FEBRUARY 2022

# Have we reached the pivot point?

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MACRO PERSPECTIVES

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# Introduction

**Stephen Dover, CFA**
Chief Market Strategist
Franklin Templeton
Investment Institute

The inflation debate—and the course policymakers should take—has intensified in recent months. In this edition of Macro Perspectives, our economists discuss what's fueling inflation and how policymakers are combating it without dampening growth—they offer differing views on whether inflation will abate or accelerate as the year progresses. We also explore the potential impacts of the US Federal Reserve's (Fed's) pivot on interest rates, Omicron-driven uncertainty, China's macro playbook, and wage and labor expectations.

Below are a few highlights of our conversation:

I think the market is being somewhat sanguine about what will happen in the second half of 2022. There is an expectation that inflation will decline sharply. I think that might be optimistic because a lot of the factors driving inflation will still be with us. The Fed is already behind the curve.
**Sonal Desai, Ph.D., Chief Investment Officer, Franklin Templeton Fixed Income**

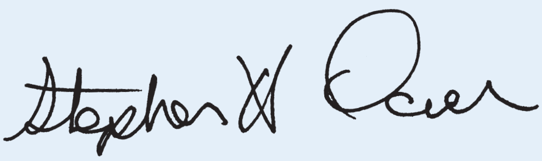
Our view is that inflation is going to moderate over the next six to 12 months. If there is an environment where expectations are for higher inflation and maybe the Fed is irresponsible in its rhetoric or policy response, that creates a bit of a behavioral self-fulfilling prophecy where people expect higher prices, and businesses raise them.
**John Bellows, Ph.D., Portfolio Manager, Western Asset**

Labor supply has not returned in the United States, which is one of the unique aspects about the American economy compared to other developed countries—we would expect the labor shortage to provoke a rise in real wages.
**Gene Podkaminer, CFA, Head of Research, Franklin Templeton Investment Solutions**

Most countries tend to follow the Fed, but in this cycle, we've seen substantial rate hikes ahead of the Fed, particularly in Latin America. In Asia, several countries have been able to maintain higher policy rates throughout the pandemic, giving them a buffer against Fed tightening. Certain local-currency valuations within these regions appear highly compelling.
**Michael Hasenstab, Ph.D., Chief Investment Officer, Templeton Global Macro**

Looking at valuations, some emerging market currencies look attractive to us. A lot of emerging markets have been raising interest rates to the point now where they may start to pivot in the other direction. We do see idiosyncratic opportunities popping up across the emerging market space.
**Francis Scotland, Director of Global Macro Research, Brandywine Global**

I hope the discussions in Macro Perspectives better inform your decision-making.



# Executive summary

## Several sharp pivots

A lot has changed since publishing Macro Perspectives in November. The arrival of the highly infectious Omicron variant of COVID-19 sparked fresh uncertainties about economic growth. As a result of inflation numbers continuing at high levels in the United States, Fed Chair Jerome Powell indicated there will be quantitative tightening (QT) and possibly several interest-rate hikes in 2022. Meanwhile, China's central bank cut a key interest rate for the first time in two years to boost growth. The future path of inflation and the corresponding response of central banks and interest rates are the biggest open questions among our economists. Below, I've summarized several key insights that caught my attention—issues that we'll undoubtedly revisit later in 2022.

## Managing expectations

While the Fed and financial markets were still downplaying inflation as transitory, Sonal understood that many households and businesses were concerned about how rising prices would impact their future spending power and how unanchored inflation expectations would impact wage- and price-setting decisions. She had assessed that price pressures were broad-based and not solely due to rising fuel and food costs which, coupled with the relatively slow pace of supply-chain normalization, continued extraordinarily loose monetary policy and massive fiscal expansion, would cause an acceleration in inflation in 2021.

As Gene and John point out, inflation expectations can trigger behavioral changes among households that ironically lead to higher inflation—a vicious circle. As an example of controlling inflation expectations, Gene highlights Paul Volker, Fed chair during the early 1980s, who convinced the public in words and deeds that the Fed was serious about controlling inflation.

Fast forward to 2022, Sonal notes several Fed members are talking about QT, which means *shrinking* the Fed's nearly US$9 trillion balance sheet. Sonal thinks an aggressive, hawkish approach from the Fed, rather than gradual incrementalism, may be warranted to stave off longer-term inflation. In her opinion, the Fed is clearly behind the curve and should be more aggressive in fighting inflation. She also thinks the political salience of inflation makes such an aggressive stance more likely.

John thinks the Fed should be cautious about being too hawkish and potentially slow economic growth, and sees a gradual approach to QT and rate hikes as more likely. While US savings rates are high, John doesn't see consumers spending the bulk of their COVID-19 savings this year. Pointing to the behavioral dynamics of the permanent income hypothesis,[1] John thinks last year's COVID-19 fiscal stimulus transfers will likely result in US consumers holding onto more of their savings in 2022, rather than continuing to spend. When the Fed does embark on QT, John notes that it bought US$80 billion of US Treasuries *every day* in 2020.[2] The proposed shrinking of the Fed's colossal balance sheet by a mere US$100 billion *a month* likely won't make all that much difference to long-term bond yields.

## Supply-chain disruptions and the labor market

From Michael's perspective, the supply-chain disruptions driving up commodity prices for items like fuel and food will likely wane later this year as more countries move toward "living with COVID" policies to avoid the damaging cycles of lockdowns. That's good news for Europe, where energy prices have been the primary inflation driver. Far trickier, however, is the issue of wage growth and labor shortages in the United States. Historically, it's the labor channel that typically creates stickier inflation. Michael thinks the United States is experiencing far greater wage growth than regions like Europe, largely due to three US-specific factors.

First, expensive housing has priced a lot of people out of regional US labor markets—they simply can't afford to live where many companies are hiring. Second, a big drop in legal and illegal US immigration is causing labor shortages. Third, an older cohort of workers is opting for earlier retirement, often by moving to lower-cost regions to stretch their savings. For both Michael and Francis, US wage growth is a big inflation wildcard that bears close watching because it's tied to productivity and economic growth. If US businesses have the pricing power to pass along wage increases to consumers, it could stoke inflation higher. In turn, this escalation could trigger a bigger policy response from the Fed than is currently expected and could increase the risk of dampening US growth.

## China's macro playbook

Looking at the global economy, Francis thinks that worries about a hard economic slowdown in China are overstated. In the past, emerging markets often followed the Fed's lead on rate hikes. But throughout this pandemic, China has acted independently in how it has handled COVID-19 and its economy.

With China's recent rate cut, Francis sees the start of a gradual reflation cycle that's different from the United States, helping buoy China's massive growth engine. Near term, China will likely shut factories to ensure blue skies during the Winter Olympics in Beijing. But after that, the Chinese government likely will deploy its ample policy toolkit to increase economic growth, while being careful to not kickstart inflation.

Gene, however, is more cautious on China's economic growth. With the country's zero-COVID-19 policy of complete lockdowns combined with the lower efficacy of its local vaccines, Gene thinks assumptions that China can maintain a stable growth trajectory are less certain. Overall, Gene's team is less sanguine on China and select emerging economies that deploy strict zero-COVID-19 policies because these restrict economic growth. They prefer more open economies like Canada, Japan, the United States and the eurozone.

## Vaxxed and relaxed

We closed our discussion on a note of refreshing positivity. Despite the arrival of the highly transmissible Omicron variant, Michael feels a palpable sense of optimism spreading among global policymakers given that Omicron fatalities are not as high as those of the previous variants. Nations with higher vaccination rates and/or widespread herd immunity can hopefully pivot to treating COVID-19 as an endemic virus that we can live with.

### WILDCARDS—WORRIES AND OPTIMISM

Here are the topics our economists are watching closely or, in some cases, keeping them awake at night:

**US inflation**
Amid the continued debate on inflation, central bankers risk getting behind the curve if not aggressive enough in fighting it, but need to balance that with caution to avoid stamping out growth.

**Wages**
Wage growth is a wildcard in the US outlook because if businesses can pass wage increases down to consumers, it could stoke inflation and thus ultimately hamper growth.

**China's trajectory**
China has dealt with the pandemic and taken monetary policy actions in an independent manner, so the key question is whether China can remain an engine of world growth and engineer a soft landing.

**Currency**
Currently, a lot of emerging market currencies look attractive to us; some countries have been tightening all through this pandemic because of the inflation story and now are ready to start stimulating.

As Gene reminded us, all the macroeconomic issues that we regularly discuss—inflation, supply shocks, wage growth, monetary policies and slowing economic growth—tie back to one catalyst: COVID-19. If we can live with COVID-19 safely, we might get back to the economic growth trends from before the pandemic. For US consumers, that means moving back to the long-standing trend of buying more services, like dining out, entertainment and traveling, instead of mostly shopping for goods. This pivot would also support the more rapid normalization of global supply chains, as the risks of shipping delays and labor shortages due to COVID-19 subside.

## How to respond

Given the outlook—for inflation in particular—is uncertain, our managers believe that a more bottom-up approach might be a more effective way to achieve returns while managing risk. For example, utilizing spread products and diversifying globally can reduce the need to focus as much on predictions about whether inflation will be higher or lower.

# Expanded viewpoints from the roundtable

## Managing inflation expectations

### It turns out you were right about inflation expectations, Sonal. In hindsight, what did you see that others didn't?

**Sonal:** When we talk about expectations, we note that market expectations are quite distinct from broader survey-based expectations. There was a time when the Fed wasn't concerned about inflation, and markets weren't overly concerned about inflation, but it felt like households and businesses were. That's changed. Clearly, the Fed is now concerned about inflation, and I think over time, the markets are probably going to become even more concerned. There seems to be broad agreement that inflation will be quite high in the first half of 2022. Now, the question is: what will the second half of 2022 look like?

I'm not anticipating inflation to be as far away from expectations in 2022 as it was last year. However, I still think the market is being somewhat sanguine about what will happen in the second half of 2022. There is an expectation that inflation will decline very sharply. I think that might be optimistic because a lot of the factors driving inflation will still be with us. When considering what to look for in shaping our forecast, we would typically look at market-based measures like Treasury Inflation-Protected Securities (TIPS) and 5-year, 5-year forwards.

However, my concern is that the Fed has had an impact in distorting these markets given the size of its purchase of nominal Treasuries and TIPS, where it owns about a quarter of the market.[3] So historically utilized signals for gauging inflation expectations have become less valuable in the last few years as the Fed's purchase program has ballooned and likely impacted pricing. I am looking more at other inflation indicators, including broader surveys of consumers.

### How do household expectations on inflation factor?

**Gene:** There's definitely a behavioral element to inflation expectations. We saw the extreme of this in the late 1970s and early 1980s when Fed Chair Paul Volker came in and basically said, "listen to me, believe me, we're going to take care of inflation." The government and US citizens ended up believing it. It changed how households behaved. It was like a self-fulfilling prophecy. Over the last six months or so, policymakers and central bankers have been coming to terms with the fact that inflation is a significant issue, and that the behavioral aspect needs to be addressed very aggressively.

So, that's what we have seen—every statement now that the Fed makes has an inflation aspect to it. When global leaders speak, they talk about inflation as well. They are acknowledging there is an inflation issue and are going to try to take care of it. Those remarks alone can help dampen inflation expectations.

I think that the market is looking through some of the inflation story and inflation headlines though. There's also not much of a reason to be despondent about slowing growth. We're slowing from a fairly high level. On an absolute basis, growth is still above trend and probably will be for the year. It's starting to converge to trend, but we're starting at a healthy level. So, growth is slowing, but it's still strong.

The big question mark is the policy response. In terms of the Fed's monetary policy, there's been very clear communication as to what the expectations are. We saw a little rattling in the markets when some of those pronouncements came out, but it seems like investors have come to terms with what is going to be happening in 2022 and the first-order impacts on fixed income and with equities.

> "I'm not anticipating inflation to be as far away from expectations in 2022 as it was last year. However, I still think the market is being somewhat sanguine about what will happen in the second half of 2022. There is an expectation that inflation will decline very sharply. I think that might be optimistic because a lot of the factors driving inflation will still be with us."
>
> **Sonal Desai**

## Western Asset's outlook points to growth and inflation perhaps falling short of consensus expectations this year. What is informing this view?

**John:** Thinking about this question, it's best to start with a degree of humility about the uncertainty related to COVID-19. There's no question inflation increases over the last three months have been more significant than most expected, us included. We're in the middle of a very difficult inflation environment for consumers, business and policymakers—it's affecting everybody and impacting market prices. Western Asset's view is that we are likely in the peak of inflation right now, and over the next six to 12 months our outlook is for inflation to moderate. There's a degree of uncertainty, and the big question is about what happens in regard to COVID-19.

## What do you do as an investor with that type of uncertainty?

**John:** If you start from a very basic economic model of what factors drive inflation—supply shocks, demand and inflation expectations—I think the case is pretty strong for moderation of inflation as we go forward. Let me drill into each factor a bit.

First, on supply: There's no question supply constraints are more significant than most people expected, which has driven up prices. Historically, supply shocks have led to very sharp increases in inflation, followed by sharp decreases in inflation. In 1973–1974, there was a classic supply shock on the energy side, resulting in very sharp inflation. Starting in 1975, inflation fell, and that supply shock receded. This was, by the way, before Volker became Fed chair in 1979. So, there are supply constraints today—like we've seen in the auto sector—that are driving up prices. But one of the most reliable patterns in inflation data is that supply shocks have another side.

Point two is demand—this is the one component that could potentially generate ongoing inflation pressures. If you have demand above trend, that could create excess activity, which in turn could drive up prices. This was a big part of inflation in 2021—there was a lot of demand. But a lot of the demand was related to the economic reopening in the wake of COVID-19 lockdowns. It was also connected to the COVID-19-related fiscal stimulus. I think there are reasons to be more cautious about demand today and going forward. As we get further away from the extraordinary events related to the pandemic, I think the arguments for continued excess demand become increasingly challenged. Demand may already be weakening, and will certainly weaken as we go through the year.

Finally, inflation expectations. If there is an environment where expectations are for higher inflation—and maybe the Fed is irresponsible in its rhetoric or policy response—I agree that creates a little bit of a behavioral self-fulfilling prophecy where people expect higher prices, and businesses raise them. I would interpret the current inflation expectations perhaps a little bit differently though—they're pretty stable when I look at various market indicators and surveys. I don't think we should extrapolate what happened during the pandemic to the post-pandemic environment.

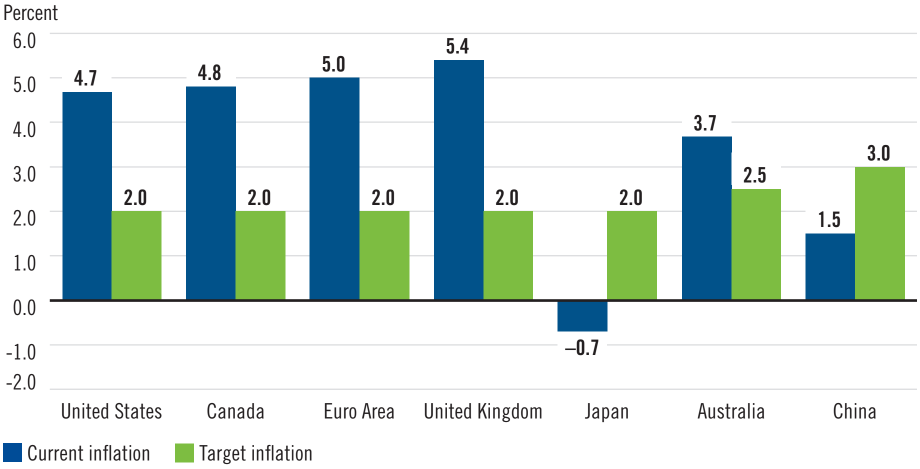
**Sonal:** Actually, John, I agree with much of what you said. I think it's really a question of degrees that we're talking here, because I do think there undoubtedly will be moderation. We aren't going to be sitting on 7%–7.5% inflation for long—that's not going to happen, in my view. But let me illustrate using the three factors you discussed.

On the supply side, one of my concerns is that some supply issues, such as the semiconductor chip shortages, may have more legs. So, it's not that I think supply shortages are here forever, but rather, it's not clear to me that they will wind down in mid-year.

In terms of demand, certainly we are not likely to see a fiscal spend this year like we did last year, so that fiscal demand goes away. However, US households still have around US$2.7 trillion–US$2.8 trillion in excess

### MISSING THE TARGET

**Exhibit 1: Current inflation rates vs. central bank target rates[4]**
As of December 31, 2021




Sources: Fed, Bank of Canada, European Central Bank, Bank of England, Bank of Japan, Reserve Bank of Australia, China National Development and Reform Commission, Statistics Canada, Japanese Statistics Bureau, Ministry of Internal Affairs & Communications (Japan), Bank for International Settlements, Bloomberg, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

savings, and households are spending those savings down.[5] And so I'd have some concern that demand could continue to be supported from that aspect.

And on the last point on inflation expectations, again, I do agree that there is a lot of stability in the longer-term expectations. But simultaneously, as of February 2022, based on my calculations, we will have been living with 5% average inflation for almost a year. As we get to the middle of 2022, on the current track, inflation is likely to still be quite substantially above that sub-2% level we've seen for much of the past few decades and for over a year. I think that that in turn would lead to demands for higher wages.

We might be in a situation where we're encountering a combination of relatively strong demand because of that healthy consumer, with low debt, a solid balance sheet and strong savings, together with supply restrictions coming both from labor and from goods. Those are the issues which give me some pause about the general consensus that inflation in the second half of the year will drop off very sharply. Base effects, absolutely, but I think some of the other factors might keep inflation higher for a bit longer.

## Michael, you are more in Sonal's camp in terms of inflation staying elevated longer than what markets currently expect, is that correct?

**Michael:** Yes, I think US inflation may be a little bit stickier. The good news is that as long as the market can see it coming down over time and that path declining, it will be encouraging.

And I think the other positive is the huge pivot over the last six months of the market not worrying about inflation and the Fed guiding in one direction, and then pivoting to another view.

> "There's certainly a question on timing. We have seen variants, like Omicron, and shutdowns because of zero-COVID-19 policies in China that could delay a return to normalization, although I do think there are arguments for a faster normalization than many might expect."
>
> **John Bellows**

The policymakers have done an excellent job of laying out expectations and, despite all the changes, not surprising the market. I think that is different than the 2014 period. We're able to pivot from a more benign outlook to needing to hike rates without real market disruption. I think that is a positive.

**John:** There's certainly a question on timing. We have seen variants, like Omicron, and shutdowns because of zero-COVID-19 policies in China that could delay a return to normalization, although I do think there are arguments for a faster normalization than many might expect.

In 2021, chip supply was a big concern. Many companies needing chips for their products overordered—which created backlogs. At some point, those orders will be filled, and it's very possible manufacturers will have too many chips because they overordered.

That "overordered" phenomenon could be happening in a lot of other places, including the labor market. The United States is seeing record numbers of job openings, along with decent wage gains. But it's not clear to me whether employers are posting job openings because they realize the labor market is tight, and we could eventually see a bit of a reversal once the labor market loosens up.

As for the direct transfers made to US households in 2020 and 2021 and their impact on excess savings, Sonal suggests those transfers have not been spent, but they will be spent in the future. I'm not at all sure those transfers will be spent in the future because they were one-time transfers, not recurring payments.

In addition, prior to the pandemic, Americans in aggregate were under-saved relative to where they needed to be—including meeting their basic needs, as well as retirement. Therefore, it's possible they will keep some, or all, of their 2020 and 2021 stimulus checks in savings, rather than spending them.

One other point on US policy. Last year, the bond market had fears that we would see a permanent shift in terms of higher fiscal spending with a Democratic administration. However, the Democrats haven't been able to get much done, and it looks like the House of Representatives could shift to a Republican majority with the 2022 mid-term elections. So those fears of higher spending in terms of fiscal policy don't seem that likely going forward.

On the monetary policy side, last year at this time, many were thinking the Fed had a new framework—much different than seen in the past—and it would get behind the curve. The Fed has in fact responded to inflation by accelerating the taper of asset purchases. Fed policymakers are also talking very hawkishly in regard to interest-rate hikes.

**Sonal:** John, I agree with a couple of your points, and I disagree with others.

On the savings rate, we are already seeing data showing some of those savings are being spent. I think the jury's out, but certainly consumers have a cushion—allowing many to step out of the labor market. I actually think, separately, that inflation might be one of the things which drives people back into the labor market because those savings will not go as far as, perhaps, they would've liked them to go.

On fiscal policy, we did get US$1.2 trillion in Biden's US infrastructure package. But I completely agree that Congress is heading toward gridlock, and there likely won't be an ongoing fiscal pressure coming from this point onwards.

On monetary policy, the Fed is already behind the curve. Otherwise, we wouldn't see inflation being where it is right now. I think the Fed is speeding up to get back toward the curve. That's a difference of opinion—but I've been a Fed skeptic, and a Fed critic, for a while now.

### If inflation doesn't moderate, how might the Fed respond differently than what we've seen recently?

**Sonal:** I think the Fed will do something different this time—in line with the fact that the environment is quite different given the pandemic—which is it is going to tighten. The big difference between the recent past and now is, of course, that we have 7% inflation versus less than 2% inflation pre-pandemic.[6] I think the Fed's degree of flexibility has gone down. At this stage, I think the market has fully internalized the idea of four interest-rate hikes in 2022—which was practically inconceivable as recently as two months ago, when people would not have anticipated anything of the kind. I agree that there will be at least four rate hikes. In terms of the shape of the curve, I think the back end will steepen.

Historically—going back to 1977—every time the Fed has tightened, curves have bear flattened. So, the front end sells off, but the back end should remain well anchored with the idea that in the future, the economy will slow down. But this time around, Fed members have also talked about QT, which I admit, I had not anticipated as the Fed has been quite dovish. Potentially, the market could start pricing in too much of the front end, but I think the back end still has room to sell off.

### John, could you explain the difference between QT and raising interest rates?

**John:** QT is a shrinking of the Fed balance sheet, which is currently very large. The Fed was buying US$80 billion of US Treasuries per day in March 2020.[7] If sometime in 2022 it starts reducing holdings by, let's say, US$100 billion per month, it's very gradual relative to its massive stock of Treasuries. It's really hard for me to see how that's going to make much of a difference in terms of 30-year Treasury bond yields. My own view is what policymakers are talking about regarding QT is not going to be as concerning as some suggest, and I am a little unconvinced it's going to drive back-end yields higher.

### If the market is under-anticipating long-run inflation numbers, how can policymakers correct this?

**Sonal:** It would mean taking a more forceful "Volker-like" stance on inflation. Not on the interest rate-front alone, but on QT.

If the Fed moves in the direction of QT sooner, and perhaps a bit more aggressively than is currently being priced in the market, that in turn means maybe five years down the road, we will not see as much inflation. That would be positive. On the other hand, if the Fed takes a gradualist approach, as it has done for most of the last 10 years, I think we potentially would see inflation for longer because at some stage, some of the monetary stimulus will need to be pulled back.

## Supply-chain disruptions and the labor market

### What role are supply-chain disruptions and labor markets playing in inflation in the United States?

**Michael:** First, a couple points on supply-chain disruptions. Like John, I think these are temporary factors. Whether it be oil prices or food prices, those can spike and be felt viscerally by people over a year. But they tend to wane. With the supply responses and many governments moving into a world of living with COVID-19—and no more extreme shutdowns—I think we can be more positive on the supply-chain component.

**Gene:** I agree with Michael that supply-chain issues will likely play themselves out by the end of this year. Inflation is now more broad-based, but it's still driven by demand, and it's still sensitive to the COVID-19 environment. That demand has shown up as a huge surge in durable goods, but there are already signs that inflation is peaking. We can see that in supply deliveries, in prices paid, even shipping rates, but inflation probably won't normalize until the end of the year.

And it'll probably be at a higher level than we've had over the last couple of decades, but only modestly. So maybe in the 2%–2.25% range versus closer to the 1.75% level that we've experienced before.

**Michael:** The part that I think is trickier, and tends to have greater longevity, is the labor market and wages. We explored many of the risks that can cause inflation expectations to unanchor in our recent Global Macro Shifts (issue 12) paper on inflation. Based on our research of the United States, and other countries around the world that have experienced more persistent inflation problems historically, the greater longevity in inflation has come through the labor channel. In Europe, most of the inflation is being driven by energy prices—oil and natural gas. In the United States, it's more broad-based. We're seeing greater wage growth and greater labor shortages in the United States than we see in places like Europe. There are three main reasons for these shortages in the United States.

First, expensive housing has priced a lot of people out of regional US labor markets—they simply can't afford to live where many companies are hiring. Second, a big drop in legal and illegal US immigration is causing labor shortages. Third, an older cohort of workers is opting for earlier retirement, often by moving to lower-cost regions to stretch their savings. Those factors together create a meaningful increase in wage prices of around 4%–6%, depending on the metric. So, I think we need to watch how that evolves and I think that will put US inflation dynamics on a different path than, say, those in Europe or other parts of the world.

**Francis:** Just to pick up a thread Michael was talking about on the nature of what creates inflation—in the 1980s, it was the supply shocks mainly manifesting in the form of rising energy prices which were the trigger for the inflation of that era because a supply shock is very restrictive. It raises prices and reduces disposable income. But if the labor market reacts by demanding an offsetting wage increase and then that feeds into the wage price buyer, this is what everybody has become concerned about today. What's different about this environment is the supply shocks seem to be more extensive, and it may be the labor market itself that's the problem. Labor supply has not returned in the United States, which is one of the unique aspects about the American economy compared to other developed countries. With all other factors being equal, you would expect the labor shortage to provoke a rise in real wages.

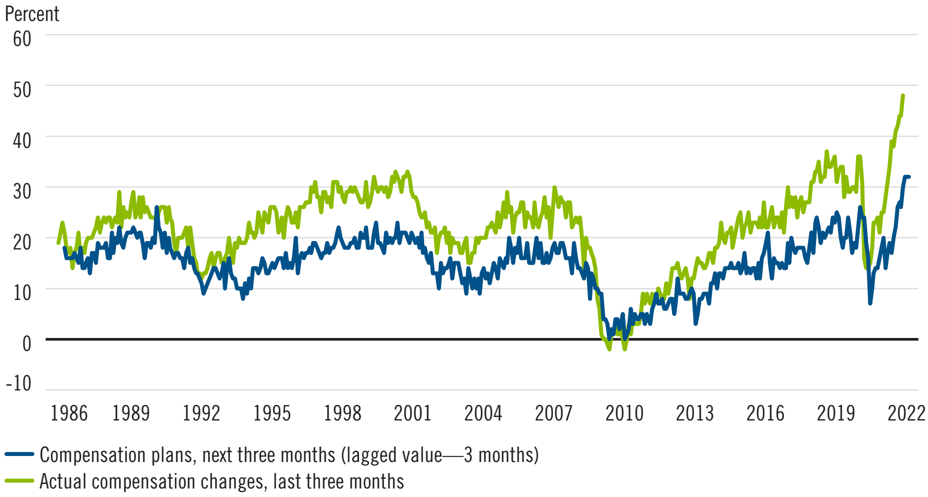
The proof in the pudding is corporate profits. If the rise in factor costs causes corporate profits to weaken, that's a sign it's not inflationary. On the other hand, in an environment like we're currently in, corporate profits are very closely connected to nominal gross domestic product (GDP) growth. There is absolutely no indication at all that inflation is having any kind of impact on business.

The rhetorical question is whether businesses can pass on those price increases. So, we get into this environment where wages now are rising, even though real wages are falling behind the increase in price inflation. It looks like this breakout in wage growth is following the breakout in price inflation. And so, we have that element Michael talked about, where this is the dangerous part in that it looks like we could get this self-fulfilling increase in expectations based around wages continuously trying to catch up to where the supply shocks have taken the price inflation.

**Gene:** We've been tearing our hair out about what's been happening in the labor markets with subdued participation and, potentially, wage gains. Responding to Michael and Francis on the dangers of US wage growth, a lot of those wage gains are centered in low-paying, COVID-19-sensitive industries, such as leisure and hospitality, and some of the retail trades. So, the real wage gains have been limited.

**CLIMBING COMPENSATION**

**Exhibit 2: Percent of US small firms that have raised or will raise compensation**
As of December 31, 2021




Sources: National Federation of Independent Business, Macrobond. The data is part of the Small Business Survey in the US administered by National Federation of Independent Business. Important data provider notices and terms available at www.franklintempletondatasources.com.

### Why aren't we seeing the same labor shortages and wage growth issues in other markets?

**Michael:** I think the United States and Europe are on pretty different ends of the spectrum regarding their approaches to labor issues. Some studies have shown that many European companies furloughed employees rather than laying them off during the COVID-19 shut-downs—they were still on the payroll but weren't working. So, when businesses want to switch back on, it's a lot easier because those employee/employer connections are still there. In contrast, the United States went through private sector layoffs, and the public sector then subsidized those people via unemployment payments. The employees largely severed ties with their prior employers, so it was possibly harder for companies to quickly rehire and start back up.

**Francis:** I think that's pretty much a uniquely US phenomenon. It seems to be specific to the US combination of the scale of the monetary and fiscal stimulus provided during the pandemic in addition to this shortage of labor supply. I think it's those elements that are conspiring to give us this wage-price scare we see right now.

> "I think fears over a China hard landing are probably overstated. Policymakers there have the tools to engineer a softer landing. China's export growth is good, global demand remains resilient and the commodity cycle looks very encouraging."
>
> **Michael Hasenstab**

## China and emerging markets

### What are you seeing across emerging markets in terms of the pandemic, inflation and growth?

**Gene:** I'd love to start in China first because I think our views are maybe a little bit different from others here. Within my team, we have had vigorous debate about how optimistic or pessimistic to be about China's recovery and what the path holds for 2022.

We have been exploring concerns about some of China's regulatory clampdowns related to "common prosperity" and technology companies. It's hard to avoid that part of the structural puzzle. We definitely have concerns about China's strict zero-COVID-19 policy, and it's unclear how that gets unwound. China has been on a declining trend growth path for many years; that's not a surprise. As the economy gets bigger, more mature, the internal market heats up. So, I'm not sold on China as a panacea. Thinking about zero-COVID-19 policies versus more open economies, we believe developed markets look more attractive, and we also think currencies have an edge over emerging markets. That said, it's really hard to talk about emerging markets as one group that looks the same because every country is different. But focusing on China, we are a little bit less sanguine on China and some of the other emerging market countries around China and the Asia-Pacific ex Japan region.

**Michael:** I think fears over a China hard landing are probably overstated. Policymakers there have the tools to engineer a softer landing. China's export growth is good, global demand remains resilient and the commodity cycle looks very encouraging.

**Francis:** To echo what Michael said, the Chinese definitely have the ability and the latitude to engineer a soft landing. I find it remarkable that the Chinese 10-year bond yield is at its lowest levels since June 2020. China has been operating somewhat independently during this whole pandemic. The economy has been slowing, and sentiment has been negative, but I think China looks pretty good in the sense that it is undergoing the start of a reflation cycle. But it doesn't want to reengineer a new credit inflation cycle or a hard landing. So, I agree policymakers there are going to do whatever it takes to generate a soft landing.

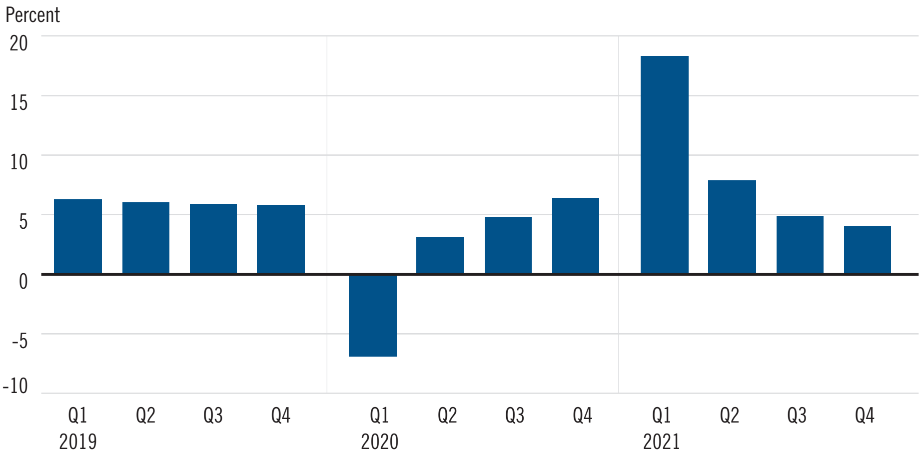
The first quarter could be a bit odd because of the Winter Olympics in Beijing as well as Chinese New Year, which could see some factories shuttered and skew some of the data. Looking beyond that, I think China should come out looking positive and continue to be the high beta source of growth in the world, as it has been for many years.

So, in terms of policy, China is moving one way, and the United States is pivoting in another direction. Currently, a lot of emerging market currencies look really cheap, so there is a constructive backdrop. Some emerging market countries have been tightening all through this pandemic because of the inflation story, and now they are ready to start stimulating. Part of this growth pivot story away from the United States to the rest of the world won't just be about China; it could include several emerging markets as well.

**SLOWING GROWTH IN CHINA**

**Exhibit 3: China's Real GDP Growth**

As of December 31, 2021




Sources: China National Bureau of Statistics, Macrobond. Important data provider notices and terms available at www.franklintempletondatasources.com.

## What about emerging markets other than China?

**Michael:** A lot of positive factors are lining up in emerging markets. There are clearly always going to be risks in emerging markets—countries can be significantly affected by global shocks or domestic shocks. But if we think about COVID-19, six months ago there was so much bearishness because emerging markets weren't vaccinating at the same rates as developed markets. There were fears that countries were going to shut down again and fall into economic hard landings. The reality is the vaccination rates have caught up substantially in several emerging markets and we have not seen the massive shutdowns and hard landings that many feared. So, I think we can be a little more optimistic about emerging markets at this stage.

In terms of relative interest rates, several emerging markets have been leading the Fed in terms of tightening. This is very atypical. A lot of countries tend to follow the Fed, but in this cycle, we've seen substantial rate hikes ahead of the Fed, particularly in Latin America. In Asia, several countries were able to maintain higher policy rates during the crisis, giving them a buffer against the expected Fed tightening cycle. Additionally, the growth story for emerging markets has continued to look compelling, particularly Asia. We think the opportunity set is exciting, and we see some good value opportunities there.

## Gene, let's turn to your thoughts to regional opportunities.

**Gene:** In terms of our positioning for regional equities, we prefer the United States, Japan, the eurozone, and Canada. Our team's positive view on the United States is based on strong US consumer balance sheets, and the strength of the US economy and US dollar.

In terms of Japan, some of Michael's arguments about emerging markets and China can apply to Japan as well. It's an export-driven economy. It has a positive role in the global economic recovery and capital expenditure cycle. Valuations look attractive, and the vaccination program has caught up, allowing the economy to function better. We are watching how quickly the relatively conservative government can open borders up and live with COVID-19 as an endemic versus a pandemic, but we see reasons for optimism in Japan.

Europe has had a successful reopening, although it is being walked back a little now. The fiscal package has been a meaningful contributor, and the European Central Bank is still relatively dovish when compared with other parts of the world. So that gives us some hope for positive outcomes there as well.

## Francis, where do you see opportunities in terms of currencies?

**Francis:** When I look at what's going on in the world, I share Gene's concern about the downside risk with Chinese policy. However, I still believe the Chinese authorities are going to do what it takes in terms of successive stimulus until they reach their goal of a soft landing. I think China would rather overdo it than risk unexpected weakness.

Looking at some of the valuation profiles, some of these emerging market currencies, such as the South Korean won or Chilean peso, look attractive to us. Generally, a lot of the emerging markets have been raising interest rates to the point now where they almost look like they are going to start to pivot in the other direction. We do see idiosyncratic opportunities popping up across the emerging markets space.

# Pivoting away from zero COVID-19

## How is COVID-19 factoring into your outlook on emerging markets?

**Michael:** My first point of optimism for 2022 is the move away from zero-COVID-19 policies and an acceptance of "living with COVID." High vaccination rates or high herd immunity should bring us closer to seeing substantially lower fatality rates from COVID-19 variants. I think countries are in a better position to manage what will likely be a reoccurring endemic, as Gene said. Particularly in areas of Asia, which have been locked down for much of the last year and a half, if you get a "live with COVID-19" dynamic, I think it's a positive story for the region. We've already had progress on the export side, which is the "stuff" Gene was talking about—and there's still a lot of demand. If you get the services sector back and the reopening of domestic economies, that's another engine of growth. These should be positive dynamics for 2022.

People have largely shunned emerging markets over the last year because of pandemic issues. I think we're moving past that, and that's exciting as we move into the new year. The global growth backdrop has continued to remain positive, despite some expected moderation. Stronger commodity prices should provide a nice tailwind for several emerging markets that in some cases is yet to be priced in.

We are also seeing some increases in regionalization. Several free trade agreements started in January involving Asia, Canada and some Latin American countries—and did not include the United States. Those regional trends appear to be accelerating. Asia has yet to fully emerge and open up, so I think there is significant potential there. In Latin America, a lot of the bad news has already been priced in—whether it was political volatility, whether it was the COVID-19 fumbles at the beginning—they are through much of it.

**Endnotes**

1. The permanent income hypothesis was formulated by Milton Freidman in 1957 and posits that consumers spend in accordance with their long-term average income. Long-term average income is seen as their permanent income. For example, a person who receives a yearly bonus may spend or save more than their normal pay in anticipation of receiving the bonus.
2. Source: Paul, H. "US Fed to Purchase $80 Billion in Treasuries, $40 Billion in MBS Per Month," *The Deep Dive*, June 11, 2020.
3. Source: Bloomberg. As of February 3, 2022.
4. For Canada and Australia, the target inflation rate in the chart represents the mid-value of the target inflation range. The current inflation rates pertain to: US - Core Personal Consumption Expenditure Inflation; Canada—Total Consumer Price Index; Europe—Monetary Union Index of Consumer Prices, All Items; UK—Consumer Price Index, EU Harmonized; Japan—Core Consumer Prices Index; Australia—Consumer Prices Index; China—Consumer Prices Index.
5. Sources: Franklin Templeton Fixed Income Research, Bureau of Economic Analysis (BEA). As of December 2021.
6. Source: US Bureau of Labor Statistics. CPI inflation was 7% year-over-year in December 2021 and 1.4% in 2020, as measured by the Consumer Price Index.
7. Source: Paul, H. "US Fed to Purchase $80 Billion in Treasuries, $40 Billion in MBS Per Month," *The Deep Dive*, June 11, 2020.

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