THE YEAR OF THE CHAMELEON

WE HAVE DUBBED 2022 “THE YEAR OF THE CHAMELEON”. LIKE CHAMELEONS, WE BELIEVE IT WILL BE ESSENTIAL FOR INVESTORS CONSTANTLY ADAPT, WITH THE GLOBAL ECONOMIC AND MARKET ENVIRONMENT CALLING FOR AN ACTIVE-MANAGEMENT APPROACH TO INVESTING THIS YEAR IN PARTICULAR. BELOW IS A SUMMARY OF OUR FORECASTS FOR ECONOMIES AND INVESTMENT THEMES IN 2022.

1. The economic outlook

After last year’s strong economic rebound, we believe we will see a soft landing this year, both for growth and for inflation. We think the strongest phase of the recovery is behind us and that global growth could decline closer to its long-term trend. But our forecast for 2022 GDP growth in the US (3.4%) and the euro area (4.5%) is still above the long-term potential of both places. We believe that some inflationary pressures will fade this year, but also that there is a risk of some more durable, structural inflation. Overall, we believe that inflation will remain higher than before the pandemic.

United States. Key to the US economy this year will be healthy consumer spending. In this regard, it is worth noting the increase in disposable income stemming from the generous fiscal support provided by the US government during the pandemic. We expect excess savings on the part of US consumers and corporates alike, to be progressively deployed this year, helping to support growth (along with interest rates that should remain relatively low).

Euro area. This winter is turning out to be challenging for the euro area, with energy prices that remain high, renewed social distancing measures and persistent supply bottlenecks. However, we expect a brighter spring with economic activity rebounding. Manufacturing should stage a belated recovery this year, while consumer spending should remain buoyant. Fiscal policy should also support growth. Although the ECB will continue buying bonds this year, it will likely aim to prepare markets for a rate increase in late-2023.

China. China suffered multiple headwinds last year related to leverage issues in the property sector and regulatory crackdowns. While we believe the problems of highly leveraged developers can be circumscribed without causing systemic risk, the slowdown in the property sector will continue to be a major drag on Chinese GDP growth, which we see declining from 7.7% in 2021 to about 4.5% this year. But policy support is increasing via increased issuance of local-government bonds and fiscal incentives in areas such as infrastructure development. This year, we could well see an upturn in the credit impulse (the rate of increase in the flow of credit).

Rest of Asia. Economies in many other parts of Asia, including the ASEAN countries, were hit hard last year because of relatively slow vaccine deployment. But we expect economies in the region to catch up in 2022, with the ASEAN countries set to be among the few (Japan is another) where growth in 2022 is higher than the previous year, thanks in part to strong export performances.

Risks. There are several risks to our growth scenario. The first stems from the reduction in the extraordinary levels of support provided by governments and central banks. Central banks in particular are quickly reducing their monthly asset purchases and a number have already started to raise policy rates. We believe they will be joined this year by the US Federal Reserve, which could decide on three 25 basis point rate rises in 2022. And the risk posed by covid has not disappeared. We believe we will continue to see different approaches to dealing with this risk: while we expect China to continue with its ‘zero covid’ policy throughout 2022 (despite the impact on consumer spending), other countries will learn to live with the virus. While we think inflation concerns will diminish in some areas, there is also a risk of more structural inflation. Rising wages are mainly a US phenomenon for the moment, but wage growth and its knock-on impact will need monitoring globally.

2. Investment ideas

Equities. We see further good economic growth in 2022, helping to push company earnings higher this year. While attention needs to be paid to rising prices, equities generally do well at times of rising inflation. But inflation also tends to cut valuations, so while we see a 10% rise in S&P 500 earnings this year, total returns from US equities could be lower (8.6%) because of the contraction in valuations. However, the impact of inflation should not be massive. Our analysis tells us that the median forward 12 month price-earnings ratio (PER) is a notch below 21x when core US inflation is 3.9% (our central scenario for this year). This is pretty close to where forward PERs are now. Valuations are also tightly linked to real interest rates (nominal rates minus inflation). On this score, while we see the Fed tightening its monetary policy, we believe it will cap the rise in nominal rates to ensure the recovery continues. This stance should continue to support equities.

We believe that euro area equities will provide slightly better total returns than their US equivalents—in part because of lower starting valuations and in part because of the continued roll-out of the EU's NextGen recovery fund. Japanese equities, on which we are also positive, should likewise benefit from massive fiscal investment, equivalent to about 10% of GDP.

All in all, while total returns will generally be lower than last year, equities should continue to be an attractive place to be, especially the shares of companies in a position to adjust their prices to inflation without eating into margins. We like such 'pricing-power' companies, which often share characteristics such as a strong brand name, a strong management team and/or a history of innovation and technological prowess.

Capital investment. Supply has been struggling to keep up with the strong demand-driven recovery we have experienced. This has led to bottlenecks that have been exacerbated by a lack of investment in a number of areas, especially as cash-rich companies have often given preference to distributing dividends or buying back their own shares. But we think supply-chain issues as well as trends toward re-shoring and automation will lead to a rise in private-sector capital expenditures in 2022 and thereafter. We also see an increase in public capital investment, with the energy crunch many countries have been experiencing and governments' commitment to achieving zero carbon emissions by 2050 an important catalyst.

Alternative assets. "Real" assets, including real estate, do pretty well in a rising inflation environment. Such assets can help protect portfolios during times of rising prices whereas government bonds, traditionally used to protect portfolios, could struggle as interest rates rise.

We also expect certain hedge-fund strategies to perform. In particular, we expect an upturn in the capital-spending cycle and further strong momentum in M&A deals to help event-driven strategies.

Dealing with income repression. Investors have had to deal with income repression over the past 10 years as central banks have rushed to deal with financial crises and most recently the pandemic. They have done this by keeping down funding costs for corporates and governments. We believe they will continue to do so by maintaining nominal interest rates below nominal growth rates for years to come. What are income-starved investors to do? Again, equities could be an answer, particularly the stocks of companies that offer attractive dividend yields. We note that 80% of Euro Stoxx 600 companies pay dividend yields higher than the yield offered on the same companies' corporate bonds (the percentage is slightly lower for the S&P 500). In short, stable companies with strong cash flows and offering sustainable dividend yields should attract investors looking for regular income.

Further solutions to income repression are to be found in credit—for example in investment-grade Asian corporate bonds. These offer relatively higher risk-adjusted returns than US credit, with the yield per turn of leverage (a measure of a company's ability to repay its debt) on Asian investment-grade indexes almost double that for US high-yield ones.

There are also areas to explore in developed-market credits. The improvements in the economy and in corporates' cash funds are reversing the pandemic-induced trend for ratings downgrades to outpace upgrades. A number of good-quality debt issuers saw their rating cut from investment grade to high yield during the pandemic. There are still a good number of these issuers, called "rising stars", that offer attractive yields as they stand on the cusp of being upgraded to investment grade again.

Nor should one forget currencies. There are a number of currencies in countries with solid fundamentals (current account surpluses and solid reserves) that offer attractive carry because of high or increasing interest rates.

Volatility. We expect volatility in financial markets to pick up this year, calling for a high degree of nimbleness. We believe investors can use volatility to their advantage. This means buying derivatives like put options from time to time (when they are cheap) and selling them when short-term market tensions increase. ■

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