

Investment Views



JANUARY 2022

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Strategy:

Strong Finish to a Strong Year

Fixed Income:

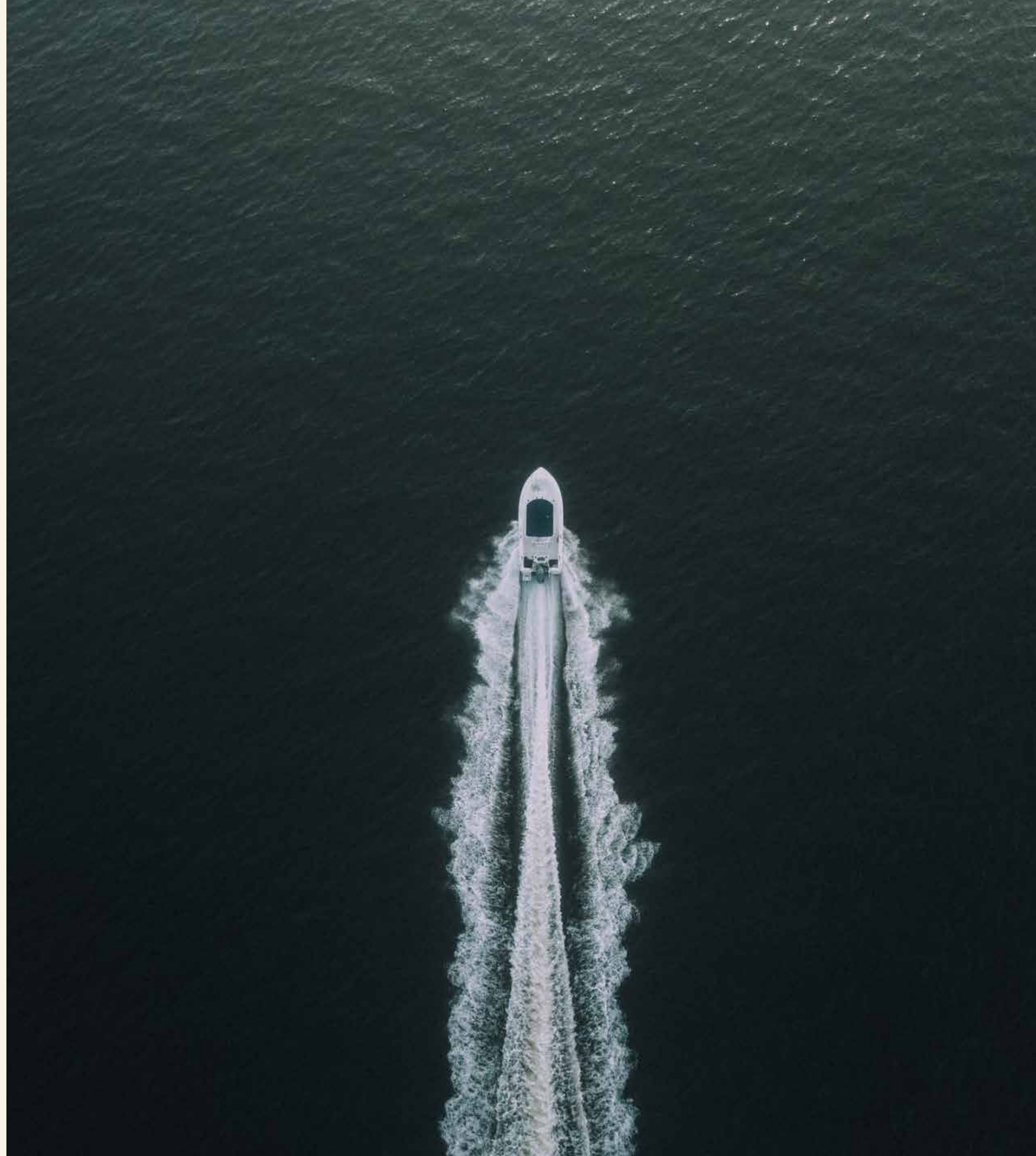
A Delicate Equilibrium

Equities:

US Equities Lead Again

Strong Finish to a Strong Year

The fourth quarter was similar in many respects to 2021 as a whole. Equities outperformed bonds, US equities outperformed global equities and there was continued uncertainty around when daily life will be free from pandemic concerns. In US dollar terms, the MSCI World index returned 7.77% in the fourth quarter, marking a very impressive return of 21.82% for the full year and a third consecutive year of double-digit gains. In the bond market, the Bloomberg US Treasury Index delivered a small positive return of 0.18% in the fourth quarter but that wasn't enough to recover losses earlier in the year, leaving the index -2.3% lower for the full year. This was the first year US treasuries posted a negative return since 2013; interestingly, in records stretching back to 1974, the index has never fallen two years in a row.



The stop-start nature of the recovery from the pandemic has caused many challenges for the global economy in 2021. Early worries around vaccine manufacturing capacity gave way to optimism in the spring, only for the Delta variant to emerge and hinder the return to normality. Optimism then picked up through the summer as the vaccine rollout progressed at impressive speed globally, only for rising cases in Europe, the need for booster shots and the Omicron variant to complicate matters again in the fourth quarter.

One of the dominant themes during the fourth quarter was inflation, which was also a topic of much debate throughout the year. As the global economy recovered, and with 2020 providing a low base for comparison, many investors expected inflation to pick up this year. This perspective included central banks, which until recently had characterised inflation as “transitory”, owing to the impact of reopening hard-hit sectors of the economy. However the pickup in inflation in the second half of the year, and also the breadth of the increase, has been greater than expected and has forced central banks to respond.

While the less supportive policy backdrop caused volatility in fixed income markets and at the individual stock level, overall stock market volatility remained subdued and the S&P 500 only suffered a maximum fall of -5%, which is much lower than the average intra-year drop of -14.0% over the past 42 years. One of the main reasons for the low level of volatility is that retail inflows into equities have been incredibly strong and the market has seen rotations between different sectors or themes, rather than outright selling. For example, at any given time, either stocks exposed to the reopening of the economy have performed well or less cyclical Technology-orientated stocks have done well. Furthermore, while inflation from higher input costs pose a risk to various companies, sectors like Energy and Financials generally benefit from inflation, so this has also helped to keep overall equity market volatility low.

21.82%

The impressive MSCI World index return for the full year.

-2.3%

Bloomberg US Treasury losses for the year.

The stop-start nature of the recovery from the pandemic has caused many challenges for the global economy in 2021.



4.11%

Gold performed well in the fourth quarter.

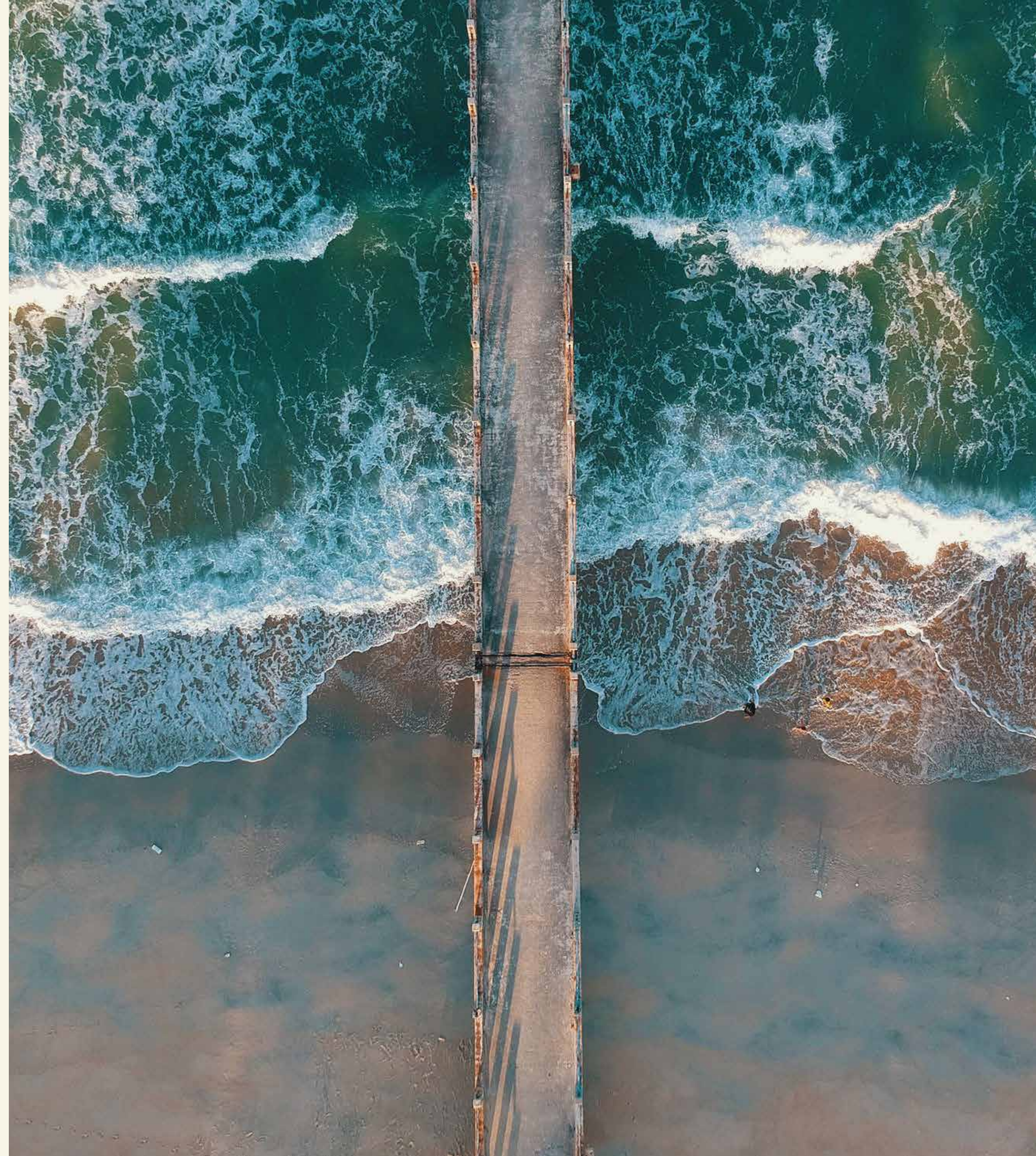
STRATEGY

Emerging Market equities struggled again in the fourth quarter, falling -1.31% in US dollar terms, marking a return of -2.54% for the full year. The continued pandemic situation has been difficult for Emerging Markets given lower vaccination rates with less scope for using monetary and fiscal policy tools available to Developed Markets. Investing in China has also presented complexities to investors in 2021. Less stable regulatory regimes have long been a consideration when investing in Emerging Markets, but the extent and breadth of China's regulatory crackdowns on the property, internet, gaming and education sectors have proved challenging. A decoupling of the US and China, the world's two largest economies, is an ongoing risk to both bond and equity markets. China has been a strong contributor to global growth over the past twenty years while also helping to keep global inflation low, which has boosted financial markets. The risks remain elevated but in the near term the internal risks, including inflation in the US, property slowdown in China and the ongoing pandemic in both countries, have reduced the chances of an escalating trade war.

With inflationary pressures building as the year progressed, one of the concerns was that the relationship between bonds and equities might shift such that bonds lose their diversification benefits of providing stability to portfolios with an equity allocation. There were some signs of this during the year, but overall bonds have remained a source of stability in portfolios. Within Alternatives, gold performed well in the fourth quarter returning 4.11%, but still finished the year -3.64% lower in US dollar terms. Oil prices remained broadly unchanged over the quarter, but have recovered substantially from the lows in 2020 as demand recovered. Things are likely to get more challenging for global markets in 2022 given the strength seen in 2021, but the backdrop is likely to remain one of recovery from the pandemic crisis.

A Delicate Equilibrium

The last quarter of 2021 was not for the fainthearted. Fixed Income markets witnessed volatility and rapid increases in government bond yields as central bankers, spooked by the highest inflation readings in almost 40 years, abandoned their previous tolerance for firmer prices. The Federal Reserve, after initially testing the market reaction to the tapering of their balance sheet, will now double the pace at which they are scaling back purchases of US Treasuries and mortgage-backed securities to \$30bn per month, putting it on track to conclude in early 2022. The two-year US Treasury yield rose from 0.28%, finishing the year at 0.73%, as Federal Reserve policy makers convinced the market that base rates would also rise by 75bps in 2022. This led to a negative total return of the Bloomberg US Aggregate Index of -1.54% for the full 2021 calendar year.



The US policy tilt followed action by the Bank of England – which raised the base rate in December by 15bps and is likely to actively reduce their balance sheet in 2022 – as well as a multitude of other countries also following suit. Such a sudden and rapid upward movement in global bond yields would normally be the precursor for a drastic tightening of financial conditions; however, equity markets and credit spreads have been resilient. A good omen for 2022 potentially, but with the resurgence of Covid-19 and slowing fiscal and monetary stimulus across the world, markets appear to have settled into a delicate equilibrium based on growth and inflation expectations, which will likely be tested over the coming months.

Economic data continued to weaken across the world during the fourth quarter, with the US impacted by Delta and now Omicron, European consumers facing the fastest and largest increases in energy prices in over a decade and Chinese economic activity slowing due to property market strains and a zero Covid-19 policy now facing the substantial challenge of Omicron. While activity has slowed, this has led to some positives with evidence that some of the supply chain disruption, which helped to drive US CPI to a 40-year high of 6.8%, is ending and energy prices have stabilised. This will have implications for inflation with a rapid slowing expected during the second half of 2022. Looking further ahead, with Chinese growth stabilising and Omicron seemingly less lethal than previous strains, risk assets could see another surge in confidence as uncertainty reduces and economic reopening (excluding China) gathers pace leading to a steeper yield curve.

Due to the announcement of monetary tightening across the world, notable rises in global energy prices and slowing global growth momentum, portfolios had been positioned for an increase in Q4 volatility. During December, with the onset of

6.8%

US CPI ended 2021
at a 40-year high.

0.73%

The figure the
two-year US Treasury
finished the year.

the Omicron strain and low liquidity, we witnessed a minor drawdown in risk assets which boosted the value of our government bonds (with 10 year US Treasury yields declining from 1.70% to 1.35%) however, this appears to have been short-lived and the market has subsequently reversed, assuming an economic rebound and minor disruption from Omicron. Nevertheless, we remain neutral duration (but underweight Fixed Income for balanced accounts) as we await further evidence that global economic growth has stabilised. With the short end of the curve now very attractively priced for 140bps of base rate hikes over the next two years, the opportunity cost of remaining underweight is much lower than earlier in 2021.

Within risk assets, with credit spreads at or near all-time lows, we prefer to keep our allocation defensive and opportunistic.

As a result, we continue to maintain an allocation to investment grade corporate credit, diversified Emerging Market debt and global High Yield in our US Dollar bond funds, but positioning is conservative and appropriate given the low prospect of default being largely offset by current valuations. In currency markets, the US dollar has become vulnerable, as the recent hawkish monetary policy changes have now likely been fully digested and positioning remains very long and stretched. In contrast, the Pound Sterling could be set for resurgence as the UK becomes one of the first major countries to reach herd immunity, allowing a broader reopening of the economy and with that much tighter monetary policy in 2022/23.

US Equities Lead Again

Global equity markets rallied in 2021, as robust corporate earnings growth in the developed world exceeded expectations, fuelled by a combination of the arrival of Covid-19 vaccines, strong economic stimulus, and low interest rates. Intra-year, market leadership swung between value and growth based on the uncertainty around the potential economic impact of new Covid-19 variants and increasing concerns about the persistence of rising inflation. Central banks largely opted to hold rates low to support economic growth and provide a positive market backdrop, while also maintaining flexibility on timing and pace of tapering asset purchases

Most of the strong returns in global equity markets were once again led by gains in US stocks. The S&P 500 rallied +27% and notched 70 record closes in 2021, the second-highest annual tally behind 1995's 77 closing highs. While price/earnings multiples compressed -8%, corporate profitability bounced back and drove a strong increase in earnings.





70

The record number of closes US stocks achieved in 2021.

45.1%

the estimated year-over-year earnings growth rate for 2021.

EQUITIES

According to FactSet data, the estimated year-over-year earnings growth rate for 2021 is 45.1%. This marks the highest annual earnings growth rate for the index since FactSet began tracking the metric in 2008. Non-US Developed equity markets gained +13%, as their more cyclically-oriented economies struggled to manage domestic and global impacts from Covid-19 waves. Emerging Market equities lagged further, declining -4% as Chinese equities fell -22%. Of note, Chinese mega-cap technology stocks sold off heavily on mounting regulatory pressures and increasing risk of de-listings from US exchanges. However, smaller, more domestically focused Chinese equities were much more resilient and more insulated from some of the regulatory crackdowns.

Developed world equities generated positive returns in all market sectors, with the greatest contributions coming from a +30% return in the heavily weighted Information Technology sector and a +28% return in Financials. US mega-cap stocks boosted market returns, with the ten largest US stocks in the S&P 500 generating 26% of its earnings and representing 31% of its market cap at year end.

The biggest individual contributors to market returns in 2021 were stocks of household names, such as Alphabet (Google's parent), Microsoft and Apple, due to their rapid profit growth, competitive moats and strong balance sheets. Alphabet surged 67%, benefitting from growth in its cloud business as well as a rebound in digital ad spending, particularly in key categories like travel that were hurt by the pandemic in 2020. Microsoft jumped 53%, benefitting from steady demand for its cloud computing and enterprise software. Apple rose 34%, despite chip shortages and the ongoing pandemic which prompted shutting even its showcase New York City retail store, after having already climbed more than 80% in both 2019 and 2020. Apple continues to benefit from the global popularity of its products, the potential for new offerings to maintain steady sales growth and a strong cash balance.

US stock market volatility was below historical averages in 2021, and market breadth was also low as those few mega-cap stocks again boosted returns. However, dispersion of market returns between individual stocks remained meaningful (between 0% and +59%: when measured as +/- one standard deviation around the average stock). While this dispersion arguably provided opportunities for active management, only 20% of core and 15% of growth mutual funds outperformed their benchmarks.

A large share of stocks fell at least 35% from their highs during the year, and the last time this happened during a period of rising markets was in 1998 and 1999. Such repricing of stocks could be viewed as a warning regarding high valuations, and the risk of holding stocks that rely excessively on liquidity, momentum and crowded trades.



34%

The amount Apple rose, despite chip shortages and the pandemic.

The biggest individual contributors to market returns in 2021 were stocks of household names, such as Alphabet (Google's parent), Microsoft and Apple...

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