Parmenion

2022 Market Outlook

Parmenion Investment Management

The new year presents fresh challenges and opportunities. Following better than expected returns for many investors in 2021 (other than those invested solely in G4 sovereign bonds and arguably Emerging Market equities), and with economies bouncing back from the Covid inflicted lows of 2020, it's a good time to consider what next.

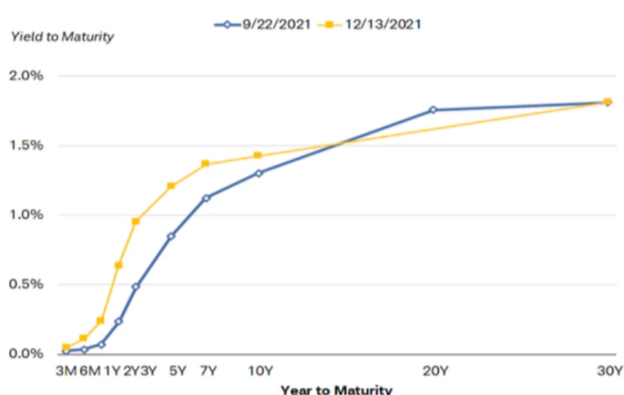
Fiscal and monetary policy seems to be changing from tailwind to headwind. Consumption is facing pressure as disposable income gets squeezed by inflation. And corporate profitability is being challenged by increasing input costs. The outlook looks harder than 12 months ago.

The situation is further complicated by high market valuations and investor expectations across many asset classes. We believe caution is warranted ahead of a likely rise in market volatility. However, this can present opportunities. Here are our 5 key themes to look out for in the year ahead.

1. Unprecedented > Transitionary > Policy error

While 2020 was the year of 'unprecedented' experiences and economic statistics, 2021 was the year of 'transitory inflation'. What will the word or phrase of 2022 be? We believe 'policy error' is one to watch.

With US inflation now at 7% and the UK over 5%, respective central banks have pivoted towards tightening the monetary tap. At a time of slowing GDP growth, renewed Covid restrictions and reduced fiscal support (as emergency relief programmes expire or get withdrawn), the risk of policy error is reflected in the flattened yield curve. Investor expectations of short-term rates have risen, while long-term rates are broadly unchanged (known as a 'bear flattening').



Source: Bloomberg, data as at 22/9/2021 and 13/12/2021

This tells us fixed income markets believe the Federal Reserve (Fed) is likely to introduce at least three interest rate hikes in 2022 and more in 2023.

However, high levels of global debt mean the increase in debt servicing costs from rising interest rates will cap how high and how quickly interest rates can rise. For example, the Bank of England forecast that a 1% increase in interest rates will cost the Exchequer an additional £25bn, money they can ill afford. With over $296 trillion of debt in the world, which is over 3x

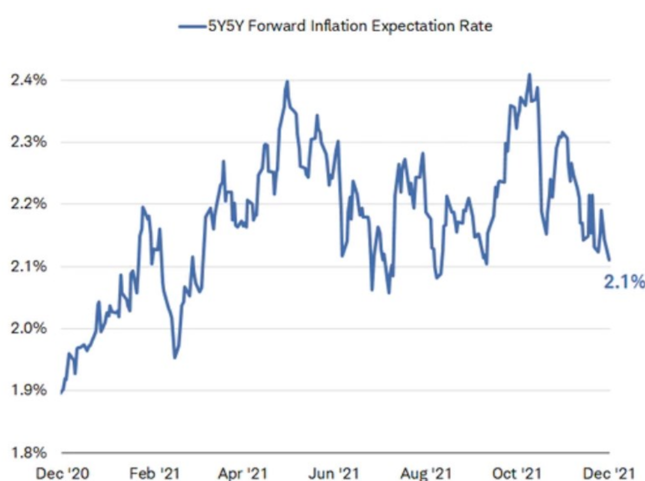
global GDP, we view the markets' fear of aggressive and rapid interest rate rises as a little overdone. Interest rates are assumed to move up but remain low.

Long-term forward-looking inflation expectations have also reverted from October as supply constraints ease and more favourable base effects kick in. That doesn't mean that concerns around inflation are unwarranted or will go away any time soon.

Inflation currently doesn't appear to be just demand driven though – but rather a supply driven problem due to the pandemic. Disrupted supply chains are taking time to correct, but improvements can be seen.

For example, many commodity prices are down off their peaks. Semiconductor supply constraints are easing, inventories are being rebuilt and shipping rates are easing. This all suggests that inflation will moderate through 2022, especially in the second half of the year, as long as wage inflation remains controlled and house prices stable.

Covid induced strains complicate the outlook as the virus restricts mobility and willingness to work. However, with the removal of enhanced unemployment benefits in the US and furlough in the UK and EU, it's expected that workforce participation should rise, helping to ease the reported tightness in the labour market. And housing, which makes up about a third of the CPI basket in the US, was at 3.8% in November - just slightly above the level it was pre Covid, but nothing untoward.



Notes: The 5Y5Y Forward Inflation Expectation Rate is a measure of the average expected inflation over the five-year period that begins five years from the date data are reported. The rates are comprised of Generic United States Breakeven forward rates: nominal forward 5 years minus inflation-linked bonds forward 5 years

Source: Bloomberg 5-year Forward Inflation Expectation Rate (USGG5Y5Y Index) as at 13/12/2021

2. Slowing growth, NOT slow growth

Risk of central bank policy error is a clear possibility, but as discussed in our **December Market Insights webinar**, it is not our core assumption. We believe the world economy continues to rebuild and regain lost ground - though this doesn't mean the resumption of a normal economic cycle.

It's not likely to be a smooth process as new waves and variants of Covid arise. But with continued medical progress in vaccinations and antivirals, combined with humans' natural drive to progress and move forward, we believe sequential recovery is likely. This suggests continued above-trend GDP growth in 2022 for the global economy, albeit with increased variation across

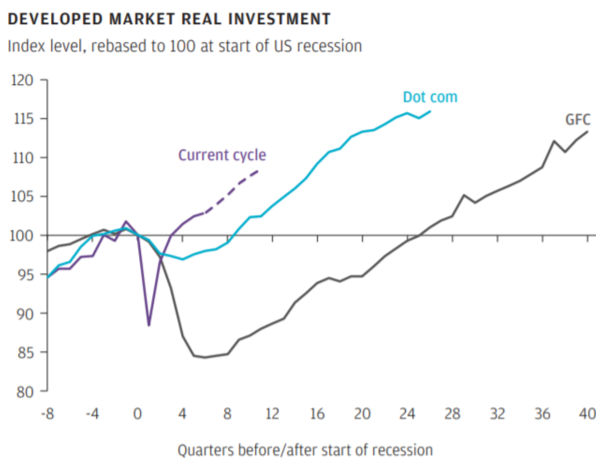
regions and countries. This divergence should represent greater opportunity for outperformance amongst active managers and tactical asset allocators.

But things are expected to change. For example, towards the end of 2021 a number of investment banks downgraded their former GDP growth forecasts for 2022 to reflect the Fed's revised path of rising interest rates, the emergence of the Omicron variant and the reduced likelihood of additional fiscal programmes (e.g. President Biden's $1.75 trillion Build Back Better initiative) being passed into law in their initially proposed form.

This illustrates the sensitivity and susceptibility to change of the anticipated economic recovery. Combined with forecast monetary and fiscal policy tightening of $5-7 trillion among the world's G4 countries (equivalent to Japan's GDP, according to Jupiter Asset Management), slower GDP growth in 2022 is an increasing possibility. This is something that central banks and politicians are all too aware of and they will want to avoid choking off the recovery.

3. A new investment cycle emerges

One notable change following the Covid recession is investment activity coming through at a much faster pace.



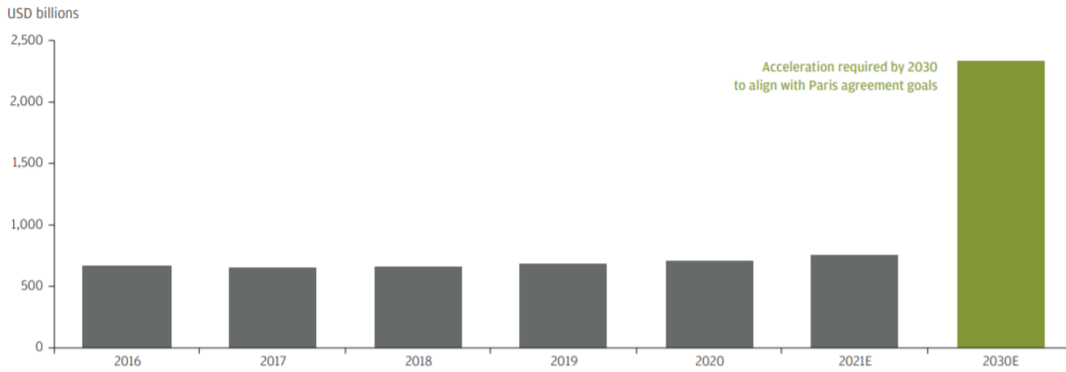
Source: J.P. Morgan Securities Research, J.P. Morgan Asset Management

There are a number of reasons for this – catch up following years of under investment, notable changes to ways of working, and the growing importance of ESG. This points to the prospect of improving productivity, something which has repeatedly disappointed since the Global Financial Crisis of 2008.

With greater productivity, companies will be more competitive and better equipped to afford wage increases, supporting the circular loop which helps to underpin consumption - a key driver of global GDP growth.

The importance of the global shift in attitude towards climate change should also not be underestimated. The transition to a more sustainable working world is a huge challenge that's going to require significant ongoing investment, far in excess of what's been observed in recent years. The next chart shows an estimated tripling of annual investment by 2030 in the electricity sector alone.

Global Investment In Clean Energy and Energy Efficiency

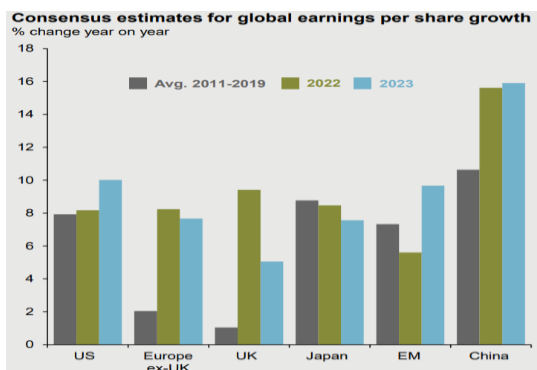


Source: International Energy Agency (2021), World Energy Investment 2021, J.P. Morgan Asset Management. 2030 forecast based on annual average investment needs in the electricity sector for 2026-2030 in the International Energy Agency's 'net zero emissions by 2050' scenario.

Clearly this expense will need to be funded. However, given the market's enthusiasm to support companies leading on energy transition and improved general sustainability, their cost of capital remains competitive, even lower in some cases. This is an enduring theme and companies can't afford to be left behind.

4. Margins moderate on corporate earnings

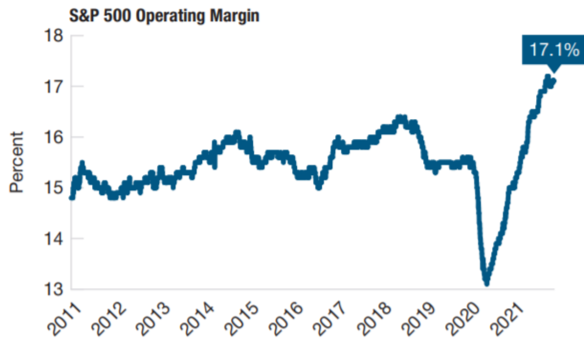
Consensus expectations for corporate earnings into 2022 are down from 2021, which is unsurprising following the 'bounce back' post 2020. However, they remain above average for most markets.



Source: FTSE, IBES, MSCI, Refinitiv Datastream, Standard & Poor's, TOPIX, J.P. Morgan Asset Management

High, single-digit earnings growth looks feasible, with scope for upside surprise in regions like Emerging Markets where expectations look modest at 5.5%. However, with rising input costs and increasing competition, corporate margins are expected to moderate. US operating margins are near record highs, so some reversion to the mean looks probable.

At a time of upward pressure on interest rates, this could present downward pressure on market multiples. However, given our expectations of modest and gradual interest rate increases, we expect this to be orderly and incremental.



Source: Standard & Poor and T. Rowe Price

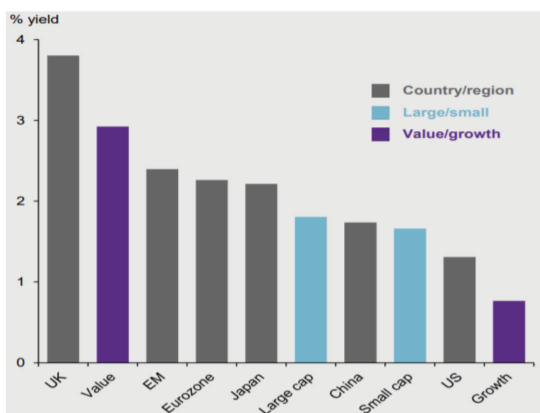
5. Recovery on track, but manage expectations

Managing investors' expectations going forward is key. The stellar returns enjoyed by many over recent years should not be assumed as the norm. Mid-single digit returns from a diversified portfolio feels prudent. The alignment of attitude to risk and capacity for loss with a client's Risk Grade is essential to be comfortable and resilient to any rise in volatility as we shift away from an environment of extraordinary monetary and fiscal policy support.

Adopting more of a total return mindset is also warranted. As markets have become increasingly expensive, changes in price rather than dividends and income have driven client returns. This trend isn't sustainable and a focus towards investments that can generate recurring cash flows could arise.

Following a decade of 'growth style' leadership, this potential represents a subtle but significant change. Given the relative yields observed below, the US may become less dominant.

Global Dividend Yields



Source: MSCI, Refinitiv Datastream, J.P. Morgan Asset Management

Easing supply-side constraints, combined with slowing consumption due to squeezed real disposable income, suggests that investors will again become focused on growth through the second half of the 2022 and beyond. The strength of the US dollar is anticipated to ease as interest rate expectations moderate, supporting the relative attractiveness of non-US assets such as broad Emerging Markets, which materially lagged through 2021.

Looking ahead

We remain cautiously optimistic while recognising a rapidly changeable world. For committed, long-term investors the benefit of compounding returns should continue to deliver, notwithstanding the marked shift from a stimulative policy driven environment to a progressively tighter one.

As always in investing there are plenty of risks, but that brings opportunities for the patient and discerning.

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