Outlook for 2022

How will markets respond?

December 2021

The value of a fund's assets will go down as well as up. This will cause the value of your investment to fall as well as rise and you may get back less than you originally invested. Where any performance is mentioned, please note that past performance is not a guide to future performance.

- After a period of surprising outcomes for both equity and debt markets, both of which have reached record prices even after the global instability caused by COVID-19, what does 2022 hold? At the forefront of investors' minds are the questions of whether inflation is transitory or more permanent, the likely rate hikes from major central banks, and if the high prices of risk assets, whether equities, corporate bonds or high yield, are sustainable.
- Jim Leaviss, CIO, Public Fixed Income, Fabiana Fedeli, CIO, Equities & Multi Asset, and Maria Municchi, multi asset Fund Manager, discussed how these issues are likely to affect their respective asset classes in the coming year.

Jim Leaviss: If you'd have asked me a couple of years ago where the 30-year bond yield would be if inflation in the US was over 6%, I certainly wouldn't have said below 2%. Is the same true for you, Fabiana, in relation to the rise in equities during this period?

Fabiana Fedeli: Yes. This has been an incredibly surprising rise in equities, and one thing I have learned over many years in the equity markets is never to take them for granted. At this point, there are three key considerations. The first is that it has been a period of extremely divergent performance. For example, from a country perspective, the US has had an incredible rise versus the rest of the world. This divergence has also been true of stocks within the same sector, which means there are still a lot of opportunities – but also the need to stay selective.

The second consideration is that, yes, it's true that equities are expensive versus their own history. But compared with non-equity asset classes, they're actually relatively reasonable. And, if you look at the amount of liquidity still around, that remains very supportive for equity markets.

The third consideration is the headwinds – at some point, that punchbowl is going to be taken away. Firstly, we're likely to see credit markets starting to tighten, and that's obviously going to have a negative impact on equity markets, and secondly, inflation will have an impact on the real world.

JL: The Fed seems to be more worried about the unemployment rate than it is about inflation – despite the fact that the market is talking about two rate hikes from the Federal Reserve in 2022 – and yet the unemployment rate is coming down every month. How do you see that balance, Maria?

Maria Municchi: I think it's very interesting, because obviously there's a huge focus on inflation at the moment, but the Fed mandate is also to promote maximum employment, and when we look at the US labour market today, there are some very interesting areas that are worth monitoring in the coming months. For example, yes the unemployment level is now relatively low, but some ethnic minorities as well as younger workers are still suffering a very high level of unemployment. Also, the participation rate is much lower than it was before the pandemic. This equates to around

5 million people having not re-entered the workforce as yet, which highlights a level of slack in the US labour market. Finally, we've seen strong evidence of wage growth over the past few months, but it's still very much focused on lower wages and younger employees.

So it's very important to look at the US labour market in the context of the current inflation picture, because it's another element that the Fed will take into account when deciding its future monetary policy. As it stands today, we see a Fed that is supportive of a strong, but also inclusive, labour market.

JL: When I think of the type of assets within fixed income that might do well in this kind of environment, I like inflation-linked bonds and TIPs (Treasury inflation-protected securities - the US Treasury version of linkers, effectively) because they will protect you to some extent when inflation is rising.

The other thing that works well for me in this kind of environment is emerging market bonds. We looked at those negative real yields in traditional developed markets bonds – minus 2% real yields in the UK and in Europe – but within emerging markets you can get positive real yields of 2% and 3%. As always, there's going to be a lot of risk and volatility when investing in emerging market debt, but that probably looks to us to be the best place for value in fixed income at the moment.

Fabiana, what would you invest in in the equities space at the moment?

FF: The overarching consideration for equities here is that there will be areas that continue to do well, areas that will do even better, and those that will perform very poorly. So, first and foremost, we have to be aware that the polarisation that has been true of equity markets over the last year or so will continue and might take a different direction. So there are opportunities, but also a need to stay selective.

Areas that we don't like are obvious – those where inflationary pressures will hurt companies, or companies that are part of supply chains with a lot of cost pressure and without the pricing power to pass it on to their own customers.

Areas that we like: I would highlight, from a sector perspective, global infrastructure. Real assets do well during an inflationary period, and particularly now we're having a strong push on infrastructure spend. This includes the renewables sector – where we expect to continue to see a lot of opportunities. However, we have to make sure that we invest in the right companies: those that are able to pass cost along and have solid balance sheets, in order to withstand the impact of variable rates.

The second area that I would point out is Japan – this is a country that has underperformed significantly, not just the US but also the rest of the market especially from a US dollar perspective. However, there are many companies with strong, increasing earnings, and there has been an improvement in corporate governance, shareholders' returns, more efficient balance sheets, and an increase in M&As, which are unlocking synergies. This is not the case for all companies in Japan, though, hence the need to also be selective in this case.

JL: For multi-asset, how do you manage the balancing act between asset classes, where previously they were negatively correlated, now that is no longer so much the case?

MM: Observing assets' correlations is something we do on a day-to-day basis, and it's very much central to how we construct portfolios. From an overall perspective, the current environment is still supportive for 'risk-on' assets, from both a macroeconomic and a valuation standpoint. The macro environment is still conducive to growth and expansion, particularly in certain sectors through sectoral and structural trends, or due to the transition to a lower-carbon economy.

From a valuation standpoint, in our view both equities and fixed income currently present some difficulties. This calls very much for selectivity within multi asset portfolios, but more importantly, for tactical asset allocation – the ability to take advantage of shorter-term market moves to grasp the opportunity that the market provides. I believe that inflation will certainly remain a key topic in the year ahead. However, it's important to think about other potential surprises to markets.

In terms of our response, we believe that it's important to maintain portfolios that are well-diversified, and the way we do that is to hold a portion of the fund in cash, as well as maintaining exposure to the longer end of developed market government bonds, including 30-year US Treasuries.

JL: Let's finish today by thinking about COP 26. I know that some of the headlines that came out of it were very encouraging, but overall, people were perhaps slightly disappointed by the outcome. Having said that, there is some impetus in the asset management industry, and in the UK government. In the fixed income team, we participated in the first green gilts issued this year; we're going to see far more green bonds and sustainable linked bonds over the course of 2022 and that will be a great opportunity for our funds to start buying some of those assets.

So, were you disappointed, or is this a step in the right direction?

FF: I would say the latter, Jim – I sympathise with those who believe that COP26 didn't do everything it could have done, but it has undeniably been a huge step forward. Even when you think about the controversy relating to coal being phased out or phased down, it's the first time that we actually have such a targeted hydrocarbon pledge on such a wide scale. So, the outcome is not perfect, but definitely a big step in the right direction. And these pledges need to be executed, and public opinion will demand delivery from both governments and companies.

MM: I agree. After two weeks of intense negotiations, the Glasgow Climate Pact really puts down on paper the key areas that we need to focus on for aiming towards the maximum 1.5 degree increase in temperature. And all these different areas, including ending deforestation, financing emerging markets and phasing down coal, are areas where almost 200 countries found agreement, which is really incredible.

This is only the beginning – there is a lot of work that needs to accelerate from here. But I think a very positive outcome is that countries are starting to have a common language and ambition towards climate change, that they can start to integrate it into their own national policies. And countries have a strong ability to introduce push and pull factors to facilitate the transition towards a lower-carbon economy, possibly faster and to a more significant extent than market players believe today. If that proves to be the case, some companies are better-positioned to respond than others.

JL: Maria and Fabiana, thank you very much.

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