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Marketing Material

2022 – strong enough for monetary detox?

The global economy should grow above potential in 2022, with inflation worries proving worse than inflation itself. Declining monetary support could unsettle markets, however.

"2022 looks quite promising from a political and economic perspective. The combination of challenging equity valuations, inflation worries, rising interest rates and lower monetary stimulus is likely to create volatility in the markets, however."

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Are the current inflation rates transitory or likely to persist? That is the dominant question on the capital markets at the moment. Looking ahead to the investment year 2022, one could also ask: Is the bubble in capital markets transitory or will it last longer?

This question is important because in the current market environment of far-above-average valuations, investors have to ask themselves what is transitory and what is sustainable, and not just when it comes to inflation. Shareholders are looking back on a year in which they have gained more than 20% so far on average[1], thanks to companies that increased their profits by almost 50% year-on-year in the first nine months. This is partly because these companies have been able to pass on cost increases easily to consumers, especially for goods, while wages have not yet risen across the board. This has resulted in a historically high net profit margin, of almost 13% in the S&P 500.[2] At the cyclical peak in 2007, it was still less than 10%.

Added to this is an extraordinarily spendthrift public sector. Current forecasts suggest the U.S. government will have spent an average of 11% of gross domestic product (GDP) more than it has taken in in taxes over the years 2020-22.[3] This level of fiscal stimulus would usually rather be seen in times of war. And then there are interest rates. Ten-year U.S. Treasury yields have been in a downward channel for 35 years and have yet to break out of it. Real yields (adjusted for bond investors' inflation expectations) have been negative for almost two years. Which of these conditions is temporary, and which sustainable?
Let's take a brief look back. As of today, 2021 was a very good year for risk assets, especially equities. Less so for bonds. We were not surprised by the rise in risk assets, but more by the magnitude of that rise – especially since there were some stumbling blocks along the way: supply-chain issues, China's regulatory reforms, recurring waves of Coronavirus and the spurt in inflation.

All of these issues remain relevant in 2022, but we think mostly in the first half of the year. We therefore expect another year of above-potential growth rates for most countries. Specifically, we expect the Eurozone to grow 4.6%, the first time since 2017 that it would grow faster than the U.S., at 4.0%. We expect China to grow by "only" 5.3% and India by 7.5%.

This positive picture is complemented by our inflation expectations, which are for a drop to below three percent inflation in the U.S. and the Eurozone.[4] In addition to base effects, for example in oil prices, and taxes in Germany, the

1 MSCI World Index, year-to-date performance until November 11, 2021; Source: Bloomberg Finance L.P.
2 Bloomberg Finance L.P. as of 11/23/21. Please note that the changing sector weightings have also contributed to this.
3 Bloomberg Finance L.P. as of 11/23/21
4 Core PCE for the U.S. and CPI for the Eurozone

increasing realignment between demand and supply should also contribute to falling inflation in the second half of the year, as supply recovers. We think this will take some pressure off the central banks to act. In our view, the U.S. Federal Reserve (the Fed) will stop its net bond purchases by mid-2022 and then hike rates once until the end of 2022. The European Central Bank (ECB) is likely to reduce bond purchases in 2022 but keep its interest rates at their current extremely low level, probably in 2023 as well. Growth rates should be declining by 2023 anyway, as the bounce back from Covid is likely to be over. We expect the Eurozone to grow by only 1.6% in 2023, and the U.S. by 2.8%. The global economy will thus be returning to the path of moderate growth, which we once called the "turtle cycle" in 2014. However, this time the growth is likely to be accompanied by slightly higher inflation rates.

The most important implication for asset classes from this economic scenario is that we do not expect any strong interest-rate rallies. We see the yield on ten-year U.S. government bonds, financial markets' main benchmark, rising only to 2% by the end of 2022. Real interest rates are likely to remain clearly negative. And that probably means that the environment for risk assets remains good, especially for equities, which can also offer protection against moderate inflation. Companies with high pricing power, which are our focus, are doing particularly well. We see the potential for, on average, share-price gains in the mid-single-digit percentage range. This would be the fourth year in succession in which equities have performed positively – a run maintained in the context of the pandemic of the century.

In view of the current strong but temporary cyclical upturn we are continuing to focus on a combination of growth and cyclical value stocks. This leads to a balanced regional distribution. After a relatively weak year, Asia's stock markets could close the gap with the overall market again in 2022, but we think there could be further market-disturbing news from China, in particular in the first half of the year. While the U.S. is tilted towards the growth segment; Europe, Japan and Asia rather represent the cyclical component. The latter also includes industrial stocks, some of which we see as big winners from decarbonization policies. The key term is Clean Technology. Sustainability, as also shown by the broad interest in the climate conference in Glasgow, should move even further up the agenda. Our conclusion from the summit is that more was achieved than expected, but less than necessary.

The economic environment described above also continues to favor some types of alternative investments. The infrastructure segment is attracting investors with its good adaptability to rising prices. And we also continue to see many interesting niches in the realestate segment. In addition to the logistics space, this includes, in particular, affordable, sustainable housing in the vicinity of major cities.

As far as bonds are concerned, we will have to be selective in 2022. Government bonds, especially longer maturities, will continue to have a hard time in an environment of rising interest rates in our view. In addition, volatility is likely to remain similar to the second half of this year, including for shorter maturities, especially in the first half of 2022, as markets are likely to test central banks' intentions for interest-rate hikes, communicated in their policy statements.

After a weaker year for corporate bonds – with only U.S. high-yield bonds showing a positive return so far – we expect better numbers again in 2022. This should be helped by the economic environment, incredibly low default rates, and a better supply-demand balance. We also expect a better year again for emerging-market bonds, even if further ambiguity in China or a temporarily strengthening dollar are likely to partly overshadow the benefits of rising commodity prices.

However, we believe the dollar might lose its appreciation momentum during the first half of 2022. The market is currently very dollar-friendly based on the interest-rate differential with the Eurozone. The ECB's rhetoric is dovish while the market is pricing in almost three full Fed rate hikes by the end of 2022. We are less hawkish and therefore expect an exchange rate of $1.20 per euro on a 12-month horizon.

In summary, we expect 2022 to be a good investment year, especially for risk assets. Indeed, we see the chief danger for assets in the markets themselves, not emanating from politics or the economy. How will stock markets react to the gradual withdrawal of liquidity by central banks and to a slowdown in growth? There could be volatility. And inflation will still be a wild card in our view, especially in the first half of the year, if it doesn't begin to settle down.

GLOSSARY

The default rate refers to the proportion of borrowers who cannot service their loans.

Dovish refers to the tone of language used to describe a situation and the associated implications for actions. For example, if the Federal Reserve Bank refers to inflation in a dovish tone, it is unlikely that they would take aggressive (contractionary) actions.

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

The European Central Bank (ECB) is the central bank for the Eurozone.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

Hawks are in favor of a restrictive monetary policy.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Profit Margin is an accounting figure which describes profit in relation to revenue in percent.

In economics, a real value is adjusted for inflation.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

Important Information

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