Focus | December 17, 2021 | 12:48

The 2022 Outlook

Feature

5 Perplexities of 2021; 5 Predictions for 2022


Douglas Porter, CFA,
Chief Economist
douglas.porter@bmo.com

There was no shortage of surprises in 2021, which started with the storming of the Capitol. On the economic front, there's little doubt that the sudden reemergence of inflation was the biggest story of the year, somehow overtaking the pandemic as the primary focus until recently. But there were many curious subplots and unexpected twists, from meme stocks, to a blockage of the Suez Canal, to a crunch for China's property developers. Here are our nominations for the **top 5 economic and/or financial surprises of the year**:

1) Inflation: At the start of the year, the consensus among private sector forecasters and central banks in the U.S. and Canada, and even Europe, was for 2% inflation or less in 2021. And that was with the full realization that base effects would artificially pump up the figures somewhat. Whoops. Instead, we are now looking at nearly 7% headline inflation in the U.S., and roughly 5% across Europe and Canada. This year's bounce has more than made up for the low readings a year ago, pumping up the two-year average well above the trends of the past decade almost everywhere (*Table 1*). *Best factoid:* The acceleration in Germany's annual inflation rate in the past year (from -0.7% to 6.0% now) is the steepest one-year change in almost 70 years.

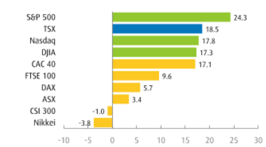
Table 1
Headline CPI Inflation Rate: All Rise
(y/y % chng)

	Nov. 2021	Nov. 2020	Two-year Average
United States	6.8	1.2	4.0
Canada	4.7	1.0	2.8
United Kingdom	5.1	0.3	2.7
Euro Area	4.9	-0.3	2.3
Germany	6.0	-0.7	2.7
Japan[1]	0.1	-0.5	-0.2
China	2.3	-0.5	0.9
Mexico	7.4	3.3	5.4

Sources: BMO Economics, Haver Analytics [1] *October*

2) Energy Prices: Shunned by investors, and almost left for dead in the spring of 2020, the energy sector thrived in many respects this year. By the peak in late October at over $85, WTI had more than doubled in the space of a year, a big factor behind the global inflation rebound. OPEC+ discipline, a revival in demand, and shareholder/ESG constraints on new energy investment all supported oil prices. Natural gas also enjoyed a rare bout of strength, with Europe and China dealing with a variety of energy issues. The Texas freeze in February also factored in. While energy prices had calmed by late 2021, most are still up 40%-to-50% y/y. And, for investors, energy was the top-performing equity market sector for both the S&P 500 and the TSX this year after being the deep laggard in 2020. In turn, this strength helped the TSX climb the global equity tables (*Chart 1*). *Best Factoid:* U.S. oil production is likely to be lower this year than last year (11 million bpd versus 11.5 mm in 2020), even with the big comeback in prices.

Chart 1
Global Equities: North America Leads
Since End-2020 (% chng : as of December 16, 2021)



Sources: BMO Economics, Bloomberg

3) Supply chain issues: There were rumblings of chip shortages in late 2020, but few appreciated just how widespread supply chain issues would soon become—and, along with oil prices, how they would emerge as one of the biggest drivers of the inflation surge. The stuck containership Ever Given in the Suez was simply the most visible of kinks in the chain, seemingly ringing the bell on the issue. We continue to assert, however, that the root cause of all the supply chain issues is the tidal wave of demand for goods that simply overwhelmed existing supply. Note that by many measures, supply is operating at an all-time high, but it just can't keep pace with stimulus-fed spending. *Best factoid:* Canadian auto production will decline again this year, even though the industry was shut down in the spring of 2020. It's not for lack of demand, but a lack of chips, that auto assemblies will be the lowest in more than 50 years of records in Canada in 2021—a harsh blow for the Ontario economy.

4) Bond Yields: Where to begin? There were at least three big surprises in what is usually the most level-headed financial market. First, yields fired out of the gate at the start of the year, with the 10-year Treasury shooting up more than 80 bps in a mere 11 weeks (or a 90% spike), one of the fastest rises in such a short period on record. Second, the sprint to March marked the peak for long-term yields for the year. And, this key yield currently remains below 1.5%, despite U.S. inflation hovering close to 7%, GDP growth approaching 6%, the unemployment rate almost all the way back down to 4%, and the Fed tapering QE. It is fair to wonder just what it would take to get yields higher, and real yields in particular, on a sustained basis. The third surprise, among many, was that after aggressive steepening early in the year, the curve flattened just as aggressively late in the year—even before the Fed begins to raise rates. *Best factoid:* The Treasury yield curve will end 2021 flatter than it began (measured on a 10s/2s spread basis), not what many would have guessed with inflation at 7%.

5) Government finances: Not all the surprises were negative this year, not by a long shot. One moderately positive development was a reasonably fast turnaround in government budget balances in many jurisdictions, albeit after a brutal hit in 2020. A solid rebound in GDP globally helped revive government revenues, as did strong personal incomes, profits and retail sales. The 12-month rolling tally on the U.S. budget deficit has narrowed from a peak of more than $4 trillion early this year to just under $2.7 trillion now. That's still far above the pre-pandemic trend of just over $1 trillion, but a somewhat shallower gap than expected. Likewise, Ottawa's shortfall is expected to drop from last year's record $328 billion, to $145 billion this year, and then below $60 billion next, even with some extra dollops of spending added on. *Best factoid:* The combined expected deficit of the 10 provinces for this year has been chopped in half just since the spring to a much more manageable $38 billion, or 1.6% of GDP. That's not small, but it's also not particularly remarkable versus prior cycles, even as the economy has been wildly remarkable.

Economist


Douglas Porter , CFA
Chief Economist and Managing Director
Economics

Douglas Porter has over 30 years of experience analyzing global economies and financial markets. As Chief Econom... (Read more)


Sal Guatieri
Senior Economist and Director
Economics

Sal Guatieri is a Senior Economist and Director at BMO Capital Markets, with over two decades experience as a ma... (Read more)


Michael Gregory , CFA
Deputy Chief Economist, Head of U.S. Economics and Managing Director
Economics

Michael is part of the team responsible for forecasting and analyzing the North American economy and financial m... (Read more)


Benjamin Reitzes
Managing Director, Canadian Rates & Macro Strategist
Fixed Income Strategy

Benjamin has been with the Bank of Montreal for over a decade. He is responsible for the Canadian macro-economic... (Read more)


Robert Kavcic
Senior Economist and Director
Economics

Robert has been with the Bank of Montreal since 2006. He plays a key role in analyzing regional economic, fiscal... (Read more)


Jennifer Lee
Senior Economist and Managing Director
Economics

Jennifer has been with BMO Capital Markets Economics for over two decades and is perhaps best known for her high... (Read more)


Carl Campus
Senior Economist
Economics

Carl Campus joined BMO Economics in 2007 as a Research and Technical Assistant; he was later promoted to his cur... (Read more)


Sarah Howcroft , CFA
Senior Economist and Vice President
Economics

Sarah Howcroft conducts risk analysis across a range of countries and industries in which BMO has strategic inte... (Read more)

An honourable mention goes to Canada's indefatigable housing market, although almost nothing there can surprise any longer. But hats off to all those calling for a 25% rise in national home prices at the start of the year. Having dispensed with the fun factoids, we now turn to the hard part—trying to discern what this all may mean for the year ahead. To paraphrase Mark Twain: Forecasting is hard, especially when it's about the future with Omicron. But here are **five of the key trends we expect to see in 2022**.

1) Many major central banks will begin (or continue) hiking even in face of deep uncertainty. This may seem like a somewhat unsatisfying call, given: a) the Bank of England already got the ball rolling, b) markets are fully priced for such, and c) economists have been consistently on the high side of reality for interest rates for much of the past 20 years (having predicted five of the past two tightening cycles). But this view is a fundamental feature of the broader outlook, of course, and it reinforces a key point—because of this year's upside surprise in inflation, central banks are going to need to forge ahead even in the face of potentially serious headwinds for growth. Chair Powell recently made the very important observation that new virus variants could actually add to inflation (through supply chain disruptions) rather than calming prices (through slower services spending). We look for 100 bps of rate hikes from the Bank of Canada, starting in April, and 75 bps from the Fed, starting in June. *Stretch call:* Should the pandemic fade (*please!*), the tightening could be sooner, faster, higher.

2) Core inflation stays above consensus. We can't claim that we got the inflation call precisely right this year, but we *were* consistently on the high end of consensus and warning about high-side risks early on. And we will stay with that winning hand in 2022, especially on core inflation. Even if supply side pressures lighten, as widely expected, there is still some sting in the tail for underlying prices. First, the 20%+ run in North American home prices is only just now beginning to make itself felt in the CPI, especially in the U.S. data. Second, some sustained pressure on wages is likely to feed through into a variety of service sector inflation, especially as spending rotates from goods to services. Third, flush households are simply willing and able to absorb some price increases. Finally, there is the wild card of food costs and the drought; another bad crop in North America could send these prices flying in 2022. *Stretch call:* Somewhat unrelated, but let's not rule out another possible high-side surprise in Canadian home prices. Given the extreme imbalance in sellers' favour, it will take a heavy-duty rise in rates to balance the market, so yet another year of double-digit home price gains is entirely possible.

3) Growth will be below consensus. Almost without fail, we have tended to be on the high side of consensus on the growth call since the early weeks of the pandemic. Our fundamental view was that massive policy support would help the economy recover quickly, and that businesses and consumers would find workarounds to the new world order. Our relative optimism began to waver this summer, amid the supply chain issues as well as the relentless virus waves. In the year ahead, we are biased to the low end of the growth call now, in part due to obvious risks surrounding the newest variant, but also because policy simply cannot be as supportive against the backdrop of raging inflation pressures (*Table 2*). *Stretch call:* This is not our official view, but, if the latest wave turns ugly, it's likely that Canada will impose more severe and longer lasting restrictions, and lead to a fifth year in a row of underperformance on GDP growth vis-à-vis the U.S. economy. In the past half-century, there has only been one other episode where Canadian growth trailed the U.S. for five consecutive years (1989-1993, inclusive).

Table 2
GDP Growth: Still Wood to Chop
(y/y % chng)

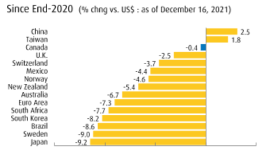
	2020 actual	2021 estimate	2022 forecast	Three-year Average[1]
United States	-3.4	5.6	3.5	1.8
Canada	-5.2	4.5	4.0	1.0
United Kingdom	-9.7	6.6	4.0	0.0
Euro Area	-6.5	5.2	4.0	0.8
Germany	-4.9	2.7	4.0	0.5
Japan[1]	-4.5	1.5	2.5	-0.2
China	2.3	8.0	5.5	5.2
Global	-3.1	5.8	4.5	2.3

Sources: BMO Economics, Haver Analytics [1] *geometric growth rate*

4) Even so, unemployment is poised to plunge further. Despite a rockier growth backdrop, we look for the unemployment rate to fall heavily in North America. Even if growth stumbles, employers are likely to hold tightly onto their staff, having gone through the recent extreme labour shortages. If growth manages to meet consensus expectations, or better, look for jobless rates to hit lows not seen in decades. *Stretch call:* The Canadian unemployment rate may grip the 4-handle for the first time since 1970. We're possibly looking at even more decades in the U.S., where the participation rate is much lower; it's possible that the U.S. jobless rate could grip the 2-handle for the first time since the early 1950s in the coming year.

5) The Canadian dollar will firm. The loonie is ending 2021 on a somewhat sour note, almost exactly unchanged from levels at the end of 2020, even after an early-year pop. In fact, the currency's performance could have been highlighted in the surprise section: who would have guessed that with a doubling of oil prices, with markets pricing up to six rate hikes from the BoC (and ahead of the Fed), and with Canada's current account swinging into surplus for the first time since 2008, that the loonie would weaken, not strengthen, on net this year? One of the biggest factors leading to this surprising outcome was a comeback in the U.S. dollar itself. In fact, as *Chart 2* reveals, the Canadian dollar still ranked as one of the stronger currencies in the world this year, but it struggled to keep pace with the revived greenback. Even with some modest further firming in the U.S. dollar in the coming year, we still look for a small gain in the Canadian dollar (from an admittedly soft starting point) on a global recovery, on the BoC leading the Fed, and on supportive commodity prices. *Stretch call:* The currency could be bolstered by oil prices reaching new multi-year highs in the second half of 2022, as demand recovers more fully, and it becomes apparent that supply is simply not responding. In turn, this could reinforce the upside potential for the Canadian dollar, even amid a cloudy growth backdrop.

Chart 2
Currencies: Dollar Rules
Since End-2020 (% chng vs. US$: as of December 16, 2021)



Sources: BMO Economics, Bloomberg

Disclosures


Aaron Goertzen , CFA
Senior Economist and Director
Economics

Aaron analyzes performance and risk across a diverse selection of industries and countries. His research is regu...
(Read more)


Art Woo
Senior Economist and Director
Economics

Art joined the Bank of Montreal in 2014. His primary responsibility is analyzing global economic, financial and ... (Read more)


Shelly Kaushik
Economist
Economics

Shelly joined BMO Economics in 2020 and conducts research on U.S. regional economies. She also provides support ...
(Read more)


Priscilla Thiagamoorthy
Economist
Economics

Priscilla joined BMO Capital Markets in 2016 and plays a key role in analyzing Canadian household trends and the...
(Read more)

Related Research

03/28/2025 Erik Johnson Focus

The Trade War Revs

03/28/2025 Erik Johnson Focus

The Trade War Revs

03/28/2025 Erik Johnson Focus

The Trade War Revs

You might also be interested in

03/21/2025	 Robert Kavcic	Focus	A Cycle Unlike Any Other The trade war presents a different playbook for growth, inflation, interest rates and fiscal policy than your textbook economic cycle.
03/14/2025	 Sal Guatieri	Focus	Has the Fed Misjudged Inflation? U.S. inflation was on a slow path back to the 2% target before tariffs but now faces a material roadblock.
03/07/2025	 Michael Gregory	Focus	Canada: Trade Alternatives amid American Tariffs Given Canada's enormous exposure to U.S. trade it's very difficult to offset even bits of the economic hit from tariffs.
02/28/2025	 Erik Johnson	Focus	Tariff Gridlock: Cost and Chaos in the Auto Industry With the threat of tariffs hanging over the auto industry, consequences of a material disruption to the supply chain are too dire to ignore.
02/21/2025	 Douglas Porter	Focus	Canada: Strong, Like Moose And now for something completely different: Some positive news on the Canadian economy.