Global outlook 2022

Spotlight on markets

Six themes in focus in 2022

Turning point for the US?

Biden’s impact on the US recovery

Betting on red

China continues to go its own way...

Quilter Investors

UAE & UK: Suitable for retail investors.
Singapore: For accredited investors and institutional investors.

Contents

Equity markets enjoyed one of their best years for decades in 2021, with double-digit returns for numerous regional equity markets. However, traditional bond investors had a more tumultuous year.

Now as 2022 approaches, we have picked out six of the key themes that could impact markets in the next 12 months.

Thanks to the fund groups below for their contribution:

AllianceBernstein

Allianz Global Investors

J.P.Morgan Asset Management

Montanaro

Polar Capital

Regnan

This document contains the views and opinions expressed by third-party fund groups that do not necessarily reflect the views of Quilter Investors.

Quilter Investors

Quilter Investors

Back to (worrying about) the future...

Paul Craig
Portfolio Manager

With the worst of the pandemic (hopefully) behind us, investors need to get back to considering the more fundamental issues that will influence their returns in 2022.

Despite the emergence of the new Omicron covid variant late in 2021, there are still plenty of reasons for investors to be positive. As we plan ahead, we have picked out six of the key themes that could impact markets in the next 12 months. More details on these can be found on the next page.

Still with us

While the onset of lockdown may have disrupted financial markets and led to the emergence of these themes, it didn't impede the strong secular investment themes that still run beneath their surface – in many cases it accelerated them.

For example, Asia continues to churn out more new middle-class consumers faster than anywhere else and China's latest crackdowns in the name of 'shared prosperity' aim to augment this.

Western populations continue to age rapidly. This presents further opportunities for the healthcare and financial services sectors after a period of rapid evolution for both was triggered by the challenges of lockdown.

Lockdown also provided a 'once in a generation' boost to online platforms of all kinds as well as those companies developing the artificial intelligence (AI) and advanced robotics that accompany the re-imagining of global industry in a theme often labelled 'Industry 4.0'.


Warren Buffett: the Sage of Omaha

Credit: Kent Sievers/Shutterstock.com

Weighing things up

As Warren Buffett (pictured above) famously once said, “in the short-run, the market is a voting machine, but in the long-run, the market is a weighing machine.”

Lockdown has done nothing to change this, but it has provided a sizeable ‘evolutionary jolt’, accelerating the take up of some products and services and the trend towards obsoletion for others. Just think of our rapid transition to a cashless society, the hastening demise of bricks and mortar retailing or the current outlook for office landlords.

Although ‘the best’ may be behind us for financial markets, ‘the worst’ of the pandemic is too. Monetary policy remains extremely loose (and should rightly be reined back), accumulated savings for companies and consumers are high, which bodes well for future spending by both, while economic growth is slowing from a high, not turning negative.

Meanwhile, company results remain robust and we can be assured that the US Federal Reserve’s (Fed) micro-management of markets is here to stay; it will continue to course-correct whenever bond yields go high enough to threaten financial markets.

This means patience, prudence and diversification across regions, market capitalisations and investment styles are likely to be an investor’s greatest weapons in the coming year.

Continued overleaf

The six key investment themes of 2022:

1 **Peak everything:** Tidal waves of stimulus have lifted everything from economic growth, corporate profits and financial markets to the price of cars, houses and raw materials. Economic growth is already slowing while company earnings growth must surely follow as government stimulus and central bank support tail away. (See ***Paul Craig's 'Peak everything' interview*** for more on this topic.)

2 **China's growing pains:** China has introduced stringent new regulations on online gaming, financial and education stocks in its latest attempt at social engineering. Meanwhile, power cuts caused by policy changes threaten Chinese (and global) growth while the blossoming crisis in China's over-extended property sector could still infect international financial markets and pull the rug from under global commodity prices. (See ***Ian Jensen-Humphreys' 'Betting on red' article*** or ***Stuart Clark's 'China: Chinese ambitions'*** for more on this topic.)

3 **The great payback:** As the chief economist of the World Bank observed, "First you worry about fighting the war; then you figure out how to pay for it."

Ultimately, we'll all pay for the war against the pandemic through increased corporate and personal taxes and through inflation, which acts as a stealth tax. We're also likely to pay through the lower investment returns that we can expect in this sort of environment. (See ***Helen Bradshaw's 'Can the UK rise to the challenge?'*** for more on this topic.)

4 **The climate war:** Government policy targeting much-needed green energy solutions has exerted great pressure on existing energy markets exacerbating shortages of coal and natural gas, leading to spiralling energy prices and power cuts. Meanwhile, supply-chain issues and OPEC policy continue to push up oil prices fuelling the current energy crisis.

(See ***Eimear Toomey's 'Is brown the new green?', Ed Heaven's 'Temperatures rising: the US and climate change'*** **or** ***Sacha Chorley's 'Supply-chain chaos'*** for more on these topics.)

5 **Unsynchronised swimming:** The dismantling of central bank emergency measures will be far less synchronised than their arrival. This will create divergence in regional interest rates, bond markets, taxes and currencies. It also increases the risk of a policy mistake by a major central bank.

(See ***Hinesh Patel's 'Inflation: crying wolf?'*** for more on this topic.)

6 **Bond markets lose appeal:** Central bank intervention has pushed government bond yields to new lows making the diversification benefits of bonds far less apparent, especially if inflation takes hold.

(See ***Mike Riddell's 'Bond markets: a little volatility goes a long way'*** for more on this topic.)

Charting a course

Quilter Investors

Peak everything

Paul Craig

Portfolio Manager

Danny Knight

Head of Investment Directors

Paul Craig and Danny Knight discuss the implications of the 'Peak everything' investment theme for investors in 2022. From an investment perspective, this comes down to monitoring the recent peak in corporate margins and economic growth.

Quilter Investors

Value versus growth – do labels really matter?

Danny Knight
Head of Investment Directors

Traditional investment wisdom has been that the 'value' style will outperform over the longer-term, but with 'growth' stocks having dominated the best part of the last decade, Danny Knight asks whether it's time to set these labels aside.

The terms 'style' investing and 'growth versus value' are often bandied about the financial media but for many of us what does this jargon mean and should we really care?

Back to basics

Essentially, 'value' investment approaches target companies whose share price is cheap relative to certain metrics such as their book value (assets minus liabilities), their earnings or the dividend they pay out. Consequently, value stocks are among those with the highest dividend yields.

Examples of so-called 'value' sectors can include banks, oil, mining, utility and industrial companies. They tend to be well established and mature businesses.

Meanwhile, 'growth' stocks may be comparatively younger companies that derive their value from the rate at which they are expected to grow their earnings in the future. Generally, these companies pay limited dividends as they are busy reinvesting their profits in growing their businesses.

Growth stocks are commonly found in the technology sector with companies like the 'FAANGs' (Facebook, Apple, Amazon, Netflix and Google) being very prominent examples in the past decade.

However, to make things a little trickier, other 'cyclical' areas (meaning companies most impacted by the economic cycle) such as financial services, travel or the automobile sector may also contain 'growth' stocks, but generally the 'cyclical' and 'value' segments of the market overlap substantially.

Credit: iStock/Chinnapong

Story so far...

In the wake of the Global Financial Crisis back in 2007-08 US technology companies were among those that made a resurgence, having previously been out of favour since the dot.com boom. This coincided with an overall trend for 'growth' companies, which saw more value-orientated funds and companies struggle.

The continued dominance of 'growth' had already been questioned when the pandemic took hold in 2020. But the quick action by central banks to adopt easy monetary and fiscal policy created the ideal environment for growth stocks to continue to thrive.

However, the emergence of a number of vaccines and the subsequent re-opening of the global economy, albeit slowly, in the first half of 2021, provided an opening for the 'value' style to stage a comeback, before this 'style rotation' again started to shift towards the middle of the year.

Finding the nuance

On the surface it may seem that 'growth or value' is a simple binary choice, but delve a little deeper and the differences between what can be considered 'growth' or 'value' is actually more subtle as both types of company can benefit, or be hindered, by the same market drivers, or the stage in the economic cycle in which we find ourselves.

For example, there is a debate about whether the recent covid-related recession has just been a mini-cycle in the longer-term 2009 recovery cycle stemming from the financial crisis, or if the pandemic has created a fresh economic cycle, just speeded up a little bit.

> *So far the pandemic has created a narrow recession that hit the consumer-facing and service part of the economy much harder than other areas.*

There are interesting views on both sides, but the important thing to note is that all cycles are essentially about recessions and capacity exceeding demand. So far the pandemic has created a narrow recession that hit the consumer-facing and service parts of the economy much harder than other areas, which makes it quite a unique economic backdrop.

For example, companies that catered to the 'work from home' culture shift have soared in the past two years, but as the world returns to 'normal' will that affect the future earnings potential of these 'growth' companies? Have they peaked, or is there still some room left to evolve?

And with inflation higher across the developed world the expectation is that central banks will have to start tightening their monetary policy, while governments are working out ways to pay back the furlough schemes and business support. This could lead to higher interest rates, higher taxes and possibly other measures, which again could affect the outlook for the broad labels of 'growth' and 'value'.

Continued overleaf

Quilter Investors

Picture: US Federal Reserve

Each country also has their own specific headwinds, the UK with the post-Brexit adjustments, China with its regulatory crackdown, the US adapting to a Democrat-led government and the horse-trading and stalling that any new initiative – such as the infrastructure bill – inevitably encounters.

Taking a broader view

Therefore, it may be time that investors move beyond the question of whether something is 'growth' or 'value', and instead pay attention to how it interacts with the wider world.

Is a company performing well because it's growth or because it's a small cap fund in a region that has an environment that benefits small and medium businesses? Then you can broaden the question and ask if that small cap trend is just in one sector, or one region, or if it is something bigger, and question what might be driving that move.

Investing is a continual learning experience. No-one knows all the answers and, as we have recently witnessed, unexpected events can throw up immense challenges but at the same time also create interesting opportunities.

The key is to look at the bigger picture and understand the importance of diversification and balancing your investments to be able to adapt to changing circumstances rather than rely on outdated labels and perceived wisdom.

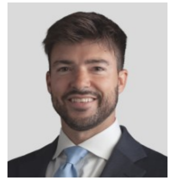
Quilter Investors

Regnan

Is brown the new green?

Eimear Toomey

Head of Responsible Investment



Tim Crockford

Head of Equity Impact Solutions

Eimear Toomey and Tim Crockford discuss how investors can take advantage of the growth being produced in numerous sectors by the transition to a low-carbon economy.

The sector stories of 2021

Winners and losers of 2021

Industry sectors

Switching the lights back on: With the world coming out of lockdown and energy demand booming against a backdrop of supply constraints and climate-driven government policy change, energy sector stocks raced away in 2021. By early November, they had gained more than 43% after falling 35% last year.

Financial sector stocks also roared back this year after double-digit losses in 2020. Meanwhile, tech stocks were big winners in both 2020 and 2021.

Despite the success of many value stocks in 2021, consumer staples, airlines and utilities sector stocks were conspicuous with only single-digit gains in a year when every other industry sector made much stronger progress.

Source: Quilter Investors as at 1 November 2021. Based on MSCI AC World Global Industry Classification Standard (GICS) sectors and industries. Total return including reinvested dividends, year-to-date to 1 November 2021.

Winners and losers of 2021

Regional equity markets and other asset classes

Diverging fortunes: By the start of November 2021, global equity markets were still on course to outperform 2020 with the MSCI All Countries World Index up more than 17% compared to gains of closer to 10% in same period a year previously.

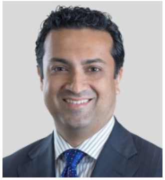
After being the top-performing market of 2020, China came back to Earth with a bump, while other Asian markets struggled too.

Elsewhere, government bond markets racked up losses, especially in the UK (gilts) although high-yield bonds (issued by companies) delivered modest positive returns. Meanwhile, the price of gold was volatile following last year’s impressive gains, calling into question its value as an inflation hedge.

With economies ‘switching on’ again after lockdown, oil prices had surged from US $51.80 a barrel (Brent crude) at the start of January to more than US $80 by the start of November with gas and coal prices also hitting new highs.

*Source: Quilter Investors. *Based on MSCI All Country and regional market indices. Total returns 2021 year-to-date to 1 November 2021, rounded to one decimal place. **Based on Bloomberg global bond and ICE Bank of America hedged indices. 2021 year to date to 1 November 2021, rounded to one decimal place. US$ gold spot rate and Brent oil futures (1st contract) in USD.*

A year under the microscope



Vinay Thapar
Portfolio Manager

The stress-test delivered by the pandemic accelerated the broad-based changes already underway in the global healthcare market and brought renewed investor focus to the sector explains Vinay Thapar, portfolio manager of the AllianceBerstein International Healthcare Portfolio.

Thanks to its innately defensive characteristics, when the pandemic first hit equity markets in March of 2020, the healthcare sector initially fell less than global markets before participating well in their recovery.

In fact, while global markets fell some 20% or more at the onset of the crisis, the healthcare sector fell only 10% and took just a month to recover those losses. Overall, the sector's returns compare favourably with those of global markets considering it has delivered its returns for less risk.

From 1 February 2020 to 31 October 2021, the MSCI World Index was up 34% while the MSCI World/Healthcare Sector Index was up 28% in sterling terms.

With global markets surging ahead again in 2021 driven by technology stocks and a resurgent energy sector amid economic re-opening, the healthcare sector has also participated in the gains. In the year to the end of October 2021, the MSCI World Index was up 19% while the MSCI World Healthcare Index was ahead 15%.

Healthcare secrets to success

The healthcare market offers investors a mix of both defensive and dynamic characteristics. The former include it benefiting from a steady stream of 'inelastic demand' as its customers will always need access to, and use of, the services and products on offer.

Such defensive qualities are complemented by strong dynamism in the form of technological innovation in the sector which continues to accelerate. Often, investors are being offered exposure to the level of technical innovation that we normally associate with the leading edge of the tech sector.

The depth of technical expertise and intellectual capital in the sector came into its own during the pandemic.

As soon as the mechanism of the virus and its genetic coding were discovered, many leading pharmaceutical, biopharmaceutical and smaller biotech companies commenced work on a vaccine from numerous vectors.

However, as investors we remained wary of the commercial opportunity a vaccine might deliver to the company or group of companies that developed it, as we believed the overall profitability and marketing opportunity for the drug would be modest.

The pharmaceutical companies with the deepest scientific knowledge gained from decades of experience with similar viruses took the lead. These companies were researching vaccine candidates and undertaking inventories of research portfolio libraries to identify additional potential treatments.

Sensibly, all the large drug-makers have long-term collaboration programmes with smaller firms and/or university/hospital laboratories. The major companies in developing the vaccine were Pfizer, which used technology developed by Germany's BioNTech, Johnson & Johnson (with Janssen), AstraZeneca (in collaboration with Oxford University) and Moderna.

Following the arrival of successful vaccines the stock price of Pfizer, Johnson & Johnson and AstraZeneca advanced but not by much more than what might have been expected. Meanwhile, the share prices of the smaller biotech companies BioNTech and Moderna both spiked with gains of between 300% and 500% over the last year.

The pandemic also benefited companies like Regeneron, which utilised its technology and experience of developing an antibody drug to fight Ebola to develop an antibody cocktail against the coronavirus.

We believe Regeneron's drug and Eli Lilly's antibody cocktail, along with the anticipated arrival of pills directed against the virus, will provide options for those who are hesitant about vaccines and thereby improve outcomes should future outbreaks occur.

Continued overleaf

Diagnosing the problem

Diagnostics also played an extremely important part during the pandemic. While delayed in its rollout, the development of both lab and at-home diagnostic tests was to have a meaningful impact in curbing the spread of the virus.

The diagnostics segment, in particular, is riding the crest of a wave of new innovation. This is transforming everything from robotic surgery technologies to preventative medicine via new diagnostic capabilities that might allow us, for example, to diagnose some cancers in advance using blood tests.

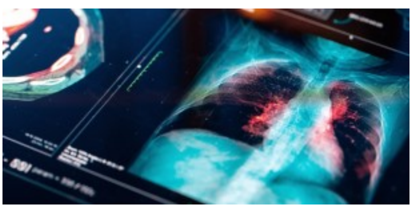
Indeed, such advances in diagnostics are one of the three key investment themes we see dominating the healthcare sector in the years to come:

1. Diagnostics

Early testing will play a key role in predicting disease more effectively at an earlier stage while the sequencing of the human genome will also help unlock potential new drugs and treatments.

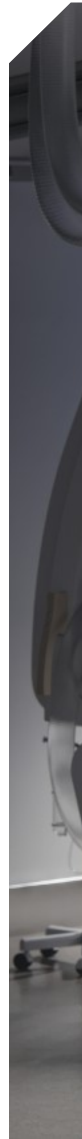
2. Minimally invasive therapies & robotics

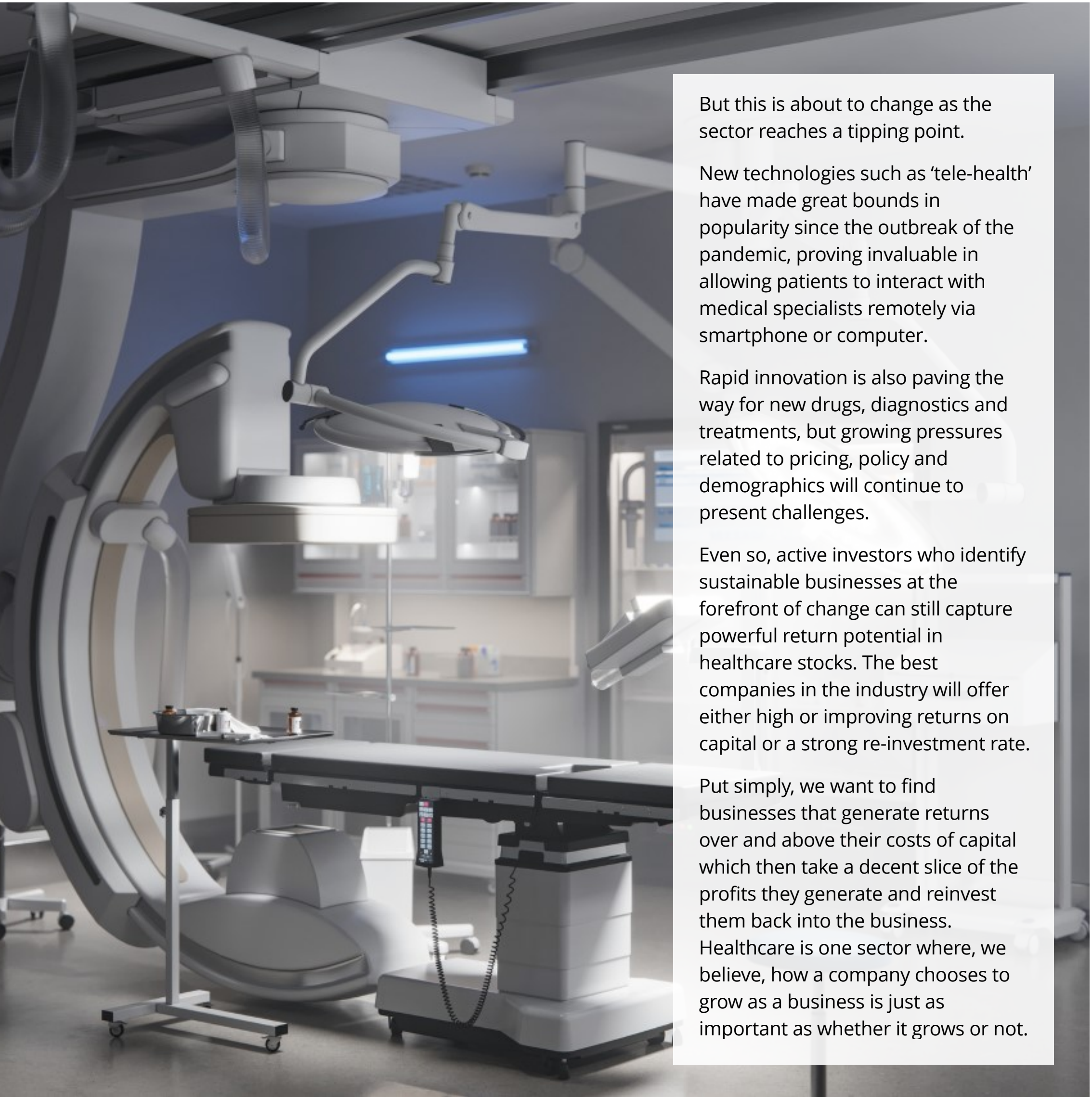
Procedures with smaller incisions create less medical complications and lead to faster recovery times for patients. Surgical robots are destined to create a new era of surgery employing far smaller incisions and far greater technical precision. With fewer complications and faster healing and recovery times, hospital stays will become shorter allowing patient turnover to rise which will drive improved efficiency and lower costs for the overall system.



3. Technology

Compared to other sectors, healthcare has so far been something of a laggard when it comes to the adoption of new technologies which could potentially revolutionise how care is provided and delivered.





But this is about to change as the sector reaches a tipping point.

New technologies such as 'tele-health' have made great bounds in popularity since the outbreak of the pandemic, proving invaluable in allowing patients to interact with medical specialists remotely via smartphone or computer.

Rapid innovation is also paving the way for new drugs, diagnostics and treatments, but growing pressures related to pricing, policy and demographics will continue to present challenges.

Even so, active investors who identify sustainable businesses at the forefront of change can still capture powerful return potential in healthcare stocks. The best companies in the industry will offer either high or improving returns on capital or a strong re-investment rate.

Put simply, we want to find businesses that generate returns over and above their costs of capital which then take a decent slice of the profits they generate and reinvest them back into the business. Healthcare is one sector where, we believe, how a company chooses to grow as a business is just as important as whether it grows or not.

The next wave of technology disruption...

Ben Rogoff
Co-head of the Polar Capital Global Technology Team

While the conditions created by lockdown were a headwind for most industries, they provided a huge boost to the technology sector. This has hastened the onset of the next wave of tech disruption and will likely underpin the sector's continued outperformance according to Ben Rogoff, a partner at the specialist asset manager, Polar Capital.

The global digital transformation may have begun long before the pandemic, but technology disruption in every aspect of the global economy has accelerated and broadened due to the impact of lockdown.

Lockdown brought increased spending in areas such as cloud infrastructure to support remote work and cloud software to support automation, collaboration and communications. It also brought wholesale changes in consumer behaviour, driving new investment in payments, fulfilment and digital delivery.

While re-opening and the supply-chain travails that have accompanied it have pressured many of the best work-from-home (WFH) stocks this year, we expect technology to prove even more critical in the post-pandemic 'hybrid-office/home-work' modality that we expect to emerge.

Powering ahead

Apart from a brief, adverse rotation early in 2021, the technology sector has more than held its own versus global equities this year following an exceptional 2020 when many of the key secular drivers, and many of our core themes as technology investors, mapped perfectly to the crisis.

Unlike last year, returns in 2021 have been more driven by revenue and earnings progress. Concerns about inflation may have capped valuations, but low interest rates and a flatter US yield curve have been positive for growth stocks, especially those in the technology sector.

However, returns within the sector have been quite uneven with US stocks significantly outperforming those elsewhere and the mega-caps meaningfully outperforming smaller names. Thematically, former WFH winners have struggled against a re-opening backdrop and supply-chain stresses while earlier laggards such as *Google* and Microsoft have generated remarkable returns this year.

Click on the icons to find out more.

Information provided is for illustrative purposes only and is not a recommendation by Polar Capital to buy or sell.

Continued overleaf

Getting to know you

Going forward, the ever-increasing use of data will result in a tidal wave of process automation and digitalisation. Our interactions will become increasingly digital, further obviating the need for paperwork while at the same time unitising work and making it far more measurable.

The increased use of data and the need for greater accuracy will also provide a strong foundation for artificial intelligence (AI) and, we believe, the next wave of technology disruption. The big beneficiaries will include the cloud titans *Google*, Amazon and Microsoft as well as semiconductor suppliers like Nvidia and AMD, in our opinion.

Red tech

Elsewhere, the recent regulatory crackdown in China was both unexpected and unwelcome. President Xi's bid for a third term (and possibly unlimited future terms thereafter) rests upon a populist agenda that has seen wealthy elites and technology billionaires targeted under the guise of 'common prosperity'.

We previously had concerns on China over political risk, and we expect it to take some time for investor sentiment to recover following the latest regulatory broadside.

Meanwhile, Taiwan represents a key fault-line in Sino/US relations as well as a critical part of the technology supply chain. China's leadership makes no secret of its desire to "reunify China" which explains why, following the western withdrawal from Afghanistan, there were concerns that President Xi might be emboldened to move on Taiwan.

However, recent comments from President Biden suggest that US resolve on the issue has not declined. While we don't expect a change in the status quo, both sides are keen to reduce their reliance on Taiwan, which is resulting in sustained demand for semiconductor equipment sourced elsewhere.

Awaiting supply

Supply-chain issues represent significant headwinds to the technology sector and to the global recovery overall. This was amply evidenced by the US $6bn hit to Apple's most recent quarter. Some sub-sectors are more impacted than others with hardware, automotive and e-commerce companies feeling the impact from shortages and input price inflation far more severely than their peers in software and digital entertainment.

We are hopeful that supply-chain shortages will prove relatively short lived and not result in too much demand destruction, but our conviction, and our visibility into this is, admittedly, limited.

Big themes

While re-opening, difficult year-on-year comparisons, and supply-chain issues are currently creating some near-term buffeting, we remain excited about the six core themes that will likely drive the outperformance of technology companies in the medium term.

As investors we're also excited about several secondary and emerging tech themes including mobility and electric vehicles (EV); payments and fintech; 'Industry 4.0'; and the arrival of the 'metaverse'.

We also remain hugely enthusiastic about the prospects for hybrid working as lockdown created a unique proving ground for the technologies that can blend the efficiencies of remote working with the social and cultural benefits of working in an office. We see this theme, in tandem with the growth of artificial intelligence, leading most industries to be re-imagined in the years to come.

The six key growth themes we see in the technology sphere are:

1. *Online advertising and e-commerce*
2. *Cloud infrastructure and security*
3. *Software as a service (SAAS)*
4. *The data economy and artificial intelligence (AI)*
5. *Digital entertainment*
6. *Connectivity and 5G*

Bond markets: a mountain to climb

Quilter Investors

Inflation: crying wolf?

Hinesh Patel
Portfolio Manager

Central bankers deployed their ammunition so vigorously in response to 2020's global health crisis that the question now facing investors is whether too much of a good thing has become the larger risk for markets, or if inflation really is 'transitory'.

Developed market central banks have remained ultra-stimulative throughout 2021 even as economies and societies are finding ways to live with the coronavirus. Growth and inflation numbers this year have been as good as they have ever been in our lifetimes, while investment returns for risk-seeking investors have continued to be attractive to boot.

Crying wolf

Yet this year has also seen US $2.1trn* of bond buying and little to no policy interest-rate tightening in developed markets, aside from isolated cases from the likes of Norway, which is setting up the fable of '*The Bankers who cried Transitory Inflation*'.

There is no way to gloss over how tumultuous the past year has been for traditional bond investors. UK gilts posted their worst annual total return on record, with the root cause a combination of current inflation and the market's pricing for future inflation.

But pre-pandemic and (hopefully) post-pandemic inflationary conditions could not be more different, with some of the issues attributable to mismatches in supply and demand cycles.

For example, companies were quick to cut order books during the pandemic, but they failed to account for the enormous global fiscal response that created a surge in excess savings that consumers were then able to spend on goods. The ability to switch-off is instant, but a ramp-up in production requires planning and lead-time, while input costs for production have also been rising.

Tapering time

Meanwhile, policymakers and investors are also grappling on the service sector and employment side of the economy where second and third-round inflationary effects may be lurking.

---

*Note: *Purchases by the four largest central banks (Fed, European Central Bank (ECB), Bank of Japan (BoJ), and Bank of England (BoE) as at 31 October 2021. For comparison this number was US $2.372trn over the period 31 December 2017 to 31 December 2018 in the aftermath of the Global Financial Crisis.*

Inflation thus far is 'bad inflation' for households. Wage gains and accumulated savings are helping offset the spike in energy prices and broader living cost pressures in the short term. Yet, survey data is showing consumers balking at higher prices on discretionary purchases suggesting the scope for inflation to pass through may be reaching its peak.

However, in the US, despite record job openings, the country is struggling to fill vacancies. It may be that fiscal policy has been overdone and central bank asset price reflation is allowing swathes of the population to feel wealthier and retire early or choose not to work.

But until the fiscal package in the US is signed off, and the effects of furlough unwind in the UK are both measured and understood, it is difficult to assess the impact of any policy-rate changes on inflation.

The Bank of England is currently priced to make a move ahead of the US Federal Reserve (Fed) in the next three months in terms of interest-rate tightening, with the Fed expected to move in the second half of 2022, in line with its communications.

The good news is that the bulk of re-pricing in markets for inflation reasons is now already done, which provides a backdrop where central banks can start adjusting monetary policy by tapering their bond purchases and simultaneously remaining accommodative to markets and the real economy.

The not so good news is that real yields — the yield on government bonds after adjusting for the effect of inflation — in our view, remain too low. The shorter-dated bonds are likely to see real re-pricing, yet the longer-dated bonds aren't too far from their long-run equilibrium.

Credit: Deejpilot/iStock.com

Continued overleaf

Quilter Investors

...the reality is likely to be that inflation will be higher than c
and for longer than initially anticipated before gliding to m
second half of 2022.

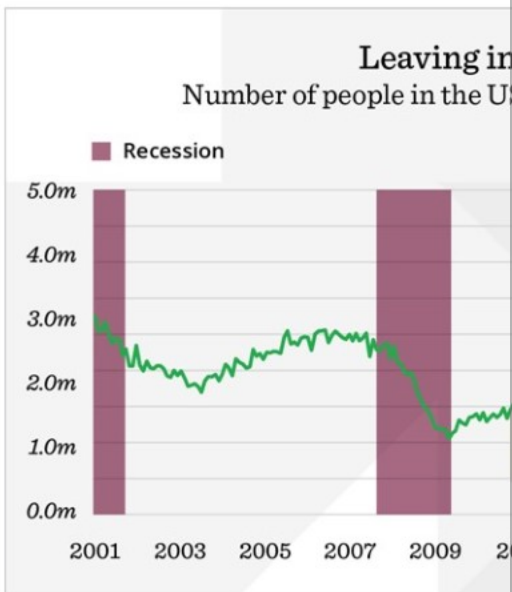
Clean-up phase

Unfortunately, monetary and fiscal policy decisions and the impact on bonds is always a messy process. Financial markets are interlinked and the change in real discount rates — the interest rate charged to commercial banks by central banks — can have wide ripple effects across equities, bonds and risk appetite. But with market valuations and expectations priced-to-perfection today there is no room for missteps by central banks in tackling inflation and the pandemic debt overhang.

In addition, there are multiple moving parts outside of central bank policy that could have a meaningful impact on the markets. For example, Chinese government decision-making that could influence supply bottlenecks or automation that may create structural employment changes to name just two.

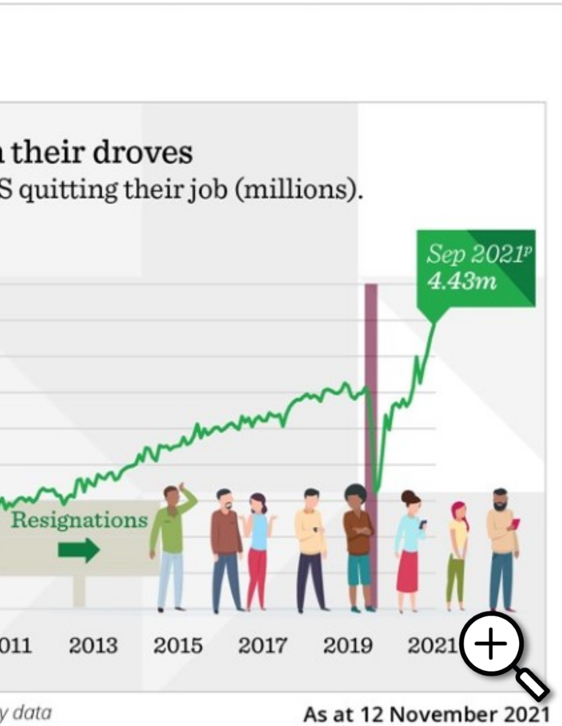
This is exactly why the central bankers need to bang on the transitory inflation drum, even if the definition of transitory may be stretched and the data here-and-now looks a little punchy. But the reality is likely to be that inflation will be higher than consumers might expect, and for longer than initially anticipated before gliding to more 'normal' levels in the second half of 2022.

The Great Resignation



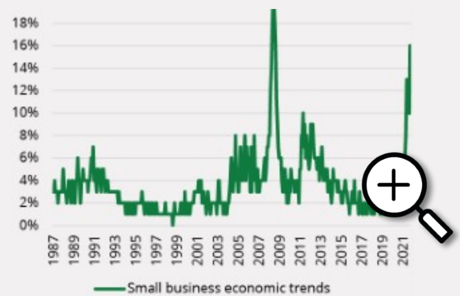
Source: US Bureau of Labor Statistics/Statista. ᴾ – preliminar

onsumers might expect,
ore 'normal' levels in the

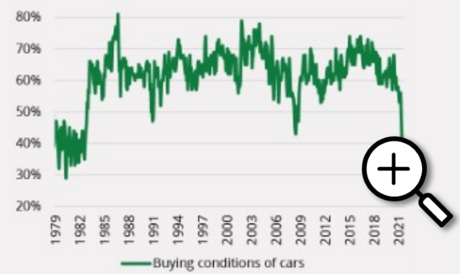


Combined balance sheet of the four largest central banks

Inflation is the most important problem for small businesses



Consumers putting off big purchases such as cars



Quilter Investors

Supply chain chaos

Sacha Chorley

Portfolio Manager

Sacha Chorley explains how bottlenecks in key parts of the global supply chain are creating inflationary pressures in western markets.

A little volatility goes a long way

Mike Riddell

Head of Fixed Income Macro Unconstrained

Mike Riddell of Allianz Global Investors explains the huge impact that central banks' actions have had on bond market returns in recent years.

On the home front

Quilter Investors

Are we headed back to the 1970s?

Mark Twain famously observed that, “History never repeats itself, but it does often rhyme.” This is much the case with recent economic events in the UK and the dark years of the 1970s.

Bobbushphoto/iStock

atlantic-kid/iStock

While worries such as an emerging global energy crisis, spiking inflation, protectionism and petrol shortages, not to mention America’s latest forced military retreat from an overseas war, may rhyme with conditions last seen in the 1970s, the underlying causes are very different.

Inflation may currently be well past the targets set by today’s independent central banks in most major economies, but it remains in low single digits – a mere shadow of the racing double-digit inflation and interest rates of the 1970s – with a generation of central bankers at the helm who are dedicated to fighting inflation and policymakers who still have ultra-low interest rates at their disposal.

Back in the 1970s, the global economy was grinding to a halt after the prolonged boom of the post-war years. Unlike today, industrial and technological innovation were in short supply

and the decade was mired in bitter industrial action epitomised by the 'Winter of Discontent' (1978–79). Such actions reduced productivity adding to inflationary pressures and hastening the demise of many UK industries.

By securing inflation-plus wage settlements, such disputes also locked-in inflation for another generation leaving central bankers with few tools at their disposal.

Times change...

The biggest change since the 70s has been the secular decline in unions. Membership has more than halved in the UK since it peaked in the 70s and its fallen by two-thirds in the US since then. This partly reflects the growth of the service sector where unionisation is far less prevalent.

When the OPEC Oil Crisis hit in October 1973, it resulted in a brutal spike in inflation and unemployment with the UK government being forced to ration electricity with rolling power cuts, an enforced three-day working week and strict speed limits on the roads.

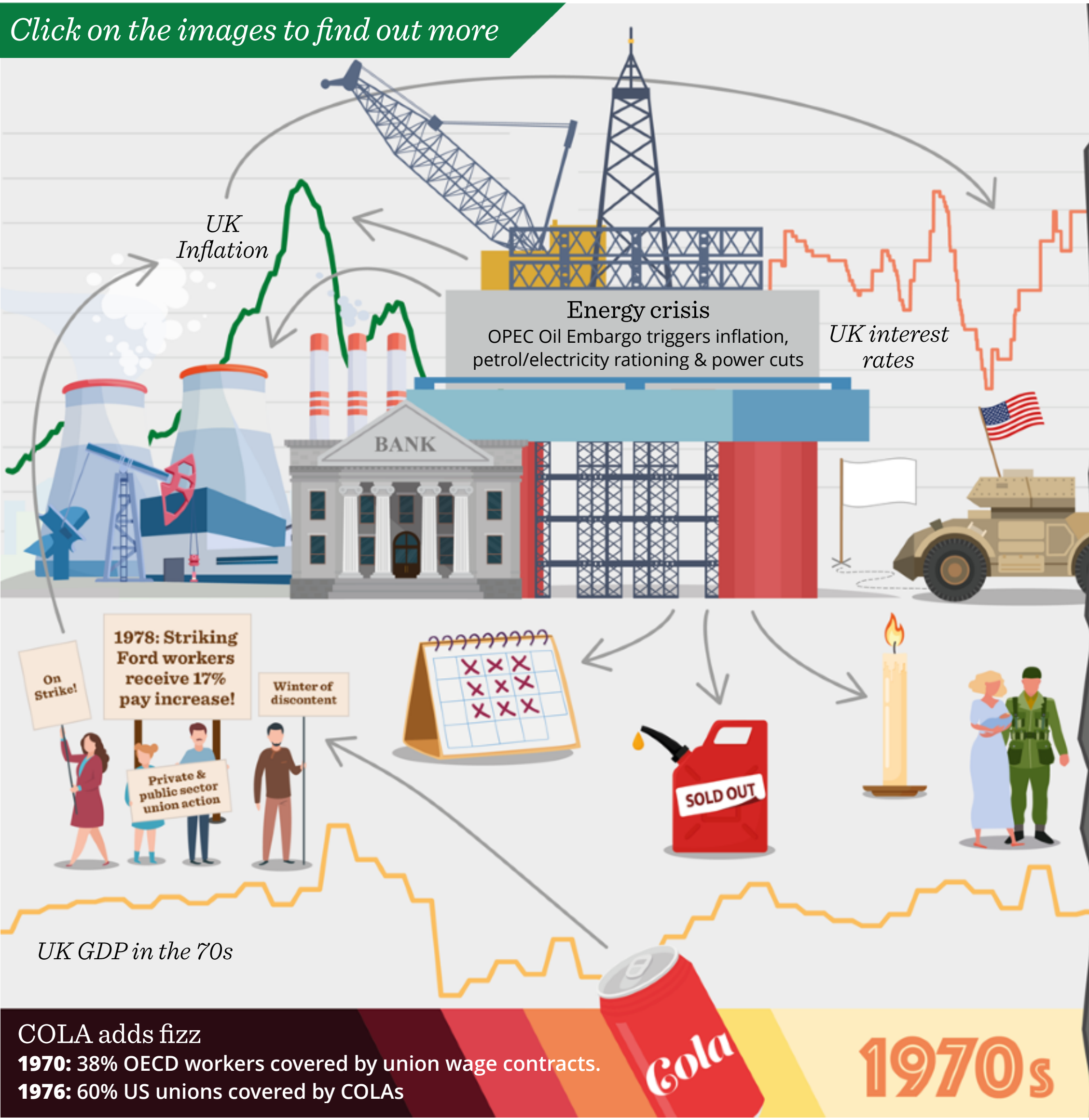
Although we may be in the teeth of a new energy crisis today, it's a result of the supply-chain disruption caused by a global economic shutdown followed by a full restart and the growing impact of policy changes aimed at reducing our carbon footprint.

1970s 2020s

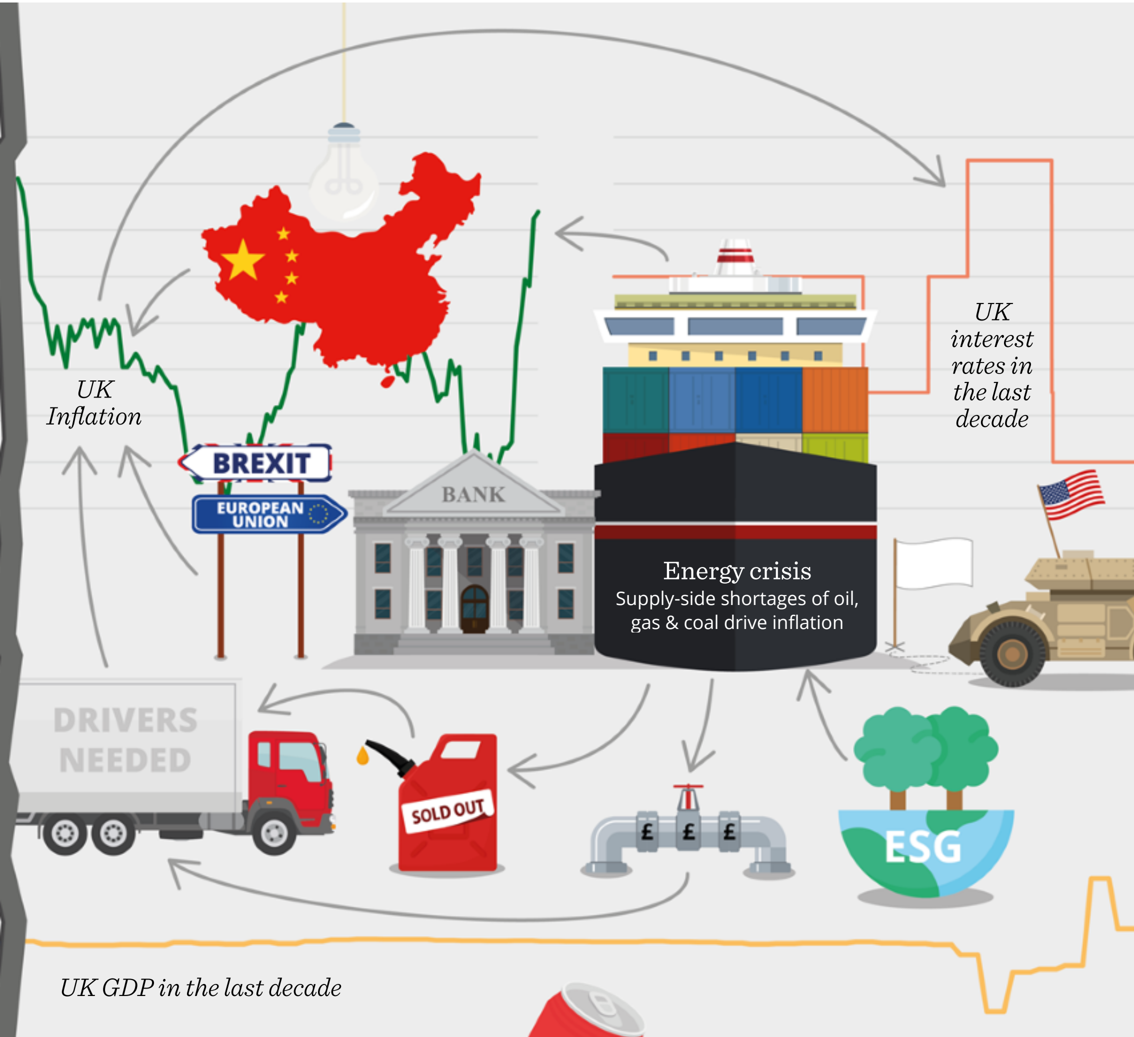
Not like 'the good old days'

Look closer overleaf

Quilter Investors



Sources: Macrobond. 1) The Economist 9.10.21; 2) Quilter Investors/Bloomberg/Macrobond. COLA: cost of living adjustments.



2020s

COLA goes flat

2019: 16% OECD workers covered by union wage contracts (lowest ever).

1995: 22% US unions covered by COLAs[1]

Quilter Investors

Can the UK rise to the challenge?

Helen Bradshaw

Portfolio Manager

Helen Bradshaw explains the triple whammy of pandemic, Brexit and tax increases facing the UK economy and what this means for investors.

Dividend and conquer?

CJ Cowan
Portfolio Manager

Dividends were one of the main areas that suffered during the peak of the pandemic, but where do we stand now, and how bright is the outlook for both UK and global dividends?

Boasting a dividend yield of more than 4% for most of the last decade, the UK market has long been the darling of equity income investors. But as the saying goes: "the bigger they are, the harder they fall", and indeed the UK was the worst afflicted major equity market when it came to pandemic driven dividend cuts.

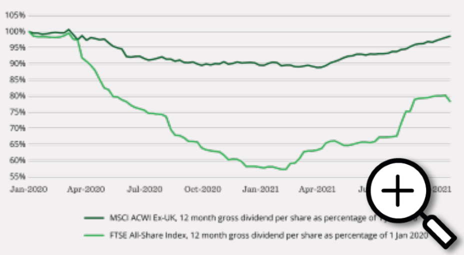
By February this year, annual payouts from the FTSE All Share Index had fallen to just 57% of their January 2020 levels compared to lows of 89% for the rest of the world.[1]

[1] Bloomberg: FTSE All Share and MSCI ACWI ex-UK 12m aggregate gross dividends per shares, rebased to 01/01/2020 level

But despite the cataclysmic fall in dividends through 2020, the UK remained the highest yielding major equity market and enjoyed a rapid rebound in 2021, with dividends in the third quarter of 2021 nearly double those paid out in the same period in 2020.[2]

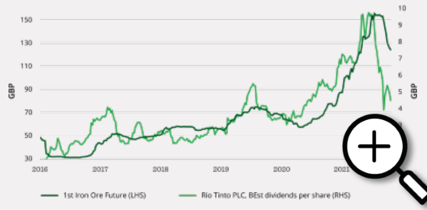
Some of this was driven by the resumption of bank dividends as the regulator-imposed ban was softened at the end of 2020 and entirely lifted over the summer. But more important was a surge in special[3] dividends from the mining sector, which enjoyed bumper profits as commodity prices soared.

Dividends per share (100 = January 2020)



Continued overleaf

Rio Tinto's dividend growth



The top payer over the third quarter, miner Rio Tinto, increased its overall annual payout by 41% compared to the start of 2020 and by 233% compared to early 2021's lows.[4]

This has left the stock with an historic yield of more than 15%[5] but it won't be sustained. Iron ore is the largest segment of Rio's business, responsible for more than 80% of the miner's earnings in the first half of 2021[6], but prices have halved since June and analysts' estimates for dividends over the coming year are being cut too.

---

[2] UK Dividend Monitor Q3 2021, Link Group

[3] One-off pay outs that are not part of a company's regular dividend policy

[4] Bloomberg, Rio Tinto Dividend per share 12m (gross) rebased to 01/01/2020 level

[5] Bloomberg, as of 1/1/21

[6] Rio Tinto half year results, June 2021

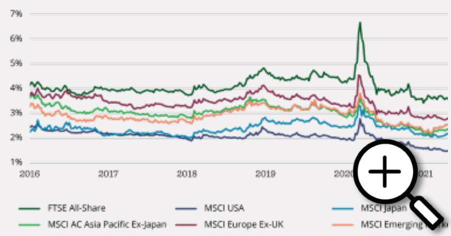
The picture looks rosier in other sectors though: housebuilders, industrial chemicals, and IT have more than doubled their payouts in the third quarter of 2021 versus last year[7], but the strongest growth has been in the retail sector. It experienced some of the harshest cuts during the pandemic so admittedly the bounce back is from a low starting point, but most companies in the sector have resumed dividend payments and their recovery is expected to continue.

So, while the mining stocks that have led the dividend recovery so far are unlikely to continue such generous payouts, we expect other industries to pick up the slack. As long as oil and gas prices remain elevated, the energy sector will continue to offer support too. Taken as a whole this means the UK market should deliver a similar amount of dividends in 2022 as in 2021 but with less sector concentration.

Globally, the UK market still offers the most attractive dividend yield on a forward-looking basis. This is partly driven by the discount that UK shares trade at compared to their global peers. So not only does the UK present an attractive opportunity for income investors but there is scope for superior price returns as the economy adjusts to its post-Brexit state and international investors' confidence returns.

Globally, the UK market still offers the most attractive dividend yield on a forward-looking basis.

Estimated dividend yield



It will take several years before the UK market gets back to pre-pandemic dividend levels though. In some cases the proportion of companies' earnings paid as dividends had reached unsustainable levels so the recent cuts may be used to reset investors' expectations. The investment required to tackle climate change also acts as a further barrier to raising payout ratios as the reinvestment of profits will be required to meet corporate net zero pledges.

This means earnings growth must take over as the primary driver of dividend growth, which of course depends on the path of the recovery, but if further lockdowns are avoided then the future looks brighter for dividends.

---

[7] *UK Dividend Monitor Q3 2021, Link Group*

A turning point for the US

Quilter Investors

Running to stand still?

Bethan Dixon

Portfolio Manager

As Bethan Dixon explains, policy decisions have the potential to impact US markets and how the country tackles its climate responsibilities in the coming year, but Mr Biden's majority is hanging by a thread...

Making progress on climate change and tackling the pandemic were top of the agenda when Mr Biden eventually reached the Oval Office at the start of 2021. On his first day, he restored the US to the Paris Climate Accord and, on his second, he issued an executive order to deliver 100m doses of vaccine.

Since then, he's slowed down a touch. Until recently, his only major policy win was back in March with the $1.9trn American Rescue Plan[1] which spent 8.2% of US GDP on $1,400 payments to most American adults, $350bn in state and local government aid and $14bn on vaccines.

By early November, two 'legacy' bills were still mired. But a late burst of activity saw the $1.2trn bipartisan Infrastructure Investment and Jobs Act passed into law by mid-November, while brass bands played on the White House lawn. The measure aims to rebuild America's roads and bridges, update its ports and improve broadband internet coverage.

Barely a week later, Democrats were cheering once more after passing Mr Biden's expansive Build Back Better bill through the US House of Representatives.

The $1.75trn social and climate spending proposal represents the most sweeping expansion of the US social security system since the 1960s.

It aims to torpedo the cost of childcare and the price of prescription drugs for seniors while expanding Medicare benefits, extending work permits to millions of undocumented immigrants and making the biggest-ever US investments into combating the climate crisis.

The bill now goes back to the Senate, where it faces implacable resistance from Republicans and frenetic deal making among Democrat power brokers.

---

[1] *All figures quoted in this piece are in US dollars ($).*

Credit: Ron Adar/Shutterstock.com

Ironically, the future of Mr Biden's climate agenda rests in the hands of Joe Manchin, a conservative Democratic senator from the coal state of West Virginia. He's already halved the size of what's become known as the 'reconciliation bill', after he severely delayed the infrastructure bill.

Rolling with it

The US economy rebounded strongly thanks to Mr Biden's effective vaccine roll-out and unprecedented levels of fiscal stimulus. Household spending rebounded substantially, business investment increased significantly and employment continued to strengthen. By mid-year, US GDP growth had hit 7% – its fastest rate of increase in a decade.

But as growth rebounded, so too did inflation with supply-chain bottlenecks and robust demand exacerbating the problem. US inflation came in at 6.2% in October, its biggest annual leap in 30 years – a long way from the Fed's average 2% inflation target.

It also noted that interest-rate increases were dependent on a continued recovery in the labour market.

At its November meeting, the US Federal Reserve (Fed) voted to maintain its target for the federal fund rate (FFR) at a range of 0% to 0.25%, which has remained constant since the spring of 2020.

It also promised to continue asset purchases of at least $80bn in US Treasuries and $40bn in mortgage-backed securities each month.

However, in the weeks following, Fed chair Jerome Powell wrongfooted bond markets in his 'hawkish' testimony to the Senate Banking Committee when he suggested that the tapering of such purchases could be brought to an end some months sooner than previously anticipated. He also argued that it was now time to "retire" the word 'transitory' from the Fed's characterisation of stubbornly high US inflation.

The Fed is currently scheduled to complete its asset-purchase programme in mid-2022 under a plan announced at the start of November. However, this could change when the Federal Open Market Committee (FOMC) meets in December to set ongoing policy.

Continued overleaf

Quilter Investors

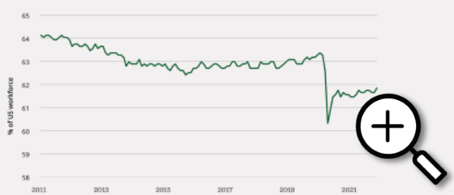
Credit: guvendemir/iStock

Labouring the point

After peaking at 14.7% in 2020, US unemployment remains elevated at 4.2% (October reading) after declining from 4.6% the previous month. As the chart (inset) shows, a key contributor to this is the labour force participation rate which has yet to recover to pre-lockdown levels.

Meanwhile, supply-chain bottlenecks and labour shortages have weighed on expectations for US economic growth in 2021. Analysts now expect 5.9% growth for the year as a whole and 3.8% growth in 2022.

US labour force participation rate in the last decade



Foreign objects

Hopes that Mr Biden would rebuild US relations with its allies remain just that.

Although his administration was quick to re-join the Paris Accords and the World Health Organisation and to re-engage Iran on its nuclear programme, it has little to show for these efforts.

Meanwhile, Mr Biden's popularity took a major hit due to the US withdrawal from Afghanistan.

More recently, the Biden White House managed to blindside its European allies – especially France, its oldest ally – by forming a new Australia, US and UK security pact.

The G20 meeting in Rome followed by the UN Climate Change Conference of the Parties (COP26) in Glasgow were a missed opportunity for Mr Biden to reclaim some political initiative. Despite making a US $555bn vow to reduce US carbon emissions (the largest US budget ever), he left home with little of real substance due to the ongoing battles within his own party and an approval rating that had already sunk to near Trumpian lows.

The US government officially hit its debt ceiling on 1 August 2021.

Carrying on regardless

Despite the political impasse, a backdrop of robust economic growth and strong company earnings growth helped US equity markets to power ahead in 2021, breaching a long succession of record highs in the later stages of the year.

The MSCI North America Index was up 23.9% in the year to 1 November – comfortably ahead of the MSCI All Country World Index, which had added 17.7% (in sterling terms). Despite the US tech giants stealing all the headlines, the top performing sectors in the year to November included energy, finance and real estate.

The US in 2022

The US government officially hit its debt ceiling on 1 August 2021 and although it was temporarily raised to US $28.9trn, this only delays a default until early December, so we can expect some political noise and the spectre of another possible US government shutdown going into the year's end.

Back in July, the International Monetary Fund (IMF) reckoned Mr Biden's 'Build Back Better' plan had the potential to lift US economic growth by more than 5% between 2022 and 2024.

However, it's difficult to predict just how much support the bill in its final form will provide to US economic growth. Whatever form it eventually takes, it's designed to be spent over a number of years and hence will not offset the reduction in fiscal spending in 2022 as a result of the pandemic relief measures being withdrawn.

Even so, US households have built up a healthy savings balance through the pandemic, which could soften the economic impact of a watered down bill, especially if consumer spending remains elevated and workers continue to return to the labour market.

Meanwhile, forecast company earnings growth into 2022 continues to look robust and while it's expected to moderate from the circa 40% growth reported in the third quarter earnings season, it provides a good foundation for equity market returns in 2022.

Even so, challenges posed by higher corporate taxes, supply-side disruption, cost inflation and potentially higher interest rates are not going to impact all companies equally, so earnings growth beyond the headline market level is likely to vary significantly across styles and sectors.

The US equity market also continues to be the most expensive regionally. This means that, with the advent of higher interest rates, many US companies will struggle to maintain their current valuation multiples, especially if their earnings begin to flag. Consequently, active management centred on strong stock selection is likely to be the key to navigating the US equity market in 2022.

MONTANARO

Temperatures rising: the US and climate change

Ed Heaven

Head of Sustainable Investment change

Head of sustainability at Montanaro, Ed Heaven, explains some of the key challenges facing Mr Biden's promises to fight climate in his all-encompassing Build Back Better programme.


There is
NO
PLANET B

China: another long march?


新世界
6-7F
好乐迪KTV
3F
4F
休闲港
吉野家
YOSHINOYA
03

Quilter Investors

Ian Jensen-Humphreys
Portfolio Manager

Betting on red

In the summer, China's authorities began the roll-out of a broad wave of new regulations which are having a profound impact on whole sectors of its economy. Ian Jensen-Humphreys explains what's driving this upheaval and the risks and opportunities it's creating.

Back in March, China's 14th five-year plan highlighted the key objective of working towards "common prosperity" and ensuring that China's "fruits are shared by the people". The shorthand for this is that the government recognised the huge sums being spent on property, healthcare and education in China and set about reducing the costs to make them more broadly accessible.

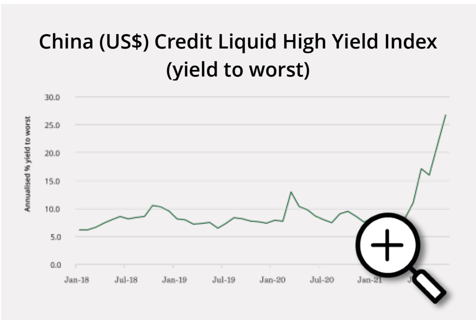
It's done this either by tightening financial conditions, for example, by limiting the borrowing available to property developers, or by imposing new regulations on certain activities such as online tuition. The latter have now been severely restricted in their offerings and must become non-profit entities. The government has even limited how long children can play video games to three hours a week.

Chinese casualties

There are clearly investor risks associated with this approach. Most immediately, the shares in some tuition companies have fallen over 90% since the start of the year and are now trading around liquidation values.

Meanwhile, the Chinese high-yield bond market, which is dominated by property developers, has largely frozen, denying firms access to the life-giving capital they need unless it's at untenable yields.

As the chart (inset) shows, yields in China's high-yield bond market have tripled since July, delivering investment losses of around 35% over the course of 2021.



Evergrande designs

So far, the most high-profile victim of the squeeze has been the property giant Evergrande, which at the time of going to press was widely expected to go into default in the coming months.

Evergrande has many different types of creditor from Chinese consumers waiting to take ownership of the unfinished properties for which they've paid, to local banks and international bondholders. It's not yet clear how these various creditors will be treated given the government's priorities.

Credit: 360b/Shutterstock

The politics of power...

One unintended consequence of "common prosperity" has been power shortages. China's President Xi Jinping has proselytised on the need for "quality of growth" rather than "quantity of growth" and one aspect of this has been a drive to improve air quality by reducing the use of coal-fired power stations.

This has led to notably lower coal production at a time when strong global demand for Chinese goods has required factories to operate at peak capacity, creating a high demand for energy.

Meanwhile, coal prices have rocketed due to the demand/supply imbalance, which has been exacerbated by the widespread flooding of China's coalfields. Because electricity prices are capped, providers have been forced to shut down power stations rather than operate at a loss (sound familiar?).

Naturally, this had a material impact on China's economic activity back in the summer and the situation is only likely to deteriorate when China's circa 660 million households switch on their winter heating.

Continued overleaf

All in the mixer?

More broadly, the slowing of Chinese growth and the slow implosion of its real-estate sector will have widespread repercussions; the former for global growth, the latter for commodity prices. Meanwhile, China's focus on steering its consumers toward "buying Chinese" could upset the apple cart for Europe's biggest exporters (think 'bling' and luxury cars).

The drive for shared prosperity will also have consequences for Chinese wages. Over the past 20 years or more, the Chinese worker's high productivity and low wages have allowed western companies to move production offshore, driving down costs and keeping a lid on global prices. Hence, the well-used adage that China was "exporting deflation".

If the cost of producing in China rises materially, we could find ourselves in a world where China is actually "exporting inflation". If this happens, the outlook for inflation in developed economies will quickly change from 'transitory' to 'persistent'.

It could also trigger a wave of production 'onshoring', as companies return home, or a new wave of 're-offshoring' as they seek out the last remaining emerging markets to offer the margins they need. However, the China paradigm has changed over the decades. Whereas western companies once flocked to China for its low wages and generous regulatory regime, they now need to maintain their presence as China has, in most cases, become their primary market.

Money to burn?

Despite the current storm clouds, there are numerous reasons to be optimistic over the longer-term outlook for China. Shared prosperity will engorge the world's largest middle class, who will have new money to spend, aided and abetted by a government bent on increased consumption.

Companies that have already established premium brands in China (with the government's blessing) will consequently have a larger target market and less overseas competition. The key will be understanding how much profit the government judges acceptable and how the authorities interpret whether common prosperity is being advanced.

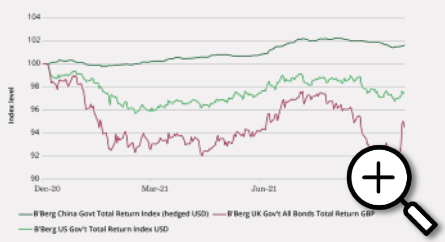
Meanwhile, the Chinese government bond market is gradually opening up to international investors and becoming a viable alternative to western markets. This offers real diversification potential as Chinese monetary policy and interest rates pay little heed to the Federal Reserve or the Bank of England.

Promises, promises...

A year ago, Chinese President Xi Jinping promised his Communist Party acolytes that it was possible to double the country's GDP and per capita income by 2035.

Most economists agree that, on the face of it, this would require something of an economic miracle especially in the face of China's rapidly aging workforce, which is set to decline by close to 7% over the same time frame.

US, UK, and China government bond returns (YTD 2021)



Continued overleaf

Between 1980 and 2010, Chinese GDP doubled four times, but debt levels were low and manageable. It doubled again between 2010 and 2020 but its debt burden tripled as a result. Another doubling of China's GDP would require average annual growth of 4.7% – which seems meagre compared to 2019's 6.1% or the 6.7% annualised growth it delivered in the previous five years – but achieving this benchmark would come at great cost.

It would either send China's debts into the stratosphere – its official debt to GDP ratio is already over 280% and would need to sail past 400% by 2035 which is unprecedented (because other economies have always collapsed long before reaching this point) – or it would need to successfully move domestic demand from investment to consumption as previously promised by the country's leadership. However, this would mean China's household income as a share of GDP would need to jump from around 50% to 70%, which represents a politically unpalatable transfer of wealth and influence from the party elite.

Ultimately, whether China's GDP doubles as promised will depend on political factors. The fact is that, according to different economists, China will surpass the US as the world's largest economy sometime between 2028 and 2032, boosted by last year's positive growth for the former and matching negative growth (of 2.3%) for the latter.

Credit: Nikada/iStock

What makes China unique is the way it continues to combine the efficiencies and speed of centralised policy...

In the meantime, Chinese policy continues to focus on creating industry leaders in key fields such as technology and advanced manufacturing while, according to JP Morgan, it's expected to add another 340 million to the 'consumer class' by 2030, compared to only around 25 million for the US.

Right now, we're witnessing the growing pains of a super-economy, but the Chinese investment market is simply too large for global investors to ignore. What makes China unique is the way it continues to combine the efficiencies and speed of centralised policy and control with powerful free-market economics and vibrant private markets. It's a recipe that has worked very well so far.

The key to success will be understanding the environment and partnering with those managers who have local expertise to take advantage of the undoubted opportunities that lie ahead.

Quilter Investors

Chinese ambitions

Stuart Clark

Portfolio Manager

According to Stuart Clark in China this year there have been two driving themes: the country's strict response to the ongoing pandemic and the revival of the concept of 'shared prosperity'.

What prospects for emerging markets?

Nandini Ramakrishnan

Head of Macro Strategy for EMAP

Nandini Ramakrishnan of JP Morgan explains how emerging markets participated in much of the recovery enjoyed by developed markets in 2021, despite the severity of the pandemic in numerous regions.

Important information

Past performance is not a guide to future performance and may not be repeated. T and investors may not get back any of the amount originally invested. Because of t money. The performance data do not take account of the commissions and costs i cause the value of overseas investments to rise or fall.

This communication is issued by Quilter Investors Limited ("Quilter Investors"), Senato registered in England and Wales (number: 04227837) and is authorised and regulatec

This communication is for information purposes only. Nothing in this communication recommendation. This communication should not be construed as a solicitation or ar jurisdiction. No representation or warranty, either expressed or implied, is provided ir herein, nor is it intended to be a complete statement or summary of the securities, m

Any opinions expressed in this document are subject to change without notice and m within the same group as Quilter Investors as a result of using different assumptions

Quilter Investors is not licensed or regulated by the Monetary Authority of Singapore

The value of investments and the income from them may go down as well as up this, an investor is not certain to make a profit on an investment and may lose ncurred on the issue and redemption of shares. Exchange rate changes may

or House, 85 Queen Victoria Street, London, England, EC4V 4AB. Quilter Investors is d by the Financial Conduct Authority (FRN: 208543).

constitutes financial, professional or investment advice or a personal n offer to buy or sell any securities or related financial instruments in any n relation to the accuracy, completeness or reliability of the information contained narkets or developments referred to in the document.

nay differ or be contrary to opinions expressed by other business areas or companies and criteria.

(“MAS”) in Singapore. This document has not been reviewed by MAS.

Quilter Investors:

expertly designed multi-asset solutions.

For more information visit quilterinvestors.com

Quilter Investors

221-1328/ QIL-258-21/December 2021