2022 INVESTMENT OUTLOOK

JANUARY 2022

STONEHAGE FLEMING

NOW AND FOR FUTURE GENERATIONS

Executive Summary

The rebound in consumer activity since the lockdowns of winter 2020/21 has been dramatic, driving impressive company earnings growth. In turn, global equities have registered another year of double-digit returns, led by the US. Government bond yields have risen from near historic lows twelve months ago while select credit and long / short managers have navigated the markets reasonably well.

We cover our investment views and portfolio strategy by addressing five critical questions frequently asked by our clients:

1: Will the Omicron variant derail the economic recovery?

No, but it will soften its trajectory. This highly transmissible variant is likely to slow the recovery through the first quarter of 2022, but we anticipate a subsequent recovery amid pent-up demand.

2: Is higher inflation being driven by pandemic or structural factors?

Both. Pandemic-related factors account for a substantial share of the current inflation surge but are likely to subside over time. There is, however, evidence that longer term inflation pressures are building, which require close scrutiny and have implications for investment positioning.

3: Can the market tolerate higher rates as growth slows and inflation rises?

Broadly yes, but expect some volatility along the way. The equity market retains healthy momentum and multiple earnings drivers. It also benefits from a relative valuation advantage over bonds. As the cycle matures we continue to expect investors to benefit from further gains. However the backdrop is well balanced suggesting periods of higher volatility are a likely consequence.

4: Is the market paying sufficient attention to growing geo-political risks?

The evolution of geo-political tensions over the coming year could spell periods of higher volatility and have a meaningful impact on which markets emerge as leaders. However, many of these issues are not new at a level which justifies a defensive stance. Whilst some investors may look the other way, these themes have our full attention.

5: How is capital being allocated in this environment?

As the current expansion transitions to 'mid-cycle' and inflation risks shift up, our focus is on investments that this environment supports. Within equities, we identify three key themes which are emphasised through our manager allocations. Firstly, companies with pricing power. Secondly, low valuation companies with competitive earnings growth and thirdly, high growth leaders which access long term trends.

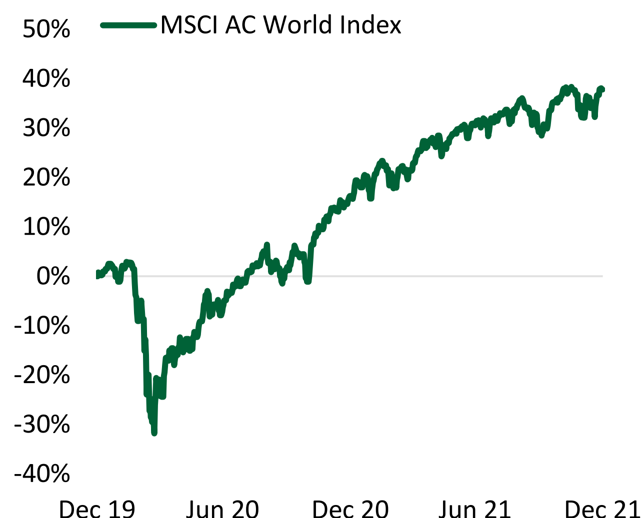
We remain reasonably optimistic on the outlook for the global economy and the prognosis for selective risk assets. Nonetheless we continue to maintain a heightened level of vigilance against potentially severe headwinds, including Omicron and future variants, the trajectory for inflation and interest rates, valuation levels and geo-political risks.

Introduction

Our investment strategy continues to favour equities as the engine of real capital growth whilst leaning away from conventional government bonds. Our equity portfolio is balanced, yet selective, favouring high conviction active managers with differentiating specialisms and styles. The US market is at the core of our global equity portfolios, representing more than half of the overall allocation.

This strategy worked well in 2021. The rebound in consumer activity since the lockdowns of winter 2020/21 has been dramatic, driving impressive company earnings growth. In turn, global equities have posted another year of double-digit returns (chart 1), led by the US. Government bond yields have risen from near historic lows twelve months ago while select credit and long / short managers have navigated the markets reasonably well.

CHART 1: Global equities were up 18.5% in 2021



Source: Bloomberg, total returns in USD, December 2021

Several major equity indices have ended the year near record highs driven by robust earnings momentum. From a technical standpoint, the market uptrend remains intact. However, as we approach the third year of recovery since the depths of the Covid crisis new challenges have emerged.

Rising inflation has dominated the headlines this year, as disrupted supply chains combined with surging demand for durable goods and raw materials.

> Whilst we expect a moderation in inflation this year the risk of longer term wage and price pressures is sufficient for central bankers to act.

This means a gradual ‘tapering’ of quantitative easing in the US, leading to interest rate hikes. We have already seen in the UK. This tightening in monetary policy comes at a time when government spending is being reduced and the highly transmissible Omicron variant is dampening consumer activity.

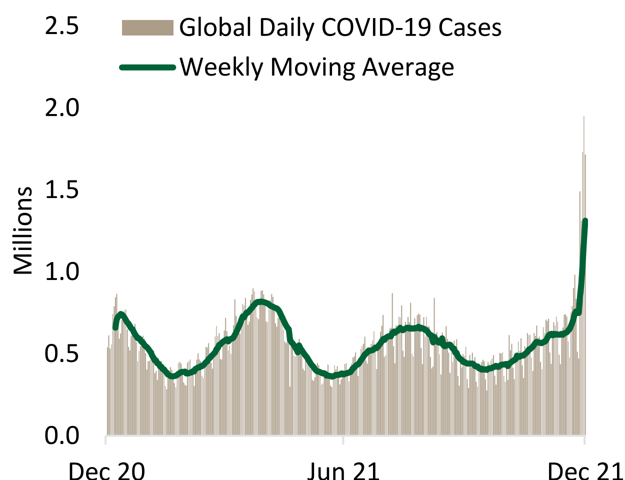
Against this backdrop, we cover our investment views and portfolio strategy by addressing five critical questions frequently asked by our clients.

1: Will the Omicron variant derail the economic recovery?

No, but it will soften its trajectory. This highly transmissible variant is likely to slow the recovery through the first quarter of 2022, but we anticipate a subsequent recovery amid pent-up demand

We have been aware of the Omicron variant and the threat it poses since late November, when it was first reported in South Africa. With infection rates rising to very high levels in recent weeks (chart 2), it is clear that this strain of Covid-19 is more transmissible.

CHART 2: Global Omicron cases have surged



Whilst there is an encouraging body of evidence emerging that suggests this strain of the virus is less severe than the Delta variant, the high volume of infections will inevitably have implications for healthcare provision. In turn, the combination of consumer caution and re-imposed restrictions is likely to act as a headwind in the first quarter of 2022.

As always there is considerable uncertainty that surrounds the next phase of the pandemic. Our approach is to focus on experience from prior infection waves and consider how the impact of the current wave compares.

It is likely that, as before, lost ground to the spread of Omicron will be recovered in the second quarter, as cases subside and restrictions are lifted. We also recognise advancements in medical science and logistics that have enabled more than 9 billion vaccinations to be administered globally, with millions now receiving third 'booster' jabs

> Medical progress looks set to continue, with recently approved anti-viral treatments due to be rolled out for widespread use in early 2022.

The emergence of Omicron, which has a significant number of mutations compared with the original virus, is a reminder of the unpredictability of this pandemic. It is clear we will continue to live with Covid-19 throughout 2022 and beyond. However, we have confidence in medical technology and the ability of society to adapt, sustaining the economic recovery that began in March 2020.

2: Is higher inflation being driven by pandemic or structural factors?

Both. Pandemic-related factors account for a substantial share of the current inflation surge but are likely to subside over time. There is, however, evidence that longer term inflation pressures are building, which require close scrutiny and have implications for investment positioning.

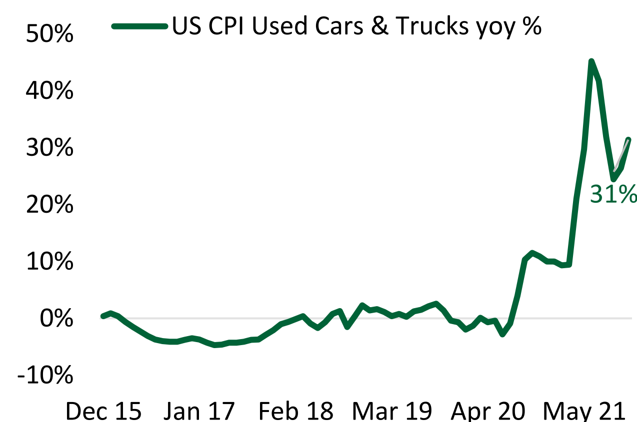
There is little doubt that the pandemic and subsequent economic reopening has had a meaningful inflationary impact around the world.

> The current inflation surge is largely being driven by a combination of shifting consumer spending patterns and supply-side disruption, which have largely been induced by the pandemic.

The car industry is a good example and one which plays a major role in the global manufacturing sector. Car production requires hundreds of microchips, or semiconductors, for essential safety and performance operations. When the pandemic emerged, factories experienced temporary closures and labour shortages while global shipping links were disrupted.

With the supply chain weakened, the availability of key inputs used for microchip production suffered. In turn, raw materials were in short supply and delivery times extended. Meanwhile, consumers' spending habits shifted to focus on large goods purchases, with transport and leisure costs removed from ongoing expenditure. Generous government support also raised consumers' ability to spend. Demand for new and used cars surged, which compounded the supply-side bottlenecks. Ultimately, prices rose (chart 3).

CHART 3: The price of used cars in the US has surged



Source: Bloomberg, November 2021.

Part of the supply deficiency relative to demand will moderate as the economic impact of Covid subsides. Whilst we are currently in the midst of an infection surge in much of the world, the kind of disruption we experienced in early 2020 is not being replayed. As 2022 progresses, factory production will rise and consumers spending patterns will tilt back to services (i.e. tourism, leisure and hospitality) with less surplus cash for large outlays.

However, part of this supply deficiency shows signs of persisting. Semiconductors permeate multiple industries, and whilst the pandemic has been the main culprit behind the microchip shortage these demand-supply imbalances were building beforehand. The rise of digitisation in recent years has led to substantial demand growth for microchips, and this is unlikely to abate any time soon. Artificial intelligence, 5G connectivity, medtech, 'smart' homes, data centres, electric vehicles, wearable technology and many other growth trends are expected to drive microchip demand higher over the next decade.

Why might this be inflationary? Because supply chains take time to adapt. The production of microchips has limited unused capacity and since the process is complex and capital intensive, time is needed to expand.

> Supply chain management is evolving to focus on simplification and resilience over cost-efficiency. This is likely to lead to higher prices.

The labour market is also a key aspect of the inflation outlook. Like the supply of raw materials, the labour market was heavily disrupted during the pandemic as workers opted for early retirement, focused on childcare or relied on savings, while demographics continue to weigh on the working population.

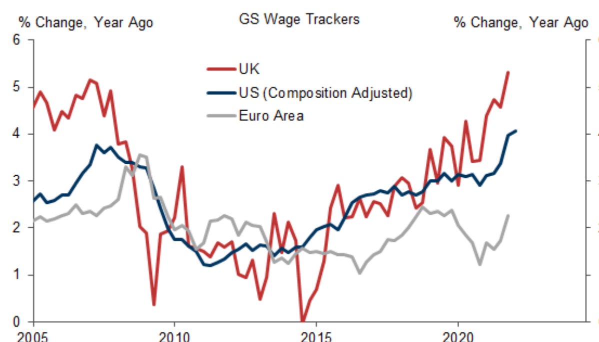
As economies have reopened labour shortages have become increasingly commonplace and are particularly acute in the UK. In this case, the furlough scheme and Brexit represent additional complexities. The pool of available low-wage labour has shrunk far more than expected in the past year, for example HGV[1] drivers, with implications for businesses and consumers.

> Company CFOs[2] named persistent labour shortages as the top business risk in a recent survey[3].

Is this the start of a wage-price inflation spiral? There is little evidence of that yet, but it is a credible threat. Labour shortages typically lead to higher wages, which in turn drives price inflation.

Wage growth has jumped to more than 5% in the UK from the 1-2.5% pre-pandemic range, with similar patterns observed in the US and Europe (chart 4).

CHART 4: Wage growth is at multi-year highs

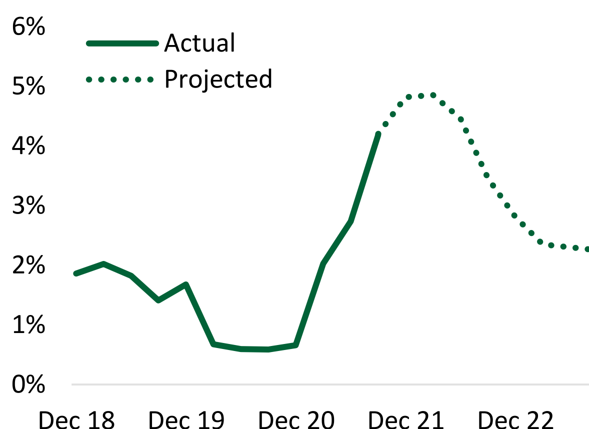


Source: Goldman Sachs Global Research, December 2021.

Over time, fewer workers will be subject to Covid-related disruption which should ease the current labour shortage. However, longer term trends point to lower net migration and higher minimum wages, both of which have the potential to act as sources of price inflation.

> We expect inflation to moderate over the coming year as the pandemic itself subsides. However, the foundation for higher long term inflation could be taking shape.

CHART 5: UK Inflation[4] should moderate in 2022



Source: OECD Economic Outlook December 2021.

[1] Heavy Goods Vehicles
[2] Chief Financial Officers.
[3] Deloitte CFO Survey, Q3 2021.
[4] UK CPI yearly % change.

3: Can the market tolerate higher rates as growth slows and inflation rises?

Yes. But expect some volatility along the way.

Major central banks have largely maintained emergency policy measures since the emergence of the pandemic, despite a strong economic recovery in 2021. But as inflation rates have risen in recent months several Central Banks are now shifting gears.

The Bank of England increased the UK base rate to 0.25% (from 0.1%) last month, and the Federal Reserve are now 'tapering' monthly asset purchases. This comes at a time when economic growth is slowing, partly because of the impact of Omicron, but also as a consequence of reduced government stimulus.

The critical issue for investors is whether central banks get the timing, magnitude and forward guidance right as they adjust policy.

> Tighten too much or too fast and equity markets will shift lower to reflect the added strain. Doing too little to stave off future inflation threatens confidence in long term price stability.

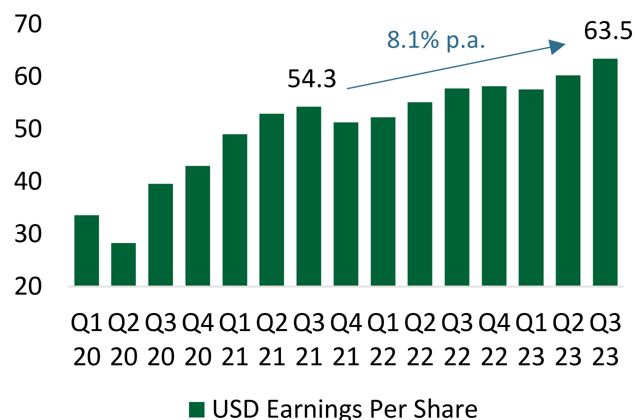
With emergency settings reflecting a monetary 'pedal to the metal' nearly two years after the onset of the pandemic, it is arguably the latter risk that is of greater concern. Interest rates have room to rise before they enter restrictive territory, and companies are unlikely to feel the burden of asset purchases winding down. This now appears to be the view of the Federal Reserve, who recently acknowledged some persistent inflationary pressures and retired their 'transitory' characterisation.

As central banks have announced a withdrawal of ultra-loose policy and started to raise rates in the case of the UK, markets have moved higher. This supports the view that doing too little is of greater concern than too much at the current time.

> Inflation is proving to be stickier than expected and investors need reassurance that central banks are not falling behind the curve.

A gradual normalisation of policy can be tolerated, however companies still need to deliver. Earnings growth has been impressive throughout 2021, driving equity prices higher. Even with a moderation in the coming months, as Omicron dampens economic activity, estimates are for c. 8% annualised growth over the next two years (chart 6).

CHART 6: Earnings momentum despite Omicron



Source: Bloomberg, December 2021. Q4 2021 onwards are estimates.

The equity market retains healthy momentum and multiple earnings drivers. It also benefits from a relative valuation advantage over most other liquid assets for generating real returns, particularly bonds. As the cycle matures we continue to expect investors to benefit from further gains. However, the backdrop is well balanced suggesting periods of higher volatility are a likely consequence.

4: Is the market paying sufficient attention to growing geopolitical risks?

The evolution of geo-political tensions over the coming year could spell periods of higher volatility and have a meaningful impact on which markets emerge as leaders. However, these issues are not new at a level which justifies a defensive stance.

Geo-political events are rarely absent from the list of potential market drivers. Furthermore, they are notoriously difficult to anticipate. However, as tensions between economic superpowers grow, the threat of a meaningful disruption to the recovery is not to be dismissed in 2022.

Russia's military build-up close to the Ukrainian border dominates geo-political concerns. Relations with the US are on a knife-edge and could result in military action, should Vladimir Putin directly invade or annex Ukraine. The implications for

investors could be significant. If Europe remains aligned with the US, recent energy shortages could be exacerbated, disrupting broad risk appetite and inflation expectations.

Fears that China may soon invade Taiwan have also escalated in recent months. The reunification of Taiwan with the Chinese mainland is a feature of President Xi's long term agenda. Meanwhile, as support for independence in Taiwan grows, US President Biden has stated that they would defend the island in the face of Chinese attack.

> Much like Russian invasion in Ukraine a cross-strait military conflict is unlikely. But even if such events are avoided these tensions have broad implications for investors.

As we pass the one year anniversary of the 6th January Capitol insurrection, the US remains deeply divided. President Biden's approval ratings indicate losses in Congress and the Senate later this year, and relations with China are a critical issue.

With China a source of lost ground to Donald Trump in 2020, the president is now adopting a harder line on the issue. Meanwhile, the Chinese authorities are increasing regulations on large companies considered too powerful. This creates a challenging environment for multi-nationals that operate in both regions.

Other geo-political risks continue to simmer. The US has stepped back from its global leadership role at a time when common challenges like Covid-19, climate change and cyber security dominate. This opens the door to long term challenges like Iran and Afghanistan escalating once more.

Many of these issues are not new. Nor do they justify a defensive stance in anticipation of an end to the current cycle. But their evolution over the coming year could spell periods of higher volatility and have a meaningful impact on which markets emerge as leaders.

5: How is capital being allocated in this environment?

> As the current expansion transitions to 'mid-cycle' and inflation risks shift up, our focus is on investments that can deliver in this environment.

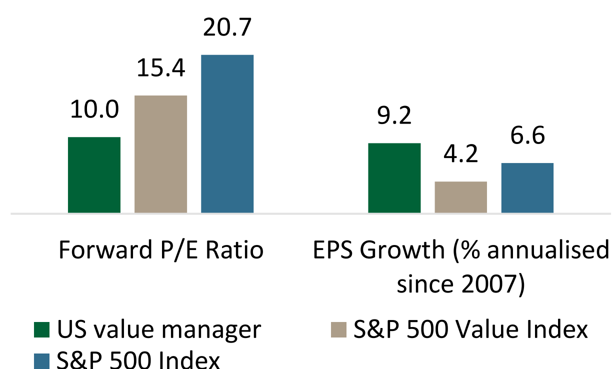
Within equities, we identify three key themes which are emphasised through our manager allocations.

Firstly, companies with pricing power. This is a commonly used term to describe businesses with defendable margins in an environment of rising input costs. Several of the active managers with whom we deploy capital consider this attribute to be a requisite for investment, and their approach is particularly relevant today.

The consumer goods sector is an example of where such businesses are often found, where brand loyalty and product necessity mean that higher costs can be passed onto consumers without volumes being impacted significantly.

Secondly, low valuation companies with competitive earnings growth. While equity valuations are elevated in some areas of the market, particularly US technology, we allocate to managers who have a clear skillset in blending value and growth within their stock selection (chart 7). These companies are typically more economically sensitive, and are posed to deliver strong returns should we see a strong recovery later this year. Furthermore their low valuation and 'cyclicality' lead to an inflation beneficiary.

CHART 7: Blending value with strong earnings growth



Source: Lyrical Asset Management, November 2021.

Thirdly, high growth leaders which access long term trends.

> Our equity managers are finding compelling structural growth themes that have the potential to deliver superior earnings growth.

One area we have tilted into recently is US smaller companies. The smaller segment of the market retains favourable earnings growth expectations overall, following a more challenging period in the second half of 2021. Furthermore, our manager in this space has an exceptional track record of delivering outperformance over many years. They identify a number of exciting opportunities across Biotech/therapeutics, technology and consumer goods, with the US consumer retaining a strong financial position.

Summary

We remain reasonably optimistic on the outlook for the global economy and the prognosis for selective risk assets. Nonetheless, we continue to maintain a heightened level of vigilance against potentially severe headwinds, including Omicron and future variants, the trajectory for inflation and interest rates, valuation levels and geo-political risks.

We wish you all a prosperous and safe 2022.

Stonehage Fleming Investment Management
January 2022

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