Outlook 2022

There may come a time to pivot

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Across much of the world, lowered mobility restrictions, large consumer savings balances and still easy policy suggest growth in 2022 will remain above trend. This supports our moderately risk-on stance, favouring equity over fixed income returns. More moderate returns and greater later-cycle volatility will likely feature in 2022.

Moreover, as always, there are risks to the near-term outlook, from a resurgent mutating virus, inflation pressures to geo-politics. And even if all goes to plan, dissipating slack and tighter policy could demand a more neutral—or even defensive—stance as H2 2022 gets underway. Key will be assessing if and when there is a right time to pivot.

Come on. Up, up, up! Up! Yes. Here we go. Pivot! Pivot! Pivot! Pivot! Pivot!

FRIENDS, NBC NETWORK
ROSS TO RACHEL, 1999

Central case outlook and scenarios

The notion that the outlook is always uncertain typically bears greater weight the further from the 'here and now' one peruses. But as 2021 draws to a close, the confluence of persistent inflation, supply-chain gridlock, and both a virus surge and new mutation has heightened even short-term uncertainty. As we look to position portfolios into 2022, it may take until well into Q1 2022 to confirm whether cyclical inflation pressures and a new virus wave subside.

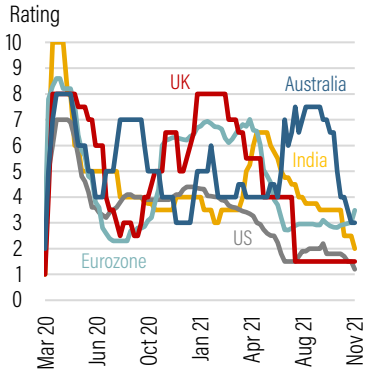
Our central case—Dynamics associated with the reopening of economies and stronger jobs markets should combine with consumers' large (excess) savings balances (and a renewed business capex cycle) to drive a relatively synchronised pick-up in global growth following Q3 2021's unexpectedly sharp slowdown. This should be sustained well into mid-2022, with UBS forecasting H2 2021 growth of 7% giving way to a still-above trend 5% pace in H1 2022. We expect Europe, the US, the UK and Australia to all expand strongly in early 2022, while India and the rest of Asia should also recover solidly, despite the headwind from a slowing China.

Dynamics associated with the reopening of economies and stronger jobs markets should combine with large consumer savings to drive a synchronised pick-up in global growth in 2022 following Q3 2021's unexpectedly sharp slowdown.

Supply-side bottlenecks should show clearer signs of dissipating in Q1, validating central banks' more gradual interest rate hiking path than markets are predicting. Longer-term bond yields will likely continue to grind higher into a 2.0%-2.5% range for the US and Australia but are unlikely to become unanchored. Equities should weather higher yields as earnings support raised valuations. This is despite steady liquidity withdrawal (tapering) by central banks ahead of more broad-based rate hikes late in 2022 and early 2023.

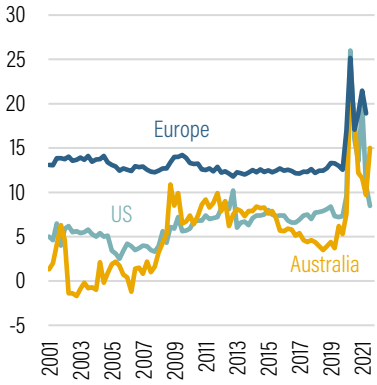
Investment returns in 2022 will depend increasingly on alpha rather than beta, with active management likely to outperform passive.

Mobility restrictions trend lower



Source: UBS. Shows mobility restrictiveness rating (0-10).

Consumer savings are elevated



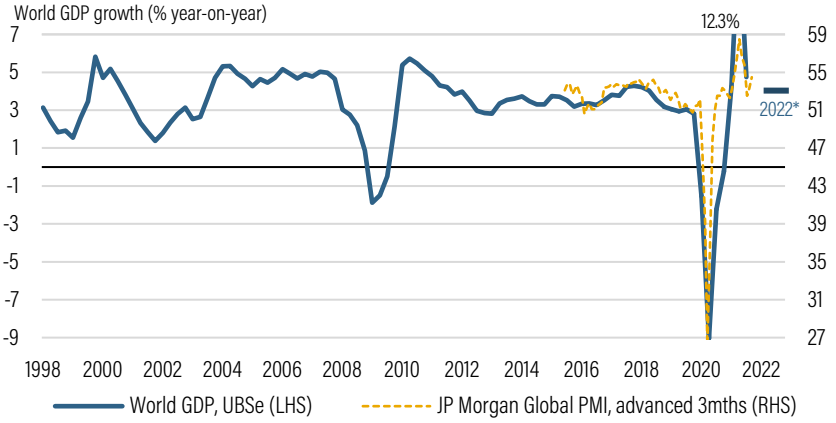
Source: Bloomberg, ABS, Factset, Australian Q3 data is RBA forecast.

"Being wrong on the duration of bottlenecks will be orders of magnitude more important than being wrong on next year's average wage growth".

UBS 2022-2023 OUTLOOK
NOVEMBER 2022

A revolving cycle of virus mutations remains a threat to the 2022 outlook.

Global growth should remain above trend in 2022



Source: UBS, International Monetary Fund (IMF), JPMorgan. * Forecast average of UBS, IMF and Organization for Economic Co-operation and Development.

As H2 2022 gets underway, conditions may suffer from 'too much of a good thing'. Falling unemployment will likely refocus attention on renewed inflation risks and the need to tighten interest rate policy, just as fading recovery momentum, rising bond yields and more pressured margins challenge equity returns. The risk is that the need for policy to turn less stimulatory will see a 'late-cycle' scenario emerge relatively quickly through H2 2022. Our central case suggests more moderate returns lie ahead for 2022, weighted to the first half of the year, with a decent dose of late-cycle market volatility. More importantly, investment returns will depend increasingly on alpha rather than beta, with active management likely to outperform passive.

Upside growth scenario—Inflation pressures will likely dissipate quicker than expected by early 2022, and renewed labour participation should limit global wage growth, as should a capex-led productivity cycle. Central banks will tighten only slowly (with hikes delayed into mid-late 2023), capping bond yields and allowing growth to remain above trend throughout the year. In this 'mid-cycle' scenario, equity return will likely be favoured throughout the year.

Downside growth scenario—While the tweaking of current vaccines should contain the Omicron variant, further mutant strains that drive renewed global lockdowns will delay recovery. Other near-term risks rest with current supply-side inflation bleeding into more problematic structural inflation. Unanchored wage and inflation expectations would see central banks flag that rate hikes are coming sooner and faster. After a further sell-off, bond yields would peak, and equities would correct until inflation pressures afford a central bank pause.

Six pivotal questions for 2022 (and beyond...)

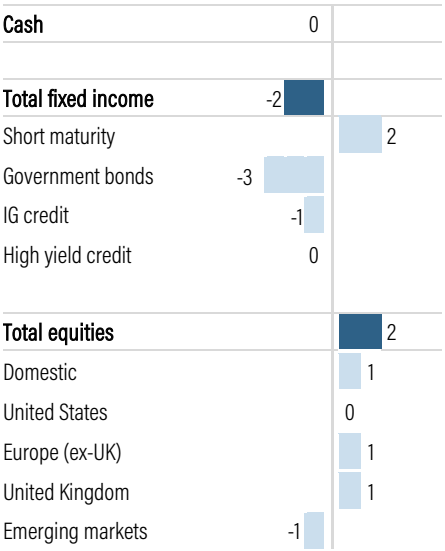
1. Will supply-driven inflation pressures ease? 'Transitory' is evolving into 'persistent' but we don't believe this makes it structural. Easing inflation pressure in early 2022 should reduce the risk that central banks prematurely end the cycle. Indicators, such as freight rates, port queues, energy and other commodity prices, are already easing. This should allow economic recovery to continue through 2022 and into 2023. Risks may re-appear later in 2022, but central bank hikes will reflect rising real rates (growth) not inflation fears.

2. Will risk positioning need to pivot more defensively in H2 2022? We expect easing inflation risk in early 2022 to see growth continue to recover strongly. A corresponding drop in unemployment to levels that have driven wage inflation in the past could see central banks shift more hawkish mid-year, flagging policy tightening later in 2022. This could be a point to pivot, moving more neutral risk until slower growth eases rate hike pressures and central banks approach more neutral settings. Equity markets may begin to consolidate through H2 2022, consistent with being later in the cycle.

3. How quickly can the world contain Omicron? There are more unknowns than knowns at this time. Early signs are that this variant is more contagious but not more deadly. If current vaccines are insufficient, tweaked versions are expected within three months (a delay to the recovery). The world is more adept at delivery and potential short-term lockdowns are likely to be less of a growth impost. Still, a cycle of mutations remains a threat to the outlook.

Diversified portfolios will continue to provide the best defence for preserving capital, given the inevitable vagaries of any outlook.

Tactical asset allocation (% weights)



Source: Crestone Wealth Management.

An increase in post-pandemic mobility, a surge in consumer spending due to significant savings, a ramp in capex, and inventory restocking are all positive backdrops for corporate earnings.

4. Can the value style keep rewarding, even for structural 'growth' bulls? While easing inflation risks may delay rate hikes, strong growth and rising real rates should continue to drive longer-dated yields higher. This should support 'cyclical value' and 'quality' as a style in H1 2022. As UBS notes, spending on services remains below pre-pandemic levels globally. Long-duration equities (such as technology) may underperform. Part of the risk pivot in H2 2022 may see peaking yields favour an additional pivot back to growth and defensives.

5. Can income make a comeback? While it is early days in the normalisation of monetary policy, rising yields have the potential to refocus attention on income as 2023 comes into view, particularly defensive government bonds. Floating rate investments will also be well-positioned to capture rising short rates, especially if inflation surprises higher. For those with limited exposure, it may be time to gradually add some diversified fixed income back to portfolios.

6. How strong could Australia's H1 2022 recovery be? The end of 'stay-at-home' orders and the reopening of state borders have underpinned a material pick-up in activity as 2021 draws to a close. Business confidence has improved and consumer spending has increased. With interest rates staying low, savings high, capex intentions rising, and pent-up housing activity in play, growth in H1 2022 could surprise positively. UBS forecasts 4-5% growth in H1 2022.

Our asset class outlook

With 2021 drawing to a close, we have maintained our tactical positioning, with portfolios moderately tilted toward equities at the expense of fixed income. Themes we expect to guide markets in the year ahead, namely bond yields, inflation and monetary policy, should become clearer as we progress through Q1 2022. Diversified portfolios will continue to provide the best defence for preserving capital, given the inevitable vagaries of any outlook.

Under our **central scenario** of near-term easing inflation pressure, we expect continued equity outperformance in H1 2022. Near-term tactical moves would likely involve regional equity shifts (including a more favourable view of emerging markets) and trimming our government bond underweight. As the year progresses and rate hikes come into focus, a reduction in the risk overweight would likely be prudent. Under the downside scenario, risk assets would struggle as growth stalls and yields rise, prompting a tactical shift to reduce risk asset weights earlier than would otherwise be the case.

A more **troubling scenario** for investors is one where inflationary pressures do not subside, taking a more structural turn. Here, central banks would be forced to consider implementing tighter monetary policy sooner rather than later, likely slowing the economic recovery and damaging growth prospects. A potential pivot to an underweight equity position could be required here.

Equities—continuing to climb the wall of worry

Globally, equities have been able to climb a 'wall of worry', reaching record highs as 2021 draws to a close. Until recently, very robust corporate earnings have overshadowed decades-high inflation, China's slowdown, rising northern hemisphere COVID-19 cases, and more hawkish central banks.

As investors look to position for the year ahead, it is these five variables that will likely dictate returns. For now, we (like central banks) expect inflation pressures to fade before central banks 'capitulate' in their views, forcing a premature tightening that ends the expansion. Consequently, we expect the equity bull market has further to run, though with more moderate returns than delivered in 2021 (given 2022 brings the end of ultra-easy policy). An increase in post-pandemic mobility, a surge in consumer spending due to significant excess savings, a ramp in capital expenditures and inventory restocking are all positive backdrops for corporate earnings.

Regionally, China's growth deceleration looks to be closer to the end than the beginning. We continue to look for reasons to become more constructive on emerging markets. With that in mind, investors should pay close attention to China's credit impulse, any relaxation of its 'zero tolerance' COVID-19 approach, any easing of property sector measures, or clarity surrounding the end to the regulatory tightening cycle. The UK is expected to emerge from five years of Brexit uncertainty and pandemic-induced inertia, while our European overweight

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...credit spreads are near historic tights, reducing their risk-reward attractiveness.

represents a hedge against inflation proving 'stickier' than currently forecast. In fact, European equities would probably respond quite positively to signs of sustained inflation.

Domestically, the backdrop for equities remains positive, albeit the large index weighting to banks (having already performed strongly) and iron ore miners (still somewhat vulnerable to slowing demand and increased supply) complicates index-level performance.

Unlike other regions, inflation and wages pressure in Australia seem unlikely to be as persistent or enduring, allowing monetary policy to remain comparatively supportive. A federal election in 2022 will likely present some uncertainty, as Australian election campaigns tend to result in a period of weak equity gains, followed by a bounce once a government is formed. Still, since 1980, economic growth through election years has averaged 3.6%, exceeding average growth of 3.1% for the period as a whole.

Australia's valuations are broadly supportive at a 6% discount to those of the MSCI World index, and below the 1% premium it has averaged over the past decade. The opening of international borders should be a tailwind (subject to the impact of the Omicron variant), with the return of major industries, such as tourism, immigration and education. With funding costs still low, confidence high, and a need to grow earnings as the cycle slows, the mergers and acquisitions (M&A) boom should also continue and support share prices.

"Amid disruption, division, and divergence, overall capital market returns will likely be lower and more volatile, but active investors capable of navigating the difficult terrain should find good alpha opportunities."

PIMCO 2021

Fixed income—upward trend in yields to continue

Bond yields have been volatile, trending higher through 2021. Markets have been factoring in a stronger pace of growth on the back of higher vaccination rates, falling unemployment, supply driven inflation risks, and an expectation of central bank tapering of stimulatory policies. We see a further gradual rise to 2.0%-2.5% for 10-year yields by end-2022 in both Australia and the US.

However, for **policy rates**, we expect global central banks to remain cautious, moving higher at a slower pace than currently implied by markets (where two hikes in the US are predicted before end-2022). We expect the US Federal Reserve (Fed) to taper through H1 2022, but only begin lifting rates late in 2022 on the back of strong data and achieving its full employment target. While other more hawkish central banks, including Canada, New Zealand, the UK and parts of the emerging markets, will be lifting rates earlier, it is the Fed that will likely pave the way for more broad tightening, including in Australia.

The Reserve Bank of Australia (RBA) is likely to remain behind the curve until such time that inflation is cemented within its 2-3% target and wage pressures become more evident. Although markets have priced a 1% cash rate in Australia by Q4 2022 and 2% by Q4 2023, we see the RBA moving more gradually, with its first move at the end of 2022. While there are risks of an earlier tightening cycle, we see tightening via retail banking systems doing some of the work. In Australia, increased borrowing costs are likely to take some of the steam out of the buoyant housing market through 2022.

Gaining exposure to decarbonisation through private markets and/or real assets presents a significant growth opportunity, while also diversifying risk.

Inflation will remain the focus, with any shocks likely to bring greater volatility. Portfolios should profit from staying **short duration** in H1 2022 and allocating to **floating rate assets** that will benefit from rising rates. Credit fundamentals should continue to improve ahead on the back of good earnings growth and ongoing balance sheet repair. But **credit spreads** are near historic tights, reducing their risk-reward attractiveness. For investment grade credit, we expect a modest widening through 2022 (given vulnerability to higher long-end interest rates), while we remain neutral on high yield with carry expected to drive low positive returns over the coming year.

Alternatives—favouring real assets and direct credit

In considering PIMCO's perspective on active management (opposite), we highlight that few asset classes are as genuinely active as alternatives. Whether investors are seeking 'alpha' opportunities or simply strong risk-adjusted returns, hedge funds, private markets and unlisted real assets are well positioned to navigate the uncertainty of the period ahead.

Hedge fund returns should continue to benefit in 2022 from increased volatility and divergence across sectors and geographies. While alternative credit strategies remain attractive, positioning should lean more defensive, with relatively low allocations to higher beta equity and credit-orientated strategies.

Private markets offer an attractive means to improve both offensive and defensive positioning. Direct lending should maintain a healthy yield premium to traditional fixed income (with greater control and protections negotiated by lenders). We expect private equity to offer outperformance relative to (fully valued) listed markets. The ongoing rapid pace of global innovation and other secular trends favour growth equity and venture capital segments.

Real assets are likely to perform strongly and should (along with private debt) attract the marginal dollar across portfolios. High-grade assets with high-quality tenants and long leases, with stable floating rate and inflation-linked income, should help address inflation pressures and prove defensive relative to growth-oriented private equity. Active asset and manager selection remain key as sizeable divergence in performance across asset quality, sector and geography is expected to continue.

Finally, we believe that decarbonisation is a structural investment theme that will dominate in 2022 and beyond. Given the significance of this theme, gaining exposure through private markets and/or real assets presents a significant growth opportunity, while also diversifying risk away from industries and assets that may fail to adapt and threaten portfolio returns.