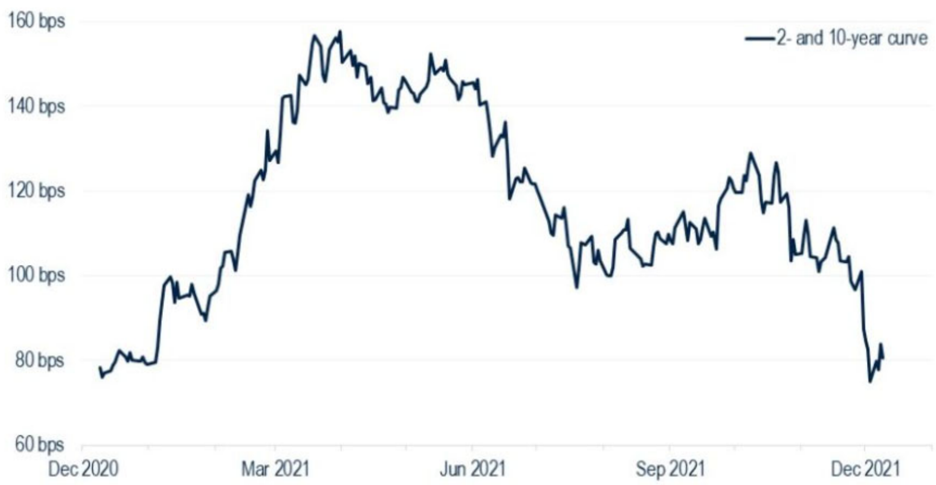
Almost two years into the COVID pandemic, we continue living and investing in a world that is ripe with exogenous risks. This environment requires a constant probing and re-probing of our core views given the significant risks on the horizon that have the potential to create a sea change in market dynamics. In this piece, we explore three key macroeconomic risks that we are focused on heading into 2022.

The principal risk is undoubtedly monetary policy errors, specifically the potential mistake of global central banks acting too fast, too soon as they attempt to tame inflation. We are already seeing it play out in real time: central banks in the U.K. and Norway recently hiked policy rates; meanwhile, the Federal Reserve seemingly abandoned its flexible average inflation targeting strategy just months after adopting it and started to signal a much faster path of rate hikes.

While it is unquestionable that consumer prices have accelerated quicker than most expected, the configuration of the current bout of inflation is largely out of the Fed's control, and officials run the risk of applying the same tried and true textbook policy response in a vacuum. Raising rates and tightening economic conditions in aggregate is not going to alleviate the severe gridlock in the ports of Southern California or reduce labor shortages; rather, applying such a blunt tool risks stunting economic growth just as the supply side of the economy recovers and more people return to the labor force. Lags in monetary policy make tightening in this cycle a particularly difficult needle to thread.

If they care to listen, the bond market is also telling the Fed and other major central banks that a potential policy mistake is on the horizon. The recent market volatility has dramatically flattened the yield curve (Figure 1), showing widespread concern that the hawkish pivot will end up hurting the long-run growth outlook.

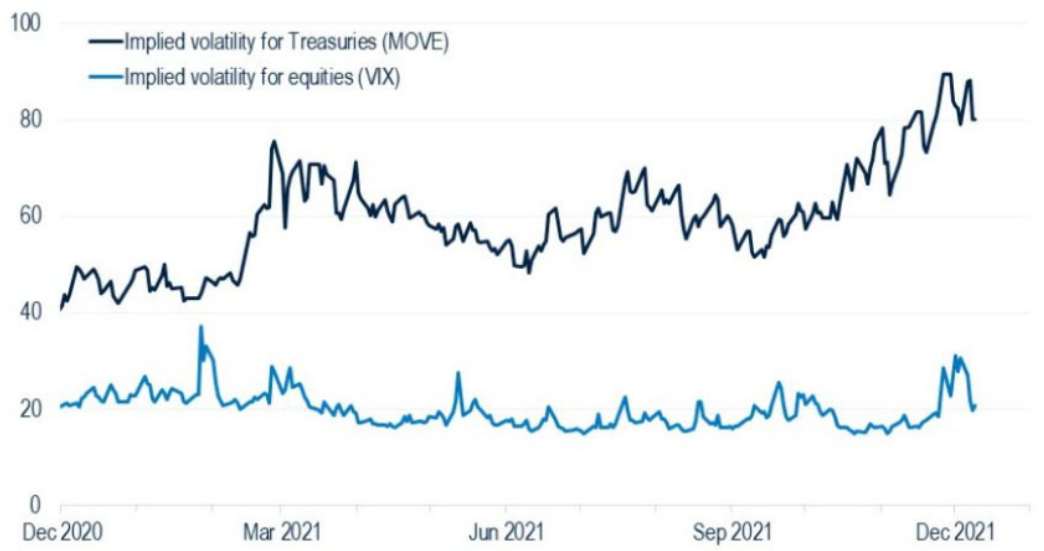
FIGURE 1: THE DRASTIC FLATTENING IN THE TREASURY 2- AND 10-YEAR CURVE



Source: PGIM Fixed Income, Bloomberg.

Largely isolated in U.S. Treasuries for now (Figure 2), volatility can very well spill into equities and the broader risk markets if policymakers stay on the increasingly hawkish trajectory.

FIGURE 2: TREASURIES' OPTIONS-IMPLIED VOLATILITY MARCHES HIGHER

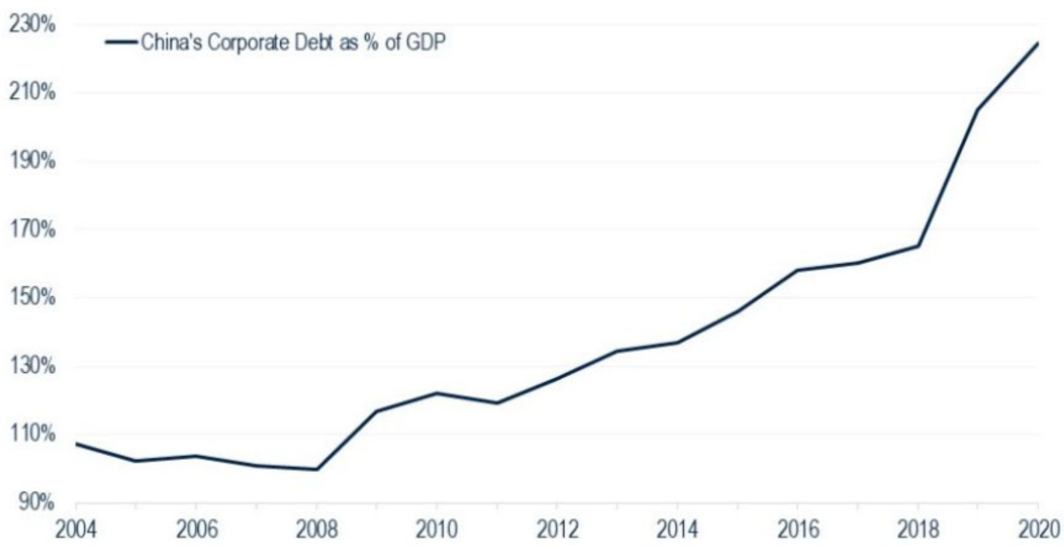


Source: PGIM Fixed Income, Bloomberg.

In the political economy arena, China's handling of its economic challenges has the potential to jostle the global markets.

China's property sector, which makes up close to one-third of its economy, morphed from a slow-burning debt problem into a full-blown collapse this year with the defaults of Evergrande and Kaisa. China's economic playbook of boosting flagging growth with rampant debt and leverage is approaching its sustainable limit. As China is caught in a classic debt trap, officials will be hard pressed to continue to fight debt with more debt (Figure 3).

FIGURE 3: CHINA'S BALLOONING CORPORATE DEBT (% OF GDP)



Source: PGIM Fixed Income, Bloomberg.

But ultimately, the economy will reach the limits of its credit expansion as investment efficiency of the corporate sector will likely continue to deteriorate (Figure 4). This problem is especially acute when the overall economy is marred by repeated COVID lockdowns and energy shortages.

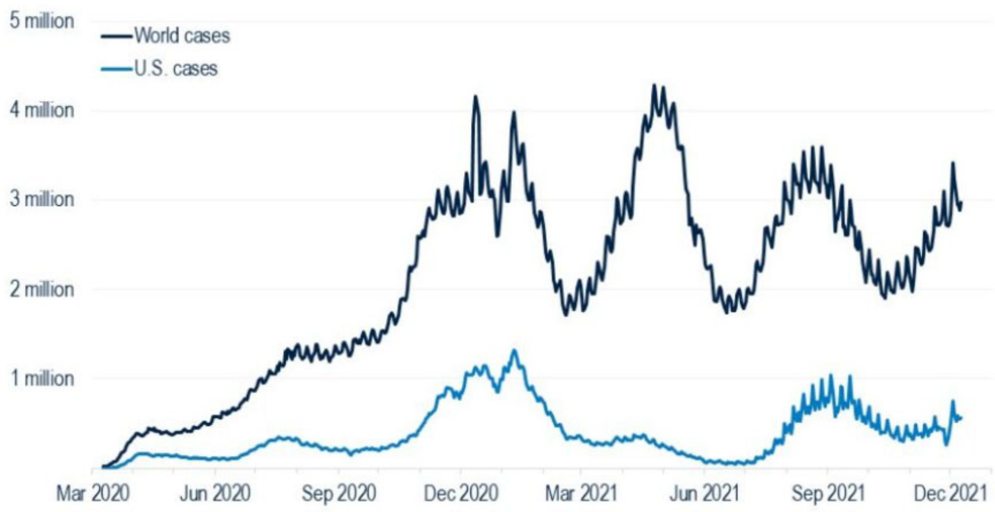
FIGURE 4: CHINA'S CREDIT UNDERPERFORMANCE VS. EM BENCHMARKS

Source: PGIM Fixed Income, Bloomberg.

The big question is what a debt overhang will mean for China's long-term growth potential at a time when the economy is already increasingly facing downward pressure and demographic challenges. We expect China's growth to slow to around 4.5% in 2022, a far cry from the growth rates of about 8% commonplace in the previous decade. To us, the era of China acting as the impetus for global economic growth is over, and the ramifications of slowing Chinese demand will present material risks for investors in 2022 and the decade to come.

Lastly, COVID is an ever-present risk factor. Long seen as a "known unknown" to us, the emergence of the Omicron variant came as no surprise. Although we are investors and not epidemiologists, it's clear that COVID remains a threat to economic growth and creates uneven paths of recovery globally depending on the varying contours of the virus. COVID will inevitably become an endemic part of daily life and the long-term steady state of the global economy. But in the short term, the ups and downs of COVID complicates central bankers' task, as another virus wave will likely slow the recovery of global supply chains and keep the pressure on inflation (Figure 5). More critically, global growth will continue to be plagued by uncertainty and inherently more volatility and opaqueness. Coming full circle, the inherent exogenous uncertainty of COVID increases the likelihood of policy mistakes committed by central banks.

FIGURE 5: CHANGES IN WEEKLY COVID CASES SURGE GLOBALLY



Source: PGIM Fixed Income, Bloomberg.

The uniquely uncertain times we now live in require us to constantly reevaluate our views to address these ever-evolving risks. But ultimately, risks present opportunities. Unevenness in global growth and asset performance is often synonymous with alpha opportunities. Beta had a great ride in 2020 and 2021, but it is much more difficult to simply follow the market when facing a tidal wave of uncertainties and a wide dispersion of potential outcomes. Despite these significant risks, we see major opportunities for alpha generation in the years ahead.

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