Invesco

2022 Investment Outlook

For Retail Use in the United States and Canada

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Executive summary

Introduction

Following dramatic fiscal and monetary policy moves in 2020 and 2021, the stage is set for 2022 to be a year of transition as policies and economies move toward a more normal state. However, issues remain that will likely define the economic and market environment, including continued supply-chain disruptions and an upsurge in demand that threaten to keep inflation high across many economies. For 2022, our outlook is centered on the question of inflation and how markets and policymakers may react to it.

Our Base Case

We expect global growth to normalize, remaining above its long-term trend but decelerating to a more sustainable rate as fiscal stimulus is gradually removed. We anticipate that inflation will peak in mid-2022 and then start to slowly moderate, backing down toward target rates by the end of 2023 as supply chain issues resolve, vaccination levels increase, and more employees return to the workforce. We look for the US Federal Reserve (Fed) to remain patiently accommodative, with a rate lift-off in the back half of 2022, although other developed countries' central banks might act more quickly. Finally, we expect volatility will increase as markets digest the transition to slower growth and a gradual tightening in monetary policy.

Transitory Inflation Risk

In our transitory inflation risk scenario, current inflation fears prove to be overblown, with inflation gradually coming off its current highs towards something close to or below 2%. We see growth higher than normal in this environment, ultimately pointing to economies being earlier in the cycle than we currently judge them.

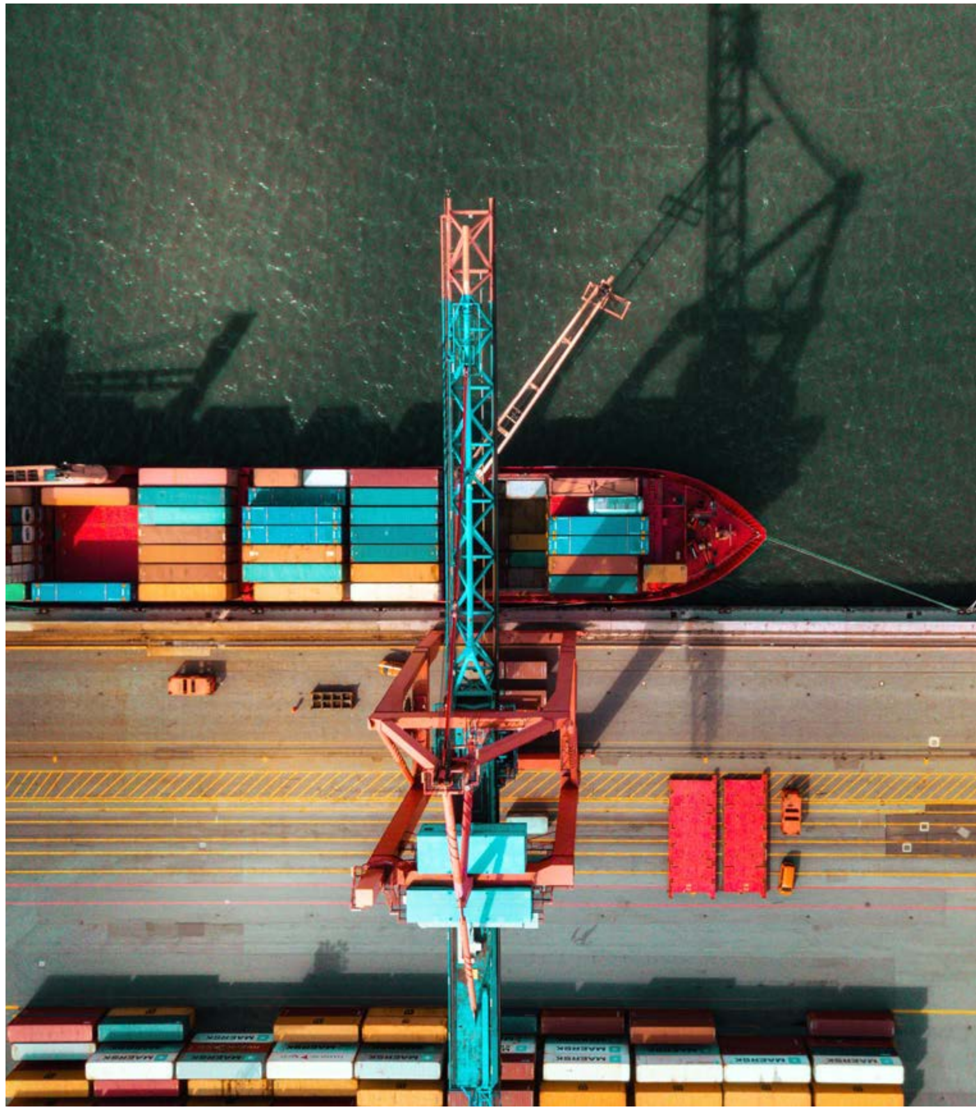
Persistent Inflationary Risk

In our persistent inflationary risk scenario, developed central banks' messaging fails to convince markets that inflation is transitory, with further elevated prints throughout 2022. We see the problem as stemming from a combination of elevated demand driven by past monetary expansion and supply-side disruptions. This causes inflation expectations to become unanchored, with medium-term expectations rising above the 4% mark persistently. This would signal a loss of credibility for those central banks, requiring action that prompts a significant risk of ending the current economic cycle.

Our base case anticipates a transition to more normal growth and a peaking of inflation in 2022.

Our transitory inflation scenario anticipates growth to be higher and inflation lower sooner.

Our persistent inflation scenario anticipates inflation to remain elevated and the Fed to become more hawkish.



Where are we in the cycle?

Returning to normal: We see the cycle resuming more normal growth patterns

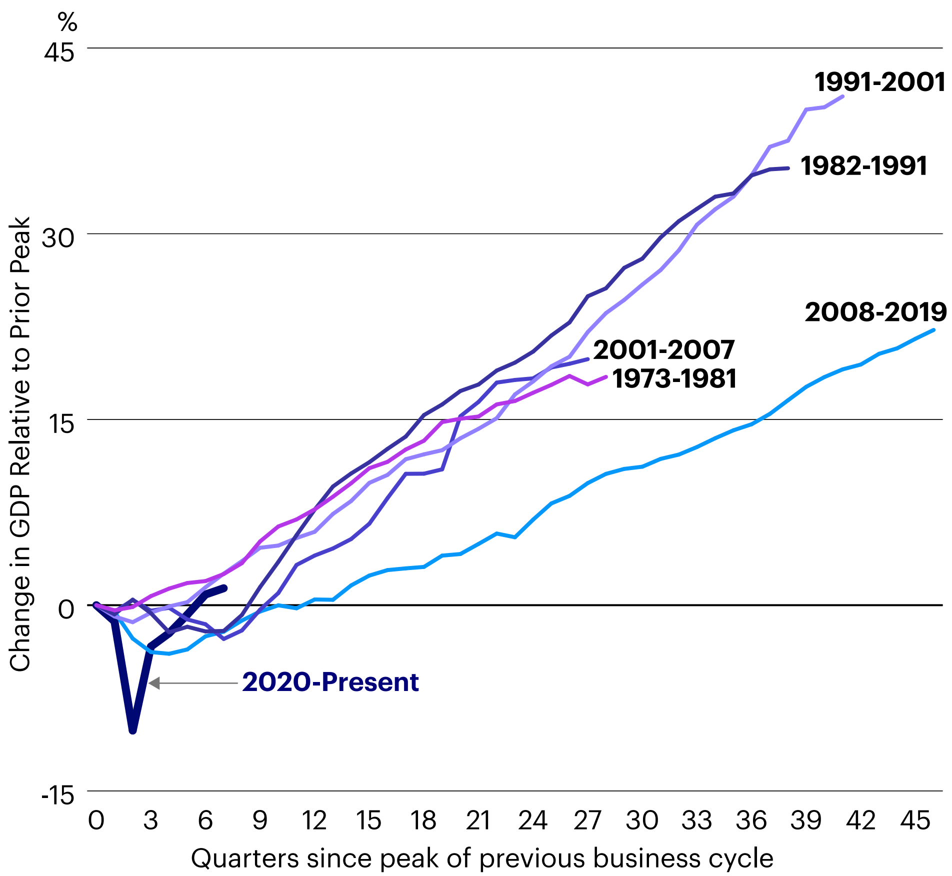
Normalization Under Way

While our base case for the global economy may resemble a mid-cycle slowdown, we believe that pandemic-driven disruptions have significantly altered traditional business cycle analysis.

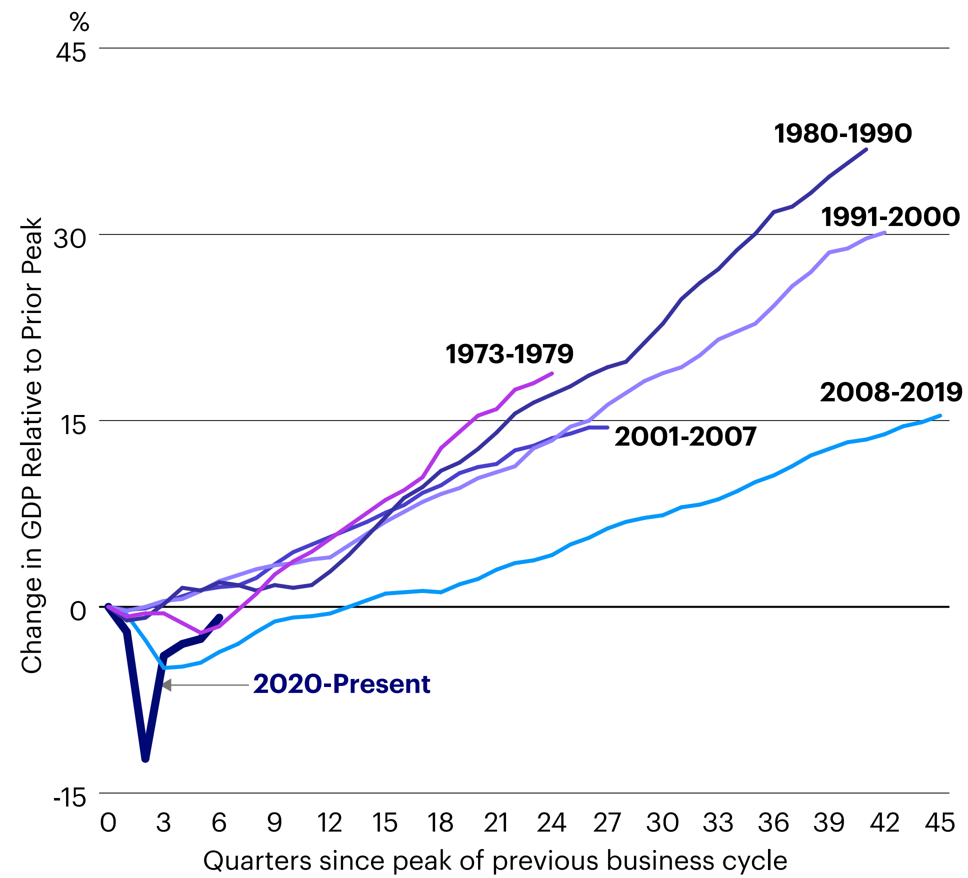
Instead, we view the path ahead as one of transition, marked by a period of continued growth but with a falling rate of change as economies digest the pandemic's extraordinary policy actions.

2022 looks set to be a year of transition as economies return to structural growth rates.

US GDP growth during business cycles



G7 GDP growth during business cycles



GDP = gross domestic product. The G7 is an inter-governmental political forum consisting of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

Sources: Macrobond, Organisation for Economic Co-operation and Development (OECD), and US Bureau of Economic Analysis. As of October 31, 2021.

We see inflation peaking in mid-2022 and a return towards trend growth

With inflation effectively baked in, we turn our attention to policymakers’ response

More Inflation
Less Growth

Base Case

Inflation peaks in mid-2022, cooling gradually into 2023

Developed market (DM) central banks maintain current tightening expectations

Economies glide toward trend real growth rates

Less Inflation
More Growth

Persistent Inflation

Inflation expectations become unanchored in light of higher inflation prints.

DM central banks react with strong hawkish pivot, prompting a significant risk of ending the current economic cycle.

Higher Probability

Transitory Inflation

Inflation gradually cools towards 2% or below.

Monetary policy proves less hawkish.

Growth remains above potential for longer.

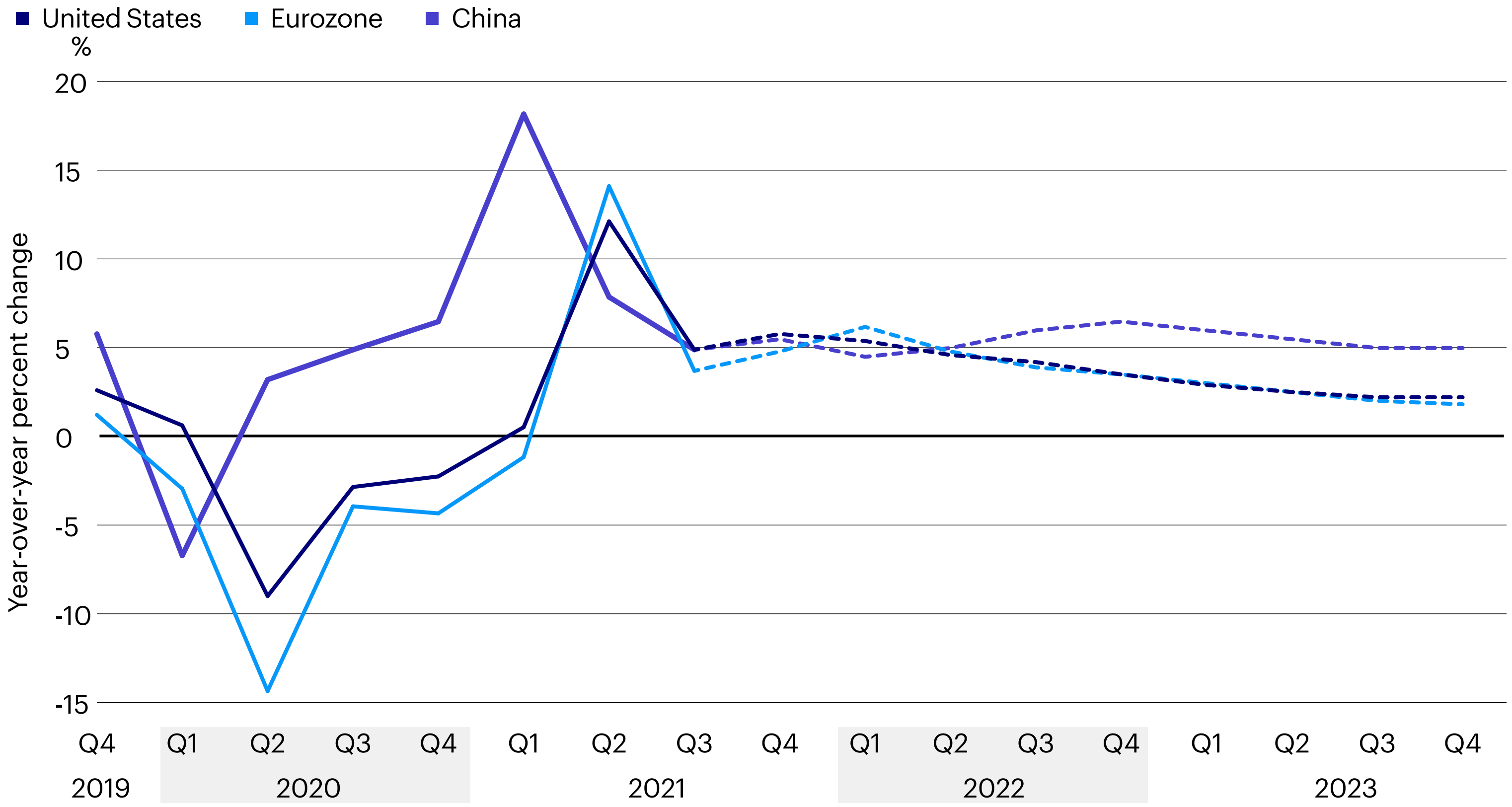
- Following a period of enormous policy actions to address the coronavirus pandemic, we find economies in a period of transition.
- While there are a variety of upside and downside risks, we view inflation as the distinguishing characteristic among our scenarios.

Source: Invesco. For illustrative purposes only.

What's the direction of economies?

US, eurozone gradually returning towards structural growth rates; China to slow temporarily

GDP growth figures ahead
Invesco's assumptions for year-over-year GDP growth



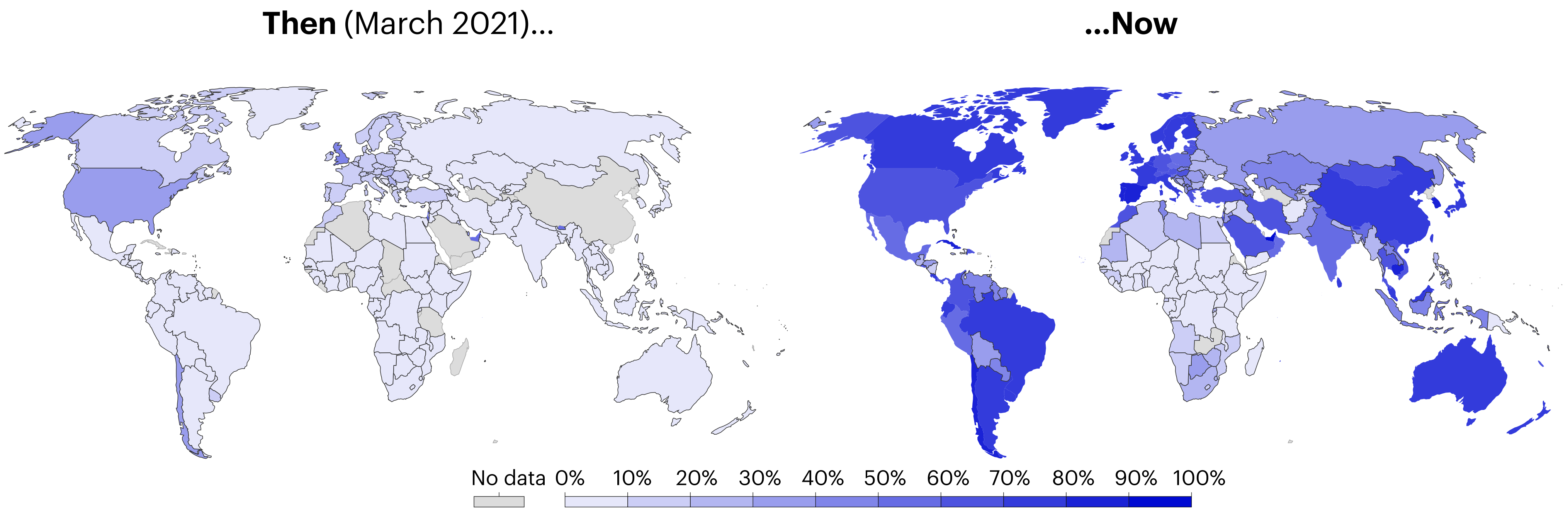
- Following large fiscal programs and very accommodative monetary policy, we see economies slowing from their elevated post-pandemic growth rates into something more normal.
- We see the US and eurozone (EZ) approaching trend growth rates as we move through 2022.
- In China, we see growth moderating into the first half of 2022, followed by a pickup fueled partly by policy support.

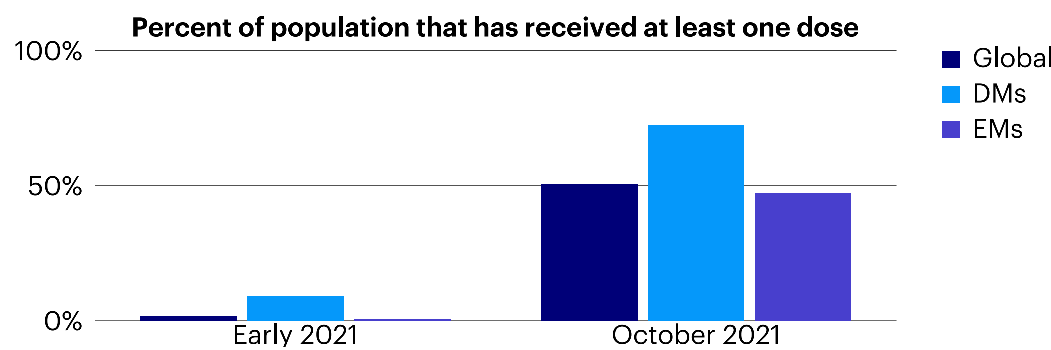
Sources: Bloomberg L.P., Invesco, as of October 31, 2021. Dashed lines indicate expected growth path.

The world's increasing immunity to the coronavirus

As 2021 has progressed, COVID-19 has increasingly faded as a risk to economies

Percentage of the world that has received at least one vaccine dose





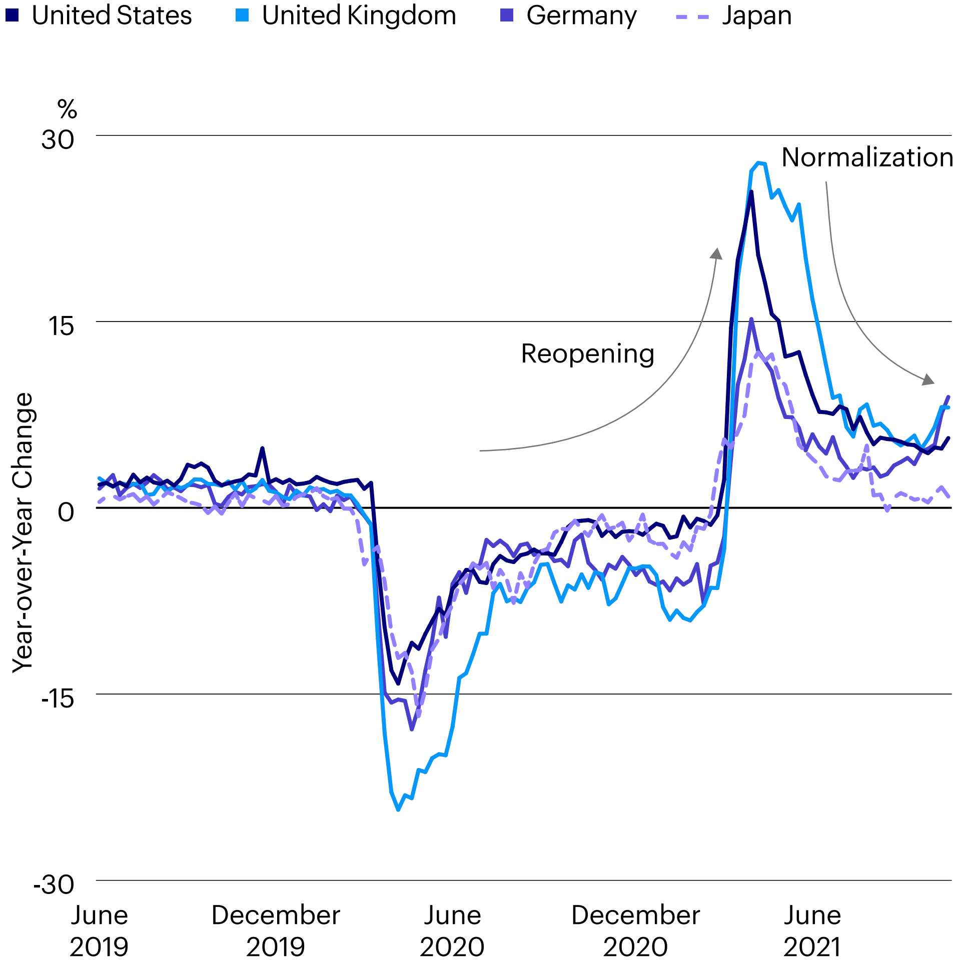
- Whether through past infection or vaccination, people around the world are gaining immunity to the coronavirus, as confirmed in seroprevalence studies.
- While we remain wary of the potential of a new mutation of the virus, at present, COVID-19 is increasingly less of a concern in our outlook as the economic impacts of the virus continue to fade – though with fits and starts along the way.
- However, an uptick in cases in some countries remains a risk that could be accompanied by lockdowns and supply chain disruptions.

Sources: Our World in Data and Invesco, as of October 31, 2021. "Early 2021" is defined as March 1, 2021.

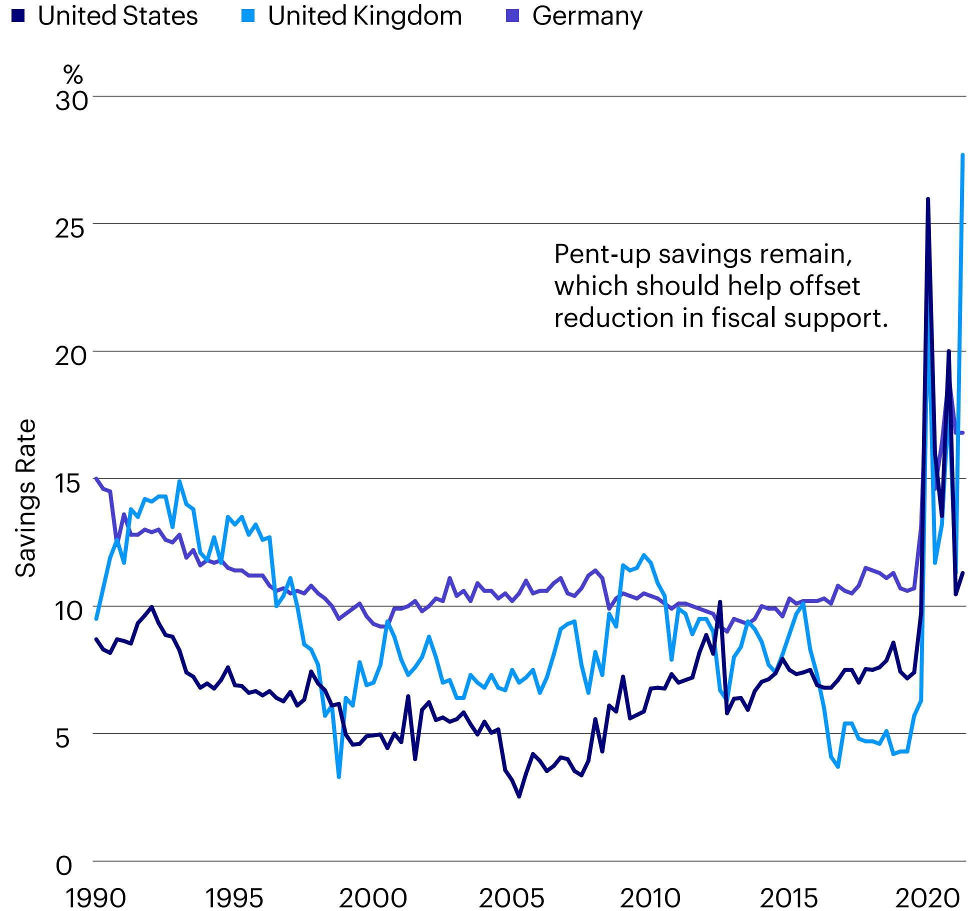
Growth is likely to return to trend

Following recovery from the pandemic, we see economic growth normalizing

Following reopening, growth is slowing but still fast
OECD weekly GDP tracker for selected economies



Household savings rates are coming off record highs, but remain elevated
% of disposable income, selected major developed economies



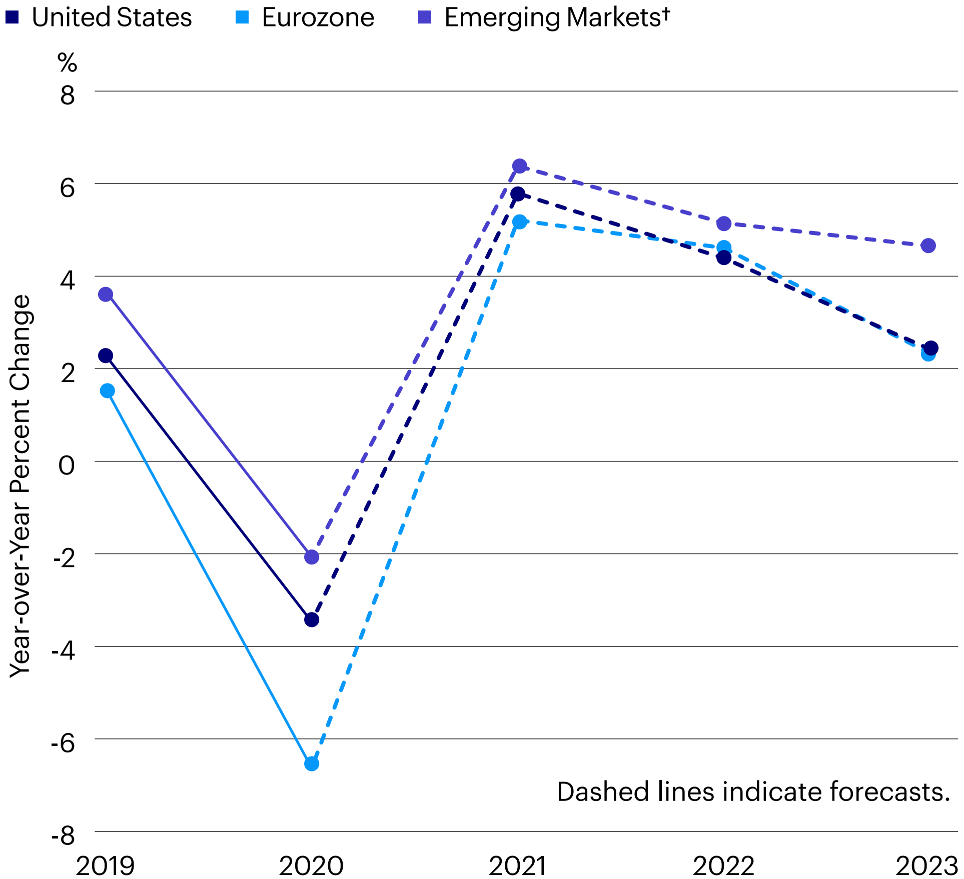
- In 2022, we expect a gradual transition away from policy-led changes in growth. Instead, we see a return to more normal growth rates as business and household spending patterns normalize.
- The continued drawdown of unusually high household savings is likely to offset fiscal tightening, allowing for a further release of pent-up demand.

Sources: Macrobond, Organisation for Economic Co-operation and Development (OECD), Refinitiv, and Invesco, as of October 31, 2021.

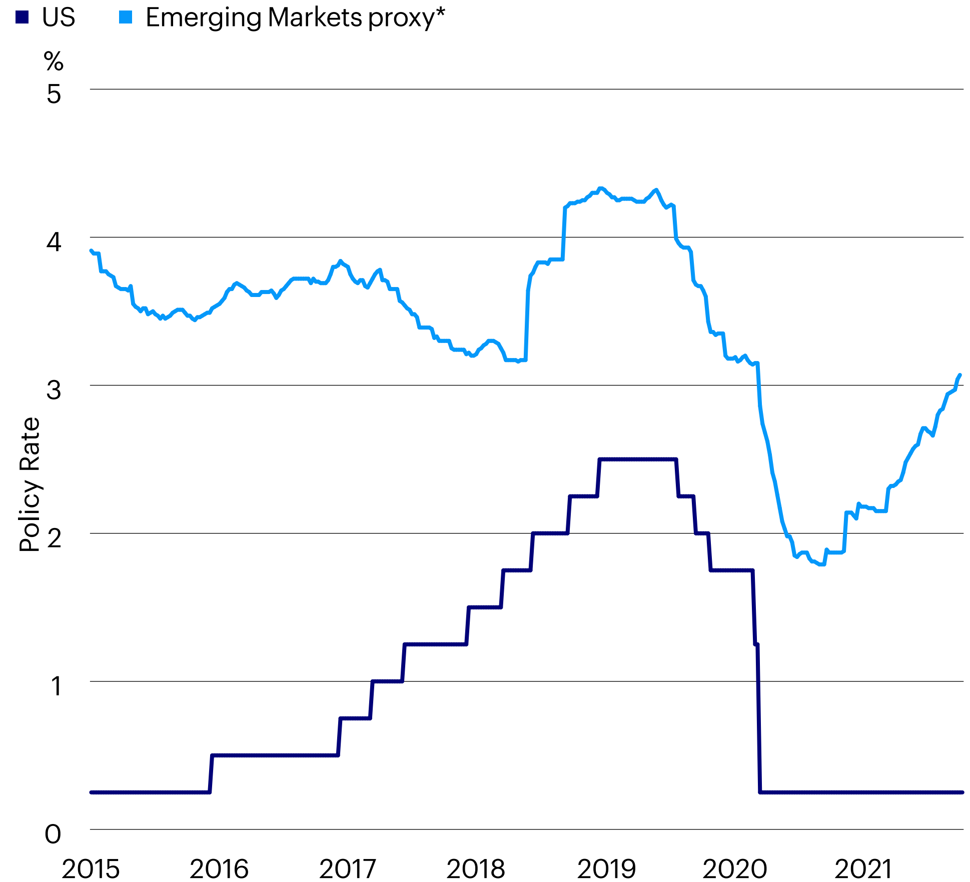
Emerging market growth is likely to diverge from developed markets

Recovery and reopening to proceed in emerging markets on the back of rising immunity

Emerging market growth is diverging from developing markets...
Year-over-year percent change of GDP, historical and forecasts



...and rate tightening is already underway
Central bank policy rates, US versus emerging markets



- In emerging markets, we see growth picking up relative to developed markets as immunity to the coronavirus is acquired, and the US dollar remains relatively neutral.
- Monetary policy tightening also appears relatively advanced in many emerging market economies. We expect further emerging market policy changes to reflect country-specific growth and inflation pressures as the US Federal Reserve normalizes in line with its guidance.

†Emerging Markets (EM) forecasts are sourced from the International Monetary Fund's October 2021 World Economic Outlook. Dashed lines indicate forecasts.

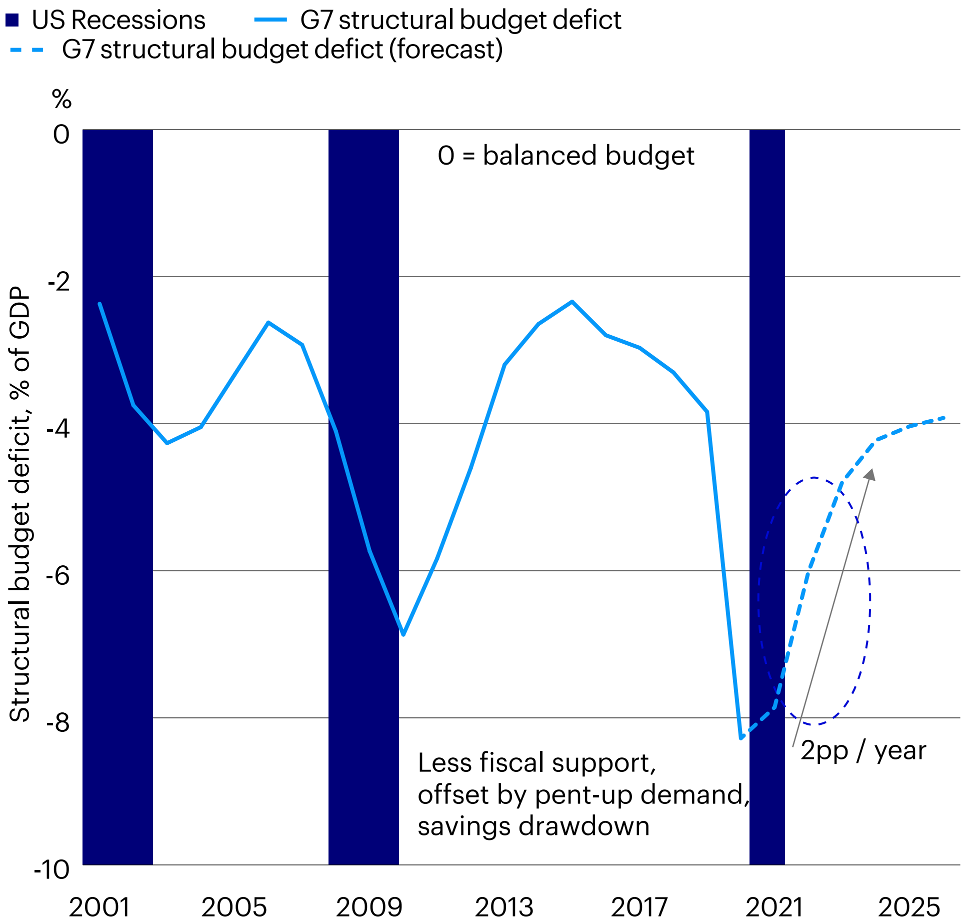
*Emerging Markets Proxy = 25 emerging market economies.

Sources: US Federal Reserve, International Monetary Fund, various central banks, and Invesco. US and eurozone forecasts are based on Invesco assumptions. As of October 31, 2021.

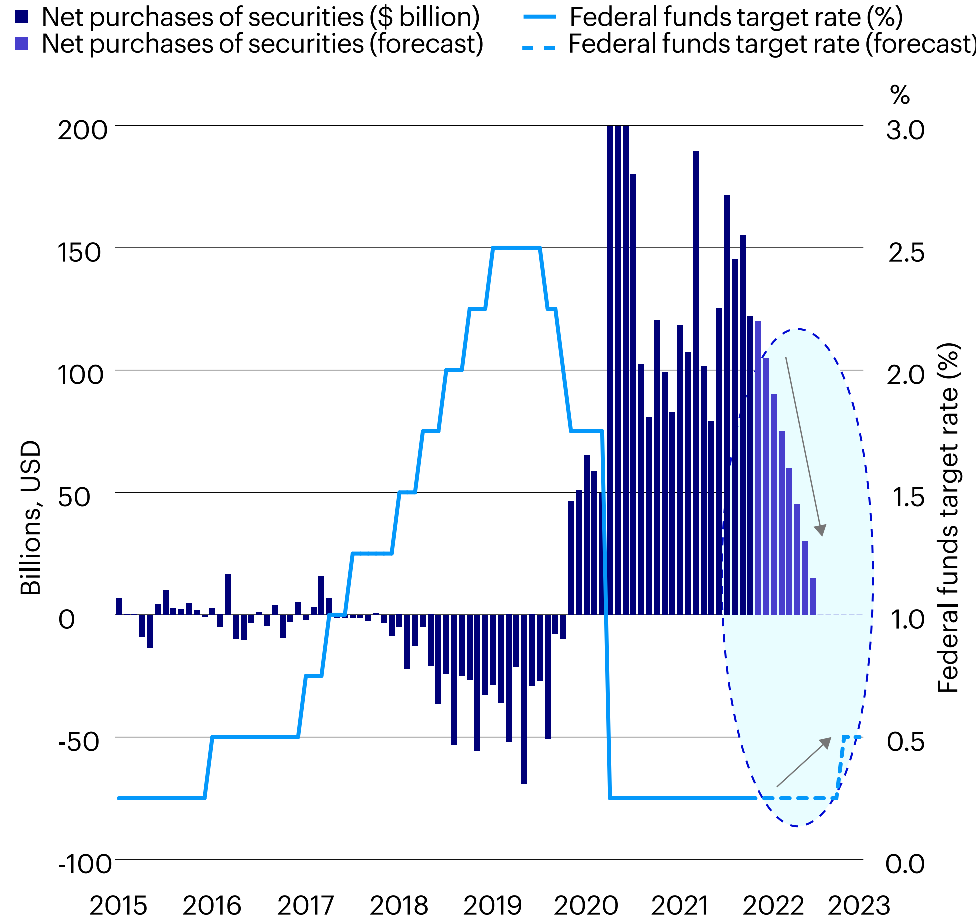
Shrinking fiscal deficits and tightening monetary policy ahead

With tapering underway, we turn next to the timing and pace of rate hikes

Less fiscal support expected in G7s in 2022
Cyclically adjusted budget balances for G7 economies



Monetary policy stance is tightening
Expected path of Fed monetary policy: balance sheet and rates



- Policy stances are changing across economies. In G7 nations, we see a combination of less fiscal support and monetary policy tightening in 2022 and beyond.
- Fiscal tightening should be offset by drawdowns of built-up private savings.
- We also expect a single rate hike from the Federal Reserve in the second half of 2022, in line with current FOMC 'dot plot' forecasts.

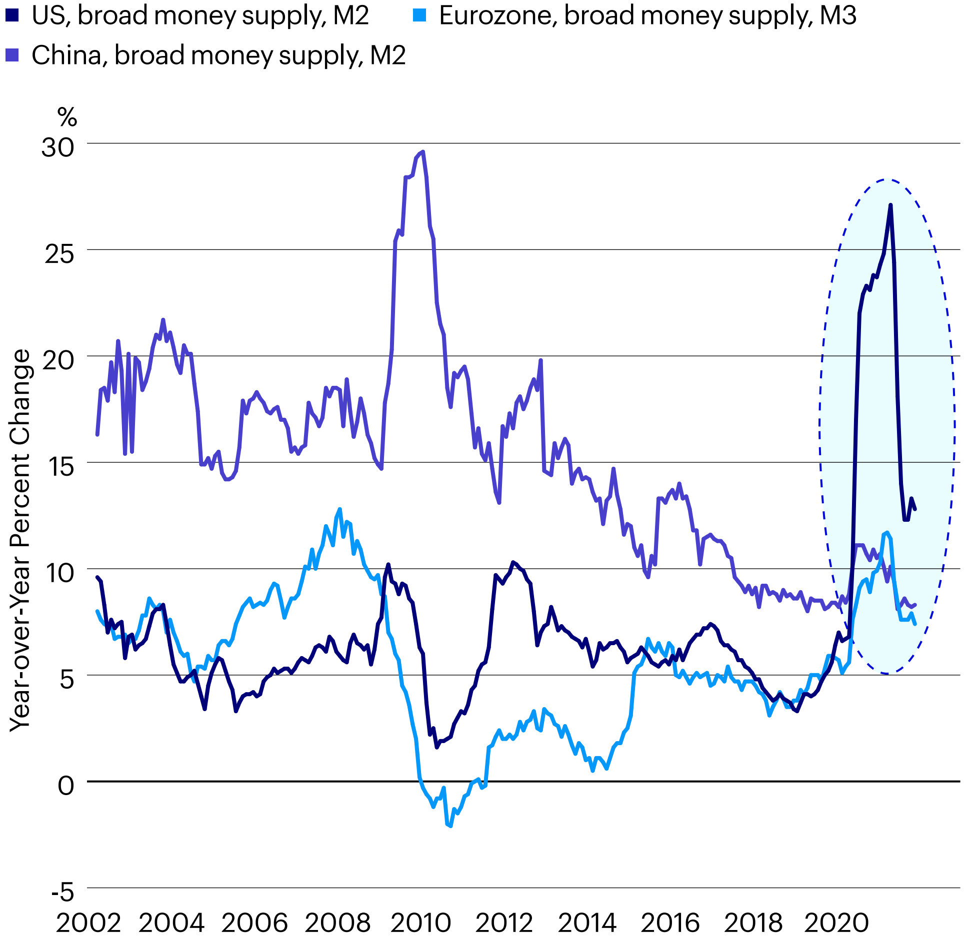
The G7 is an inter-governmental political forum consisting of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States.

Sources: International Monetary Fund, US Federal Reserve, and Invesco, as of October 18, 2021. FOMC = Federal Open Market Committee. Past performance is not a guarantee of future results.

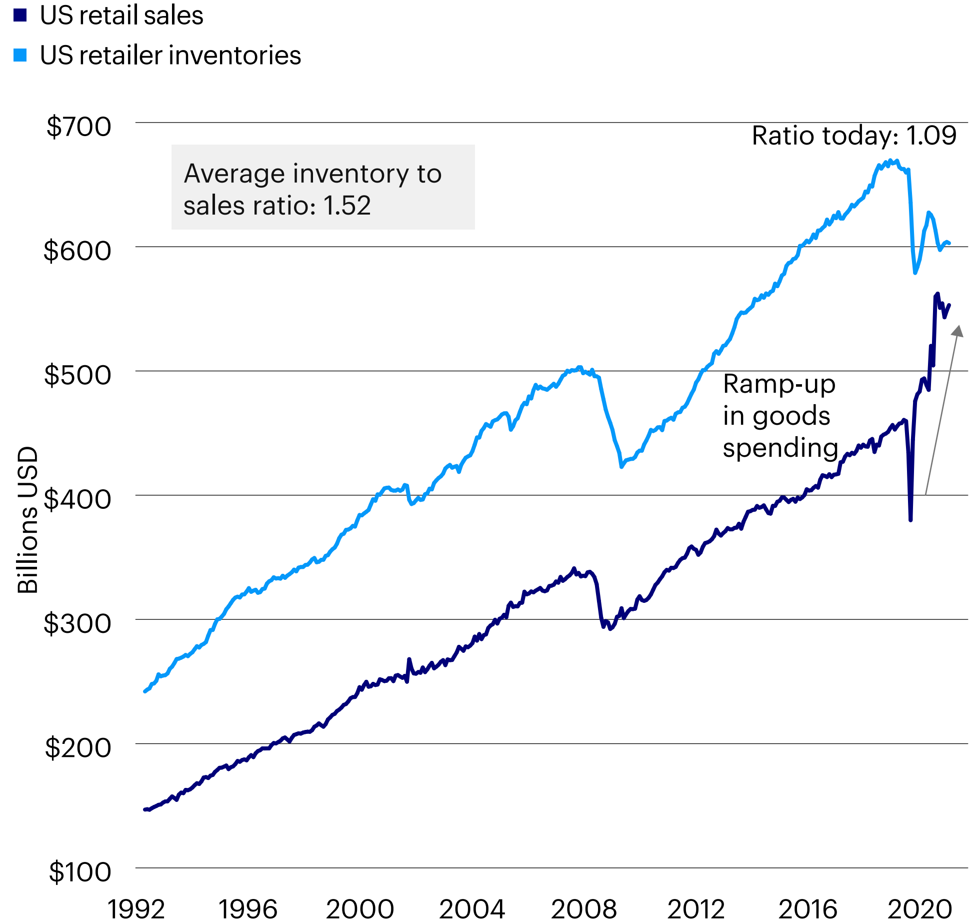
Inflation is likely on track to peak in mid-2022

Economic data signals slowing inflation is likely

Money supply growth has peaked...
Broad money supply growth for selected economies



...and the inventory crunch should normalize
US retail sales versus inventories



- We see inflation continuing to rise until peaking in mid-2022, followed thereafter by high but falling readings.
- We are encouraged by falling money supply growth. When viewed as a precursor to inflation, this suggests fewer inflation pressures ahead.
- Moreover, COVID-19 resulted in a concentration of spending in durables while supply chains became strained, resulting in heightened price pressures that appear to be resolving slowly.

M2 is a measure of the money supply that includes cash and checking deposits as well as savings deposits, money market securities, mutual funds and other time deposits. M3 is the broadest measure of an economy's money supply.
The inventory to sales ratio is calculated by dividing the value of retailer inventories by the value of retail sales.
Sources: Macrobond, US Federal Reserve, European Central Bank, People's Bank of China, US Census Bureau, and Invesco, as of October 31, 2021.

Risk scenario: Inflation proves transitory in the short term

If inflation has already peaked, we figure more dovish policy and greater growth potential

Factors that could cause inflation to moderate in 2022...

Temporary supply-side issues fading.
Commodity and freight prices are partly surging on temporary, pandemic-induced supply factors. We believe this to be transitory. Prices appear to have already peaked for used cars, many commodities, freight, and a number of other goods.

Slack remains.
Capacity utilization remains depressed, indicating supply-side slack. We also anticipate labor market normalization as more workers return to the workforce, alleviating some wage pressure.

Spending reorienting.
Spending had shifted into goods due to social distancing. As reopening continues, spending is likely to continue to rebalance more to services.

Pent-up demand is fading.
Pent-up demand has been elongated by supply chain issues. Its impact on inflation should be a one-off and relatively short-lived factor.

Fiscal stimulus is fading.
Fiscal stimulus is expected to drop in 2022, which is likely to reduce overheating risk.

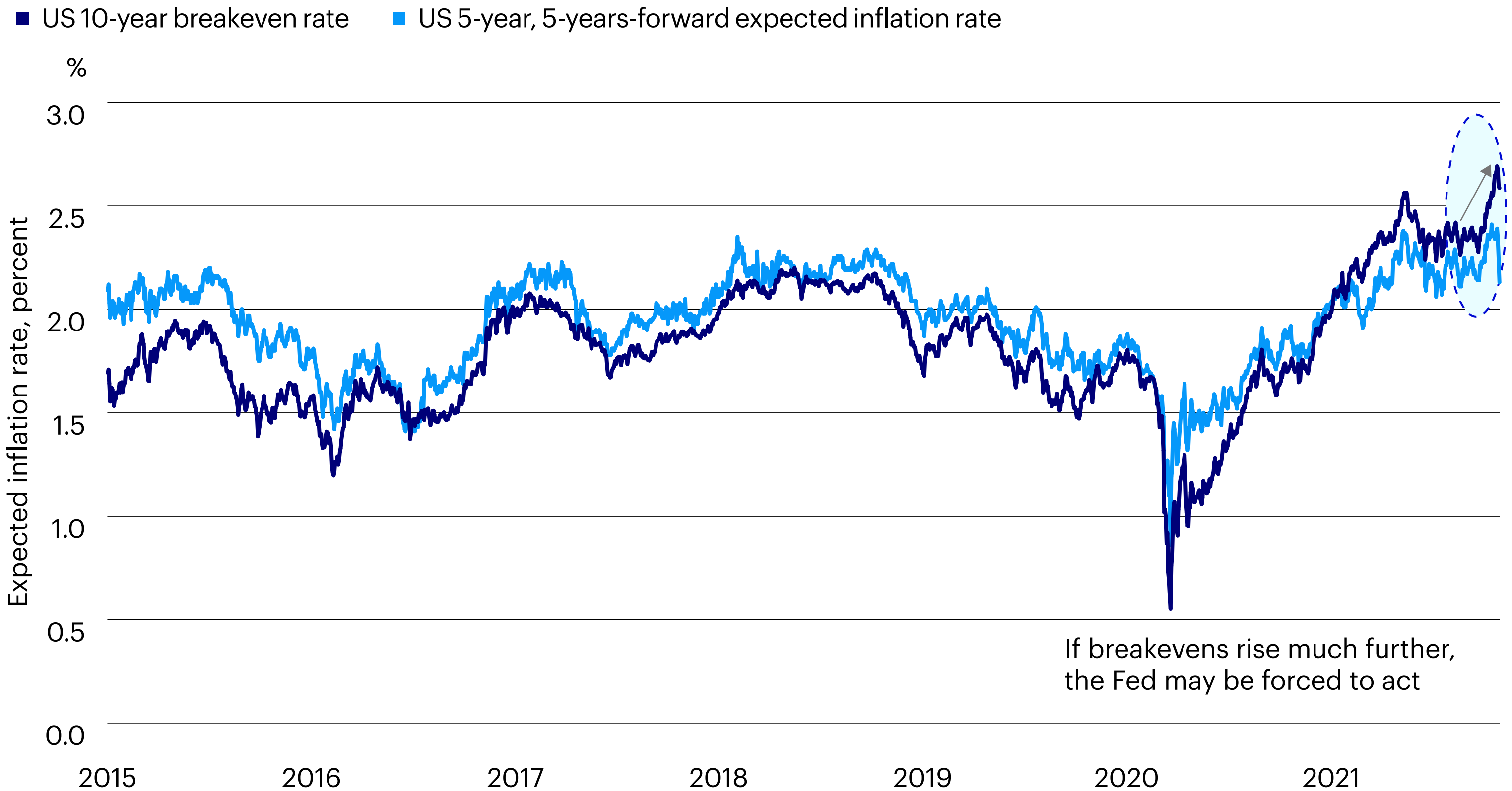
- In this scenario, we hypothesize that current fears of inflation prove to be excessive, with inflation in major developed countries falling to 2% or below.
- We see growth higher than normal in this environment, ultimately pointing to economies being earlier in the cycle than we currently judge, which would cause us to favor cyclical assets.

Source: Invesco.

Risk scenario: Inflation persists without cooling

If inflation prints continue at their high rate, we see Fed action in play

If inflation expectations become unanchored, we see corrective actions from central banks
Market-based inflation expectations for the United States



- In this scenario, we see persistently high inflation leading to an unanchoring of inflation expectations above the 4% mark. We expect this to force developed market central banks into a more hawkish policy pivot.
- In this environment, we would expect a curtailment of the economic cycle and would favor defensive assets.

Sources: Macrobond, Federal Reserve, US Department of Treasury, and Invesco, as of October 31, 2021.

Summary of our Scenarios

Persistent inflation	Base case	Transitory inflation
Inflation expectations become unanchored in light of higher inflation prints, prompting further and accelerated hawkish Fed action.	Inflation peaks in mid-2022, cooling gradually into 2023. DM central banks maintain current tightening expectations. Economies glide into trend real growth rates.	Inflation gradually cools towards 2% or below. Monetary policy proves less hawkish. Above potential growth continues for longer.

Assets with relative attractiveness

Persistent inflation			Base case			Transitory inflation		
Gold	DM ex-US sovereigns (Hedged)	Inflation-protected bonds	Equities	Alternatives (Real estate)	Commodities	Equities	High yield	IG credit

Sectors and tilts with relative attractiveness

Persistent inflation			Base case			Transitory inflation		
Low volatility	Large caps	Defensives	Information technology	Large caps	Consumer staples	Industrials	Materials	Energy
Communications	Quality		Utilities	Health care	Real estate	Value	Financials	Mid/small caps

Regions with relative attractiveness

Persistent inflation			Base case		Transitory inflation	
Japan	**Canada**	**Australia**	**Emerging markets**	**US**	**Developed ex-US**	**US**

Currencies with relative attractiveness

Persistent inflation			Base case	Transitory inflation
CAD	**JPY**	**CHF**	**Emerging market currencies**	**USD**

High inflation ← Inflation rate → *Low inflation*

DM = Developed markets; IG = Investment grade; UK = United Kingdom; US = United States; CAD = Canadian dollar; JPY = Japanese yen and CHF = Swiss franc; USD = US dollar
Source: Invesco. The asset choices are designed to show our favored assets within a diversified selection of asset categories.

Relative tactical asset allocation positioning

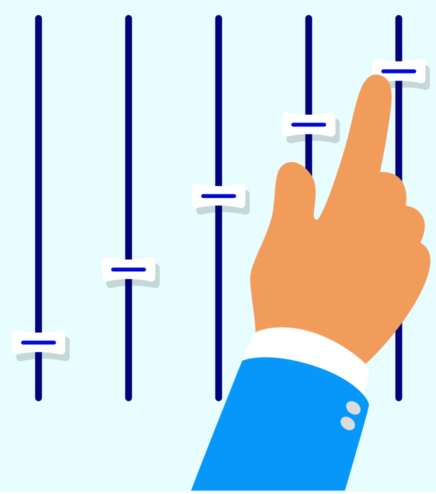
Declining compensation for growth risk, with rotation towards defensive sectors

Reduce risk posture, with slight overweighting of equities, but titled towards defensive sectors. Expect higher volatility and greater convergence in returns across asset classes.

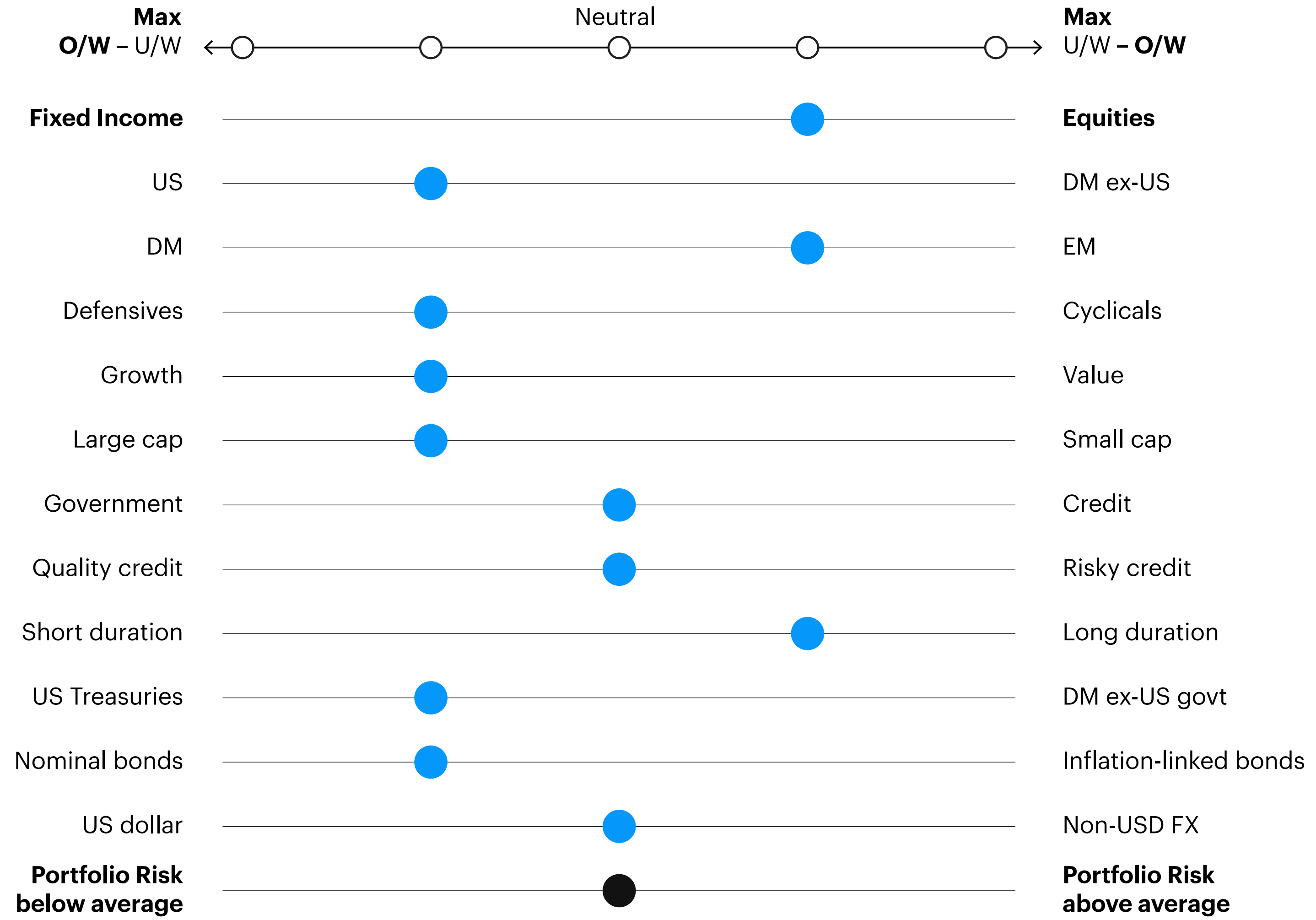
Equities: Favor emerging markets on cyclical divergence. Favor US, quality, and large caps on slowing growth expectations and stable to lower long-term bond yields.

Fixed Income: Moderate overweight to duration, expecting higher rates up to intermediate maturities, but stable to lower yields in the long-end. Overweight US Treasuries.

FX: Overweight emerging market currencies.



Relative Tactical Asset Allocation Positioning: Base Case



O/W = Overweight; U/W = Underweight; DM = Developed markets; EM = Emerging markets; USD = US dollar; FX = Foreign exchange.

Source: Invesco Investment Solutions, as of October 31, 2021. Note: For illustrative purposes only.

Relative tactical asset allocation positioning

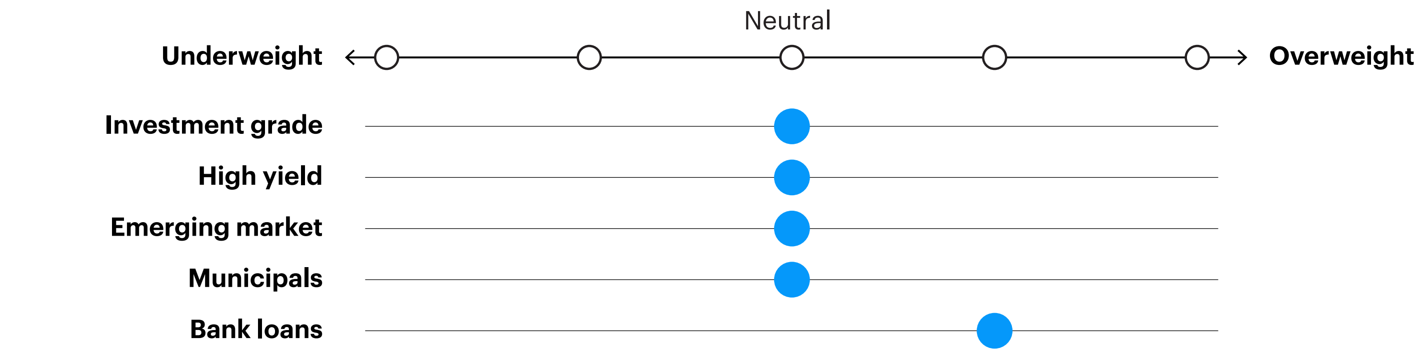
Investing in Fixed Income*

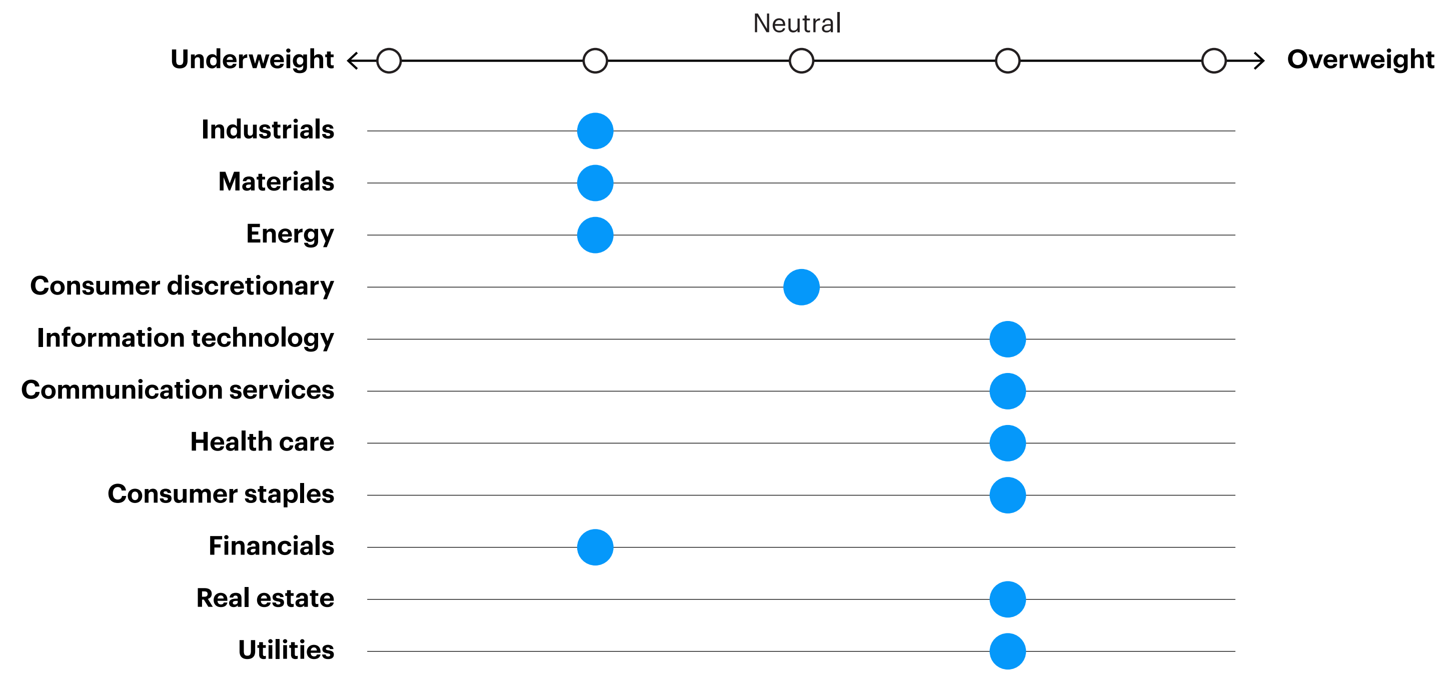
- Solid economic growth is supportive of credit fundamentals, and low interest rates globally continue to be supportive of technical for credit markets.
- Valuations are very tight in a historical context, limiting the potential upside from spread tightening and increasing the potential downside in a widening scenario. Low overall yield levels increase the risks when overall yield levels rise.
- Bank loans are supported by strong credit fundamentals and may benefit from rising rates as bank loans have floating interest rates.

Investing in Equities**

- Across scenarios, our sector allocations are a byproduct of our factor/style allocations.
- In our base case scenario, we expect slowing growth and peaking inflation to support moderate outperformance of defensive sectors with quality characteristics and higher duration (IT, communication services, health care, real estate, and consumer staples).
- Favor quality and large caps, given slowing growth expectations and stable (or lower) long-term bond yields.
- Favor US equities over developed markets ex-US, as the global slowdown favors regions with lower cyclical exposure and lower operating leverage.

Absolute Tactical Asset Allocation Positioning: Base Case





* Source: Invesco Fixed Income, as of October 31, 2021.
** Source: Invesco Investment Solutions, as of October 31, 2021.

2022 Investment outlook: Tactical asset allocation

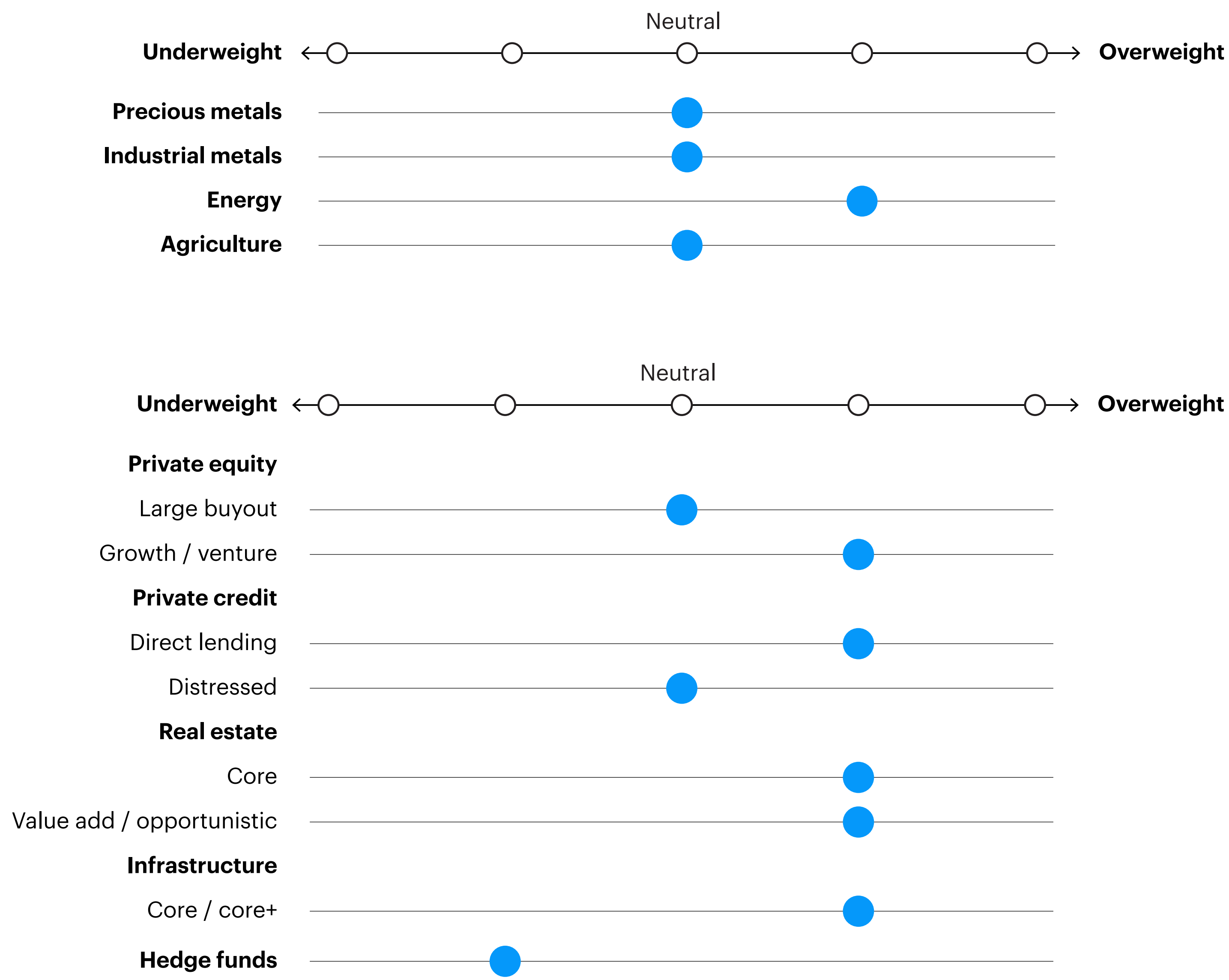
Investing in Commodities*

- Agriculture provides the least economically sensitive exposure with outcomes dependent upon weather, crop yields, and inventory levels, as well as the rate of change in the US dollar for exported commodities.
- With more developed and emerging economies reopening, energy demand will increase while producers maintain a disciplined approach to raising production.
- Given their high economic sensitivity, we are neutral on industrial materials due to anticipated slowing growth. The ongoing slowdown in China limits upside potential.
- Gold responds favorably to rising inflation and the decrease in real rates as growth decelerates. Exposure to silver and its crossover use as an industrial metal is a potential limiting factor.

Investing in Alternatives**

- Within the private equity space, we favor growth and venture categories which are expected to continue to outperform across a range of macroeconomic scenarios, while buyout strategies may face headwinds driven by relatively high valuations and an increasing supply of dry powder competing for deals.
- Direct lending strategies should continue to benefit from strong credit fundamentals and have the potential to benefit from increasing interest rates given their floating rate structure.
- Real assets respond favorably to inflation, both as a result of increasing revenue as well as physical asset appreciation. The potential for a continued rebound in global trade, passenger travel, and office occupancy, coupled with relatively attractive valuations and inflation protection, results in a favorable outlook.

Absolute Tactical Asset Allocation Positioning: Base Case



* Source: Invesco Systemic & Factor Investing, ETF and Indexing teams, as of October 31, 2021.
** Source: Invesco Investment Solutions, as of October 31, 2021. Alternatives tactical asset valuations represent our view of which asset classes are likely poised to outperform over an approximate 3- to 5-year timeframe, October 2021. Note: For illustrative purposes only.

Important information

The opinions expressed are those of the author, are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.

All data as of October 31, 2021, unless otherwise stated. All data is USD, unless otherwise stated.

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In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

Commodities may subject an investor to greater volatility than traditional securities such as stocks and bonds and can fluctuate significantly based on weather, political, tax, and other regulatory and market developments.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Commissions, trailing commissions, management fees and expenses may all be associated with mutual fund investments. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Please read the simplified prospectus before investing. Copies are available from your advisor or from Invesco Canada Ltd.

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