

Looking Ahead to 2022, with a Focus on Social and Environmental Drivers of Markets

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Global markets are in the midst of a major transition, with social and economic conditions deeply intertwined with the shifting landscape. As you'd expect of a significant transition, it's difficult to accomplish smoothly and generates mispricings, imbalances, and opportunities along the way. In this ESG Outlook, we start with a brief discussion of **the backdrop to this economic transition**—how we got here—before exploring **our current inflection point**, as the new paradigm we've shifted into is starting to run up against inflationary constraints, with social and environmental considerations exacerbating the increasingly difficult trade-offs. Next, we delve into how **the climate transition** is adding to already mounting inflationary pressures and is likely to produce economic and market volatility going forward. Lastly, we discuss why **the influence of private sector sustainability efforts on capital flows and pricing is likely to accelerate in 2022**.

The Backdrop: How We Got Here

Two powerful forces that have defined our world for the past few decades have been globalization, or the integration of economies around the world into one system, and rapid technological progress. These contributed to falling inequality *across* countries as hundreds of millions of people in emerging markets were lifted out of poverty—most notably in China. They also contributed to increasing inequality *within* developed countries, as many workers grew uncompetitive relative to improving technologies and cheaper labor in emerging markets. In developed countries, global integration and technological transformation created gains for consumers and shareholders but, without policy direction to address them, also hurt many workers. Inequality reached extremes, producing a populist and nationalist pushback. And as wealth and economic power built up in Asia and especially in China, conflict between the US and a rising China began to intensify.

Over this period, global warming accelerated, with a rising toll from extreme weather events, and awareness of the environmental footprint of the global economy gradually increased. Yet the policy action over the last decade, and even in the last year, has fallen far short of what would be required to limit global warming to 1.5–2 degrees. Now we're at an inflection point, with the latest [UN Intergovernmental Panel on Climate Change report](#) emphasizing that time is running out to shift human behavior before much larger and more irreversible damages hit and with popular opinion in many countries giving policy makers a clear mandate to more forcefully address environmental issues.

The primary tool of policy to guide the economy over this period was monetary, with the Federal Reserve having the largest impact due to the prominent role of the dollar around the world. Since the 1980s, every economic downturn was met with successively easier Fed policy, first in the form of lower interest rates and then through money printing (QE). Seemingly unlimited money printing never produced much in the way of inflation because the underlying forces of globalization and automation were offsetting, disinflationary pressures. Over this period, **dissonance grew between classic measures of growth and unemployment, which had traditionally been excellent proxies for standards and quality of life, and deteriorating social and environmental conditions**. These classic economic measures guided monetary policy makers, but lower interest rates and money printing were insufficient tools to address the new social challenges that emerged. Meanwhile, low inflation and little private sector appetite to borrow at ultra-low rates meant that there was more room for governments to step in without adverse effects.

After decades of relying solely on monetary policy (first interest rates that were lowered all the way to zero, then a decade of quantitative easing), we anticipated the need for a new paradigm that combined the force of monetary and fiscal policies (what we call Monetary Policy 3, or MP3). COVID proved a catalyst for this paradigm shift. The initial effects of COVID rapidly exacerbated inequalities, hitting many of those worst off hardest, both economically and in regard to health outcomes. The ensuing MP3 policy response was exceptionally large; led by the US, central banks printed massive quantities of money and fiscal policy injected cash directly into the hands of consumers and businesses. In the US, MP3 achieved what years of stimulative monetary policy alone could not: a majority of households, including those in the middle and toward the bottom, are now in better financial shape, with the strongest balance sheets they've had in decades.

Our Current Inflection Point: Rising Inflationary Constraints

The coordinated monetary-fiscal response to COVID demonstrated how effective new MP3 policies can be. Households are driving a broad-based, demand-led boom; in the US, we're also now experiencing the tightest labor market in decades, with secular highs in job openings and secular lows in layoffs and firings. Wage inequality is falling, with low-wage workers seeing the highest relative wage growth in decades. But the policies enacted so far have used up much of the "disinflationary runway," bringing us to a turning point where policy makers are beginning to face constraints due to rising inflationary pressures. Fiscal-monetary coordination is much more potent than interest rates or quantitative easing because it directly puts money into the hands of spenders. And it is inflationary by nature: in countries where it was used, MP3 more than made up for the incomes lost to widespread shutdowns but did not make up for lost production. In other words, it created demand without supply. As a result, **shortages, rationing, and inflationary pressures are building wherever you look**, from commodity markets to labor markets, across a wide and diverse range of products and sectors.

In the face of rising inflationary pressures, both monetary and fiscal stimulation are now fading. A growing number of central banks are beginning to pull back their extraordinary level of stimulation, with a particularly notable shift in tone at the Fed, acknowledging that persistent and broadening inflation calls for a policy response. Accelerating inflation is also creating pushback against fiscal spending, including Biden's ESG-focused spending agenda (Build Back Better). The future of this agenda is now increasingly uncertain, and if the Democratic Party loses control of Congress in this November's midterm elections, new major spending bills will face even more significant headwinds.

In 2020 and 2021, policy makers addressed COVID's economic damage and its social tolls without experiencing much tension between their objectives; their support to those hit hardest often served both goals simultaneously. In 2022, addressing social and environmental issues will increasingly come into conflict with the need to keep inflation at bay. It's never been more urgent to address climate change, but as will be discussed in more depth in the next section, progress is now more difficult in the context of already mounting inflationary pressures. In terms of social pressures, the past year has highlighted the persistence of traditional globalization, and we see signs that a wave of technological transformation is accelerating and could prove persistent; automation and digitization are increasingly cost-effective and may transform and globalize the service sector in the same way as manufacturing was over the past 30 years. Policies can ensure that the benefits of such developments are divided in a way that benefits most people and are especially impactful over time if the money is spent productively, but rising inflationary pressures will constrain policy makers' freedom to do that. Low real rates have allowed for arguments that it would be a missed opportunity to not run expansionary fiscal policy; such low rates make it unlikely that fiscal spending will crowd out private investment and imply very low real debt service costs for the government. Rising real rates change that calculus. And the Fed is much less likely to be able to worry about maximizing employment across socioeconomic cohorts when constraining inflation becomes its main task.

Looking ahead, we see a self-reinforcing cycle of nominal spending and income growth; more tightening will likely be required than is priced in, and inflation will likely prove higher and more persistent than is priced in. Risky assets are significantly less attractive than they were last year. And, as we discuss below, the imperative to address climate change—with rising political consensus pressuring policy makers and growing investor consensus pressuring private sector actors—will be an important force exacerbating these challenges.

The Climate Transition Adds to Mounting Inflationary Pressures

Stepping back, the task ahead to transition the global economy away from emitting carbon and toward green energy is enormous and quite likely to exacerbate inflationary pressures. Previous energy transitions tended to be driven by the development of new energy sources that unfolded over long periods of time; economic actors gradually chose to build capacity using newly available and cheaper energy options, making these transitions deflationary. By comparison, the green energy transition is intended to rapidly replace existing energy sources with new ones, turning over the world's energy base over about 30 years. **Nothing like this has ever been done before.** Achieving a shift of this scale is likely to be inflationary as proactive spending to transition existing energy capacity adds marginal spending into already hot economies, and many of the proposed mechanisms to accelerate such replacements are inherently inflationary.

We've laid out **four types of mechanisms** that can accelerate the climate transition:

1. **Carbon Pricing:** Raising the cost of carbon to reduce demand.
2. **Supply Squeeze:** Limits on the supply of carbon-intensive energy.
3. **Green MP3:** Governments spend on green initiatives.
4. **Green Tech Breakthrough:** New technology dramatically reduces the cost of green energy.

Carbon Pricing is the classic economist's answer to climate change; via a carbon tax or cap-and-trade, pollutants that raise the earth's temperature, i.e., oil, gas, and coal, become more expensive to encourage a switch away from them. A higher price for burning fossil fuels is also reflective of the true cost imposed on people around the world, today and in the future. But raising prices is nonetheless directly inflationary, at a time when inflation is broadly rising. Energy inflation (and inflation in the goods that require energy, like food where fertilizer is a key input) tends to be the most politically sensitive type of inflation around the world—because it is the most regressive type of inflation, with food, heating, and transportation costs making up a large share of spending for lower-quintile households. **Squeezing the supply** of dirty energy sources is similarly inflationary, but it is also stagflationary—as supply of fossil fuels is removed without necessarily adding alternative supply, economic activity will fall without adequate energy to fuel it. This creates more challenging policy choices.

As we survey what is occurring globally with regard to curbing climate change, we see that the paths so far have been especially inflationary. This adds to the inflationary pressures that are building from other cyclical forces. The most extreme example has been in Europe. The continent is home to the largest emissions trading schemes in the world, and many countries proactively restricted energy supply from coal and nuclear sources. Yet as rising energy prices started to bite in 2021, it prompted widespread questions around how climate change can be tackled in a politically palatable way. European governments have stepped in to offset rising energy costs for the most vulnerable households, and some businesses that are unprofitable at high energy prices were forced to stop production.

In the US, the Biden administration hoped to curb climate change through **Green MP3** policies, using government resources to subsidize renewable electricity or electric vehicles, as well as directly spending government money on the transition (e.g., building out electric vehicle charging infrastructure). This path has the potential to be much less painful than carbon pricing or supply constraints because each economic actor involved sees lower prices (through subsidies) or receives government cash directly, rather than experiencing higher prices and scarcity. But MP3 is still inflationary through supporting aggregate demand, and today's already inflationary conditions—combined with ongoing political polarization—have led this legislation to stall.

Technological transformation, by contrast, is a deflationary process: **Green Tech Breakthroughs** can lead to lower costs for renewables than fossil fuels. There is significant private sector capital funding such developments, though as the history of other technological advancements illustrates, government support at

the early stage is often critical. The Chinese government has spent significant sums subsidizing the early-stage development of electric vehicles and solar technologies, and China is now the global leader in both. In the US, free-market ideologies have often constrained such policies, though growing competition with China is gradually changing this narrative (for example, advanced energy technologies was one of the focus areas designated in the US Innovation and Competition Act, designed to compete with China).

Each of these mechanisms on its own is likely insufficient to successfully transition away from fossil fuels; a mix will probably be required. For example, where green tech breakthroughs have been successful and transitioning from fossil fuels is already economical, it may still take some mix of subsidies, taxes, or regulation costs to encourage economic actors to move at the pace that will be required to curb climate change. Even a well-coordinated global effort using all four of these mechanisms to transition the global energy system rapidly would be extremely difficult, and what we have today is very far from a coordinated transition. Instead, we are seeing large divergences between policies across players and regions.

The most significant first-order market implications will be high volatility and secular inflationary forces across commodity markets. It will only get more difficult for developed world oil and gas producers to get access to capital as private investors shy away from increasing their exposure to the sector and make “net zero” commitments. And yet, there is not nearly enough energy supply to meet demand, as renewables simply cannot keep up with the roaring global economy; sustained high oil prices will be required to gradually bring oil supply online (which means emissions wouldn’t fall much) or take a bite out of demand (which would be stagflationary and could prove politically challenging). And as the private sector moves to gradually transition away from carbon-intensive energy sources, it will need a massive amount of other commodities like iron, copper, and nickel to build the renewable power grid, build charging stations and electric vehicles, etc.—**and the supply of industrial commodities will also lag**, taking years to come online. High commodities prices, in turn, add to already mounting inflationary pressures constraining policy makers and carry implications for relative country asset prices, balance of payments, and currencies. For investors, this raises the importance of a more balanced strategic asset allocation in the face of these inflationary forces, and particularly the **inflation-protecting role that commodities can play** in a portfolio.

The Influence of Private Sector Efforts to Address Social and Environmental Challenges Will Accelerate in 2022

While policy makers will encounter more difficult trade-offs going forward, the private sector is increasingly determined to act to address social and environmental challenges. A growing number of institutional investors have explicitly incorporated ESG considerations into their mandates, a shift we believe will be consequential and long-lasting because once sustainability is embedded in investment objectives, it will eventually percolate into funds’ governance structures, CEO and CIO hiring decisions, incentive systems, talent choices, investment training, risk systems, and, most importantly, asset allocation and security selection processes. An increasing number of institutional asset owners and banks are committing to align their capital with the “net zero” transition, and similarly, individual investors are increasingly choosing to align their capital with social and environmental goals. Further supporting this trend are the numerous global regulatory regimes and industry bodies requiring investors to report on the impact profile of their portfolios, be it the forthcoming SFDR regulatory regime in Europe, the Modern Slavery Act, or emerging industry standards like the TCFD. Over time, we believe this investor focus will affect the actions of corporations, which are under increasing pressures from these investors (and other stakeholders) to improve the sustainability of their business models and business practices. For entrepreneurs looking to start new companies, capital is already much more readily available for businesses with social and environmental goals. And companies pursuing projects in unsustainable areas such as coal and fossil fuel production are already seeing early signs of financing pullback from banks and capital markets.

That said, **the impacts of social and environmental considerations on capital flows have been modest relative to what we believe still lies ahead of us.** There has been a lack of alignment on what ESG means; many players shifting their asset allocations in different ways, even if all driven by ESG considerations, will not yield much market impact (consider, for example, how lowly correlated different ESG ratings have been).

Many investors have also adopted an incremental approach, as reflected, for example, in how most common ESG indices track the market relatively closely and **intentionally avoid making large deviations**, limiting their impact. So far, the shift in capital flows has been quite gradual. Looking at the disclosed equity holdings of a group of institutional investors that have publicly expressed significant interest in ESG (accounting for about \$1.5 trillion in public equity assets), we see they have made relatively slow moves so far, and only 4–5% of the mutual fund and ETF universe is currently in ESG-labeled funds.

Going forward, corporations and investors who have made large public commitments on sustainability will need to turn these commitments into actions and results. This will require fundamental changes to investment processes, new data, new analytical capabilities, and new portfolio-construction approaches. The push for quality ESG data and metrics will be a central theme—investors will demand it, and regulators will increasingly require it. What is reported tends to shift behavior: it's very hard to track and manage toward what you cannot or do not measure. Carbon data, for example, is on the fastest track to becoming what financial performance data is today. Much like corporate profits must be reported and investors try to evaluate how successful corporate strategy will be at boosting profitability, the reporting of carbon emissions will become required and investors will assess whether corporate strategy will be successful in reducing emissions. The growing cohort of investors committed to aligning their portfolios with a successful climate transition will pay attention to these figures alongside corporate profitability. In other words, **the combination of investors' commitments to sustainability and standardized reporting could produce much larger and more coordinated shifts in capital flows and asset allocations, as well as company behavior, than what we've seen to date.**

We also know from prior cases that these shifts tend to take place gradually over decades. The withdrawal of institutional investors from the tobacco sector was gradual, but by the 2000s ESG-conscious institutions had almost no investments there. These same investors have also been shifting out of the oil and defense sectors for 10 years and 20 years, respectively. With a growing share of investors prioritizing impact and sustainability, we believe there is significant room for ESG flows to run—and that sustainable investing's largest impacts on relative stock valuations and the incentives facing public corporations are still ahead of us.

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