Investment Outlook 2022

2021 will be remembered as a bumper year by many investors. Most developed equity markets enjoyed double digit returns led, once again, by the US. There were several tailwinds to performance including macroeconomic measures, such as low interest rates and stimulative fiscal policies, as well as the successful roll out of coronavirus vaccination programmes in many countries. The main laggards were emerging markets, and in particular China, as well as developed Asian economies. Investor sentiment in China was undermined by a regulatory crackdown, which impacted the tech space, as well as the well-publicised problems in the property sector. Several property developers, most notably Evergrande which defaulted on its debt payments in December, now appear close to insolvency. Fixed income markets also had a difficult year as inflation consistently exceeded forecasts around the world. CPI inflation hit 5.1% in the UK, 4.9% in the eurozone and 6.8% in the US. This increased the pressure on central banks to tighten monetary policy through curtailing bond purchases and increasing interest rates. In many cases central banks acted, although the ECB are still clinging to the 'inflation is transitory' mantra. As might be expected under these circumstances, index-linked bonds significantly outperformed conventional government bonds. It was a strong year for the global property market including the UK. The latter benefited from the economy recovery as well as interest from global investors given the attractive rental yields in the UK together with the scope for rental growth, in some cases linked to inflation.

Looking ahead to 2022, we identify three key issues for investors to consider. Firstly, the interplay between inflation and interest rates is likely to continue to impact on asset prices. If inflation continues to exceed market expectations, then the quicker interest rates are likely to rise. In the short term some of the base effects in the inflation calculation (which is a rolling 12-month figure) should decline by the middle of the year. However, we believe that longer-term inflationary pressures related to macroeconomic policies and labour cost dynamics are likely to persist. At the very least, we expect inflation to run ahead of the yield curve (market interest rates). In this environment inflation-linked bonds are likely to continue to outperform conventional government bonds and we are positioned accordingly. Secondly, we anticipate the global economy recovery will continue. The outlook for the UK economy appears to be relatively robust. For example, Goldman Sachs predict UK growth of 4.8%, the highest in the G7 and well ahead of the 3.5% forecast for the US. We remain overweight UK equities given the attractive valuation relative to other markets. The plethora of bids for UK companies in 2021 indicates that international investors share our positive view on UK valuations and are prepared to act on it. Thirdly, there are several potential curveballs to keep an eye on. Russia's rhetoric towards Ukraine and NATO has become extremely belligerent while Taiwan increasingly seems to be in the crosshairs of China's unification policy. Assuming these two geopolitical issues do not boil over, the more immediate risk is the ongoing slowdown in the Chinese property market. Given that

the latter accounts for circa 28% of GDP this poses a significant risk to economic growth. Most commentators expect the government will eventually step in and co-ordinate a bailout. However, deflating a bubble is easier said than done. Even though the valuation of Chinese equities has fallen significantly we are not yet convinced now is the time to increase exposure, but we continue to review the situation.

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