Annual outlook

Catch-2022

Unravelling the policy paradox

An investor's guide to the year ahead for the global economy, multi asset, equities, fixed income and real estate.

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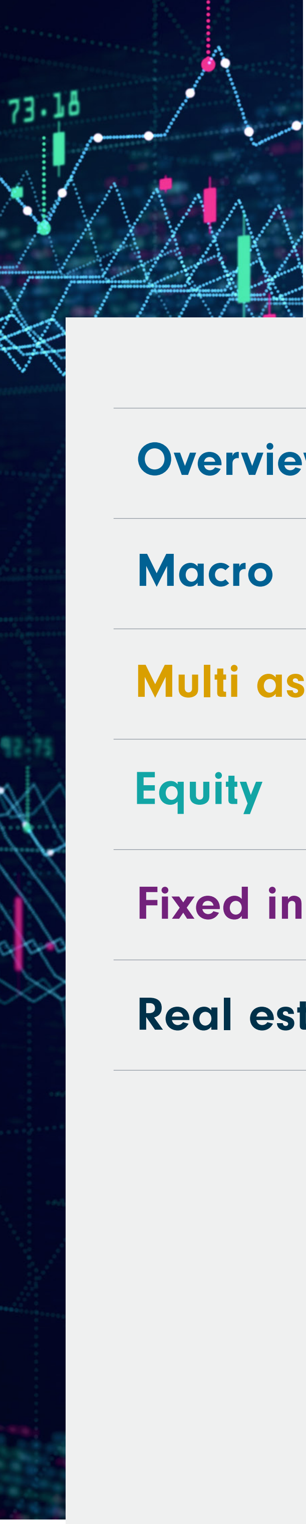

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Overview

Andrew McCaffery
Global CIO, Asset Management

The policy paradox

2021 brought the recovery many had hoped for. Businesses reopened, commuters returned to their desks, and the bravest of us even went on holiday. But no one could describe it as 'getting back to normal' amid rocketing energy prices, high debt levels, and past-the-peak growth.

These conditions increase the risk of a policy mistake in the next 12 months as central banks and governments try to navigate various 'Catch-22' (or Catch-2022) narratives - reminiscent of the conundrums faced by the air crew in Joseph Heller's 1961 novel - without losing the trust of markets.

One dilemma is how to tighten monetary policy and rein in inflation without killing off the recovery. Another is how to cope with higher energy prices as the world transitions to a low-carbon economy. Fine-tuning policy settings to unravel these conflicting dynamics will not be easy.

Persistent inflation

Despite central bank rhetoric about inflation pressures being transitory, some price rises look set to persist due to supply chain blockages and de-globalisation, and, longer term, due to the cost of getting to net zero. Letting inflation spiral out of control would only make it a bigger issue later on, but clamping down aggressively could hamper growth when it is already stalling.

On balance, we expect interest rates to remain lower for longer despite higher prices and central banks' desire to taper asset purchases relatively swiftly. Ultra-low rates are needed to keep the system afloat given debt levels are higher today than during World War Two.

China's focus on the real economy

China, meanwhile, appears determined to move to an economic model geared to the real economy, rolling back debt and addressing inequalities, rather than reacting to any downside in financial assets. This should be helpful for markets in the long run, increasing moral hazard and enabling investors to price assets more accurately.

Nonetheless, the country's policy stance could weigh on global growth in 2022, and consensus expectations may be revised lower.

Climate impact on asset allocation

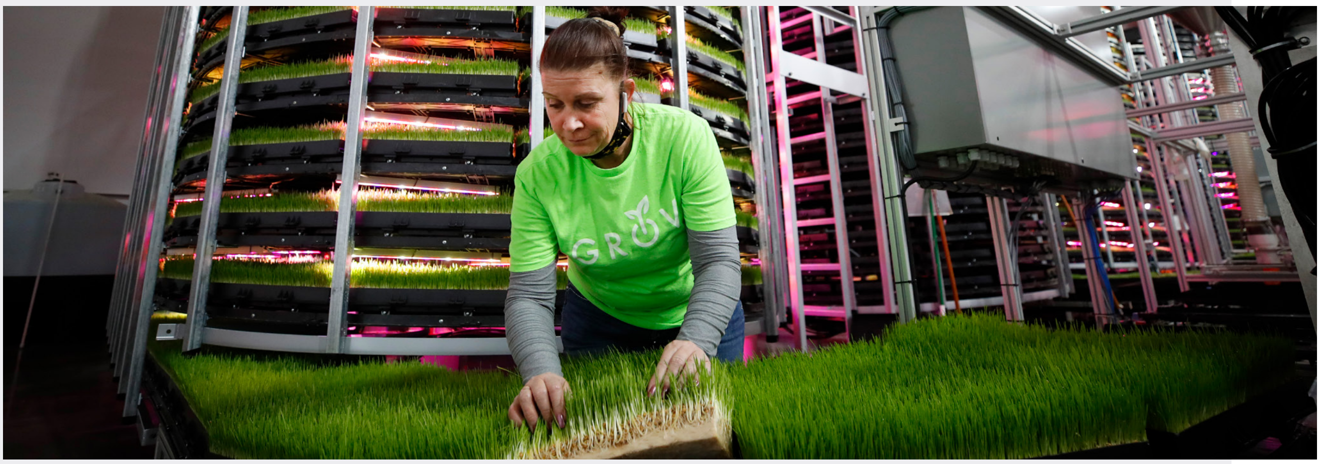
The need to think about the impact of climate factors on asset allocation increased in 2021 and will accelerate in 2022. Fossil fuel importers wish to improve energy security while investors are hunting for climate solutions and new technologies in preparation for a more radical repositioning of the economy. National government recognition of climate change is high, and climate policies are proliferating, even if global cooperation cannot be guaranteed.

This will not make the challenges of changing consumption patterns any easier, however, and we expect plenty of bumps on the road to net zero, some of which have yet to be priced in. Given the potential for an increase in correlations between publicly-traded securities in 2022, we think private markets could continue to offer alternative growth profiles for long-term investors, especially in the greening of brown assets. Select Asian bonds and equities should act as diversifiers, while (value orientated) sections of the developed equity markets and real estate may provide hedges against moderate inflation.

US dollar dynamics

The environment around the US dollar is changing as the country relies more on friendly strangers to buy its debt. The currency may benefit from a more defensive stance in 2022 if volatility rises. But if China and Japan accelerate an unwinding of their exposures and/or move up the yield curve, worried by debt ceiling debates, the US fiscal deficit, and high levels of money supply, then at some point the Fed may have to offer higher yields to attract domestic buyers.

At the same time, fiscal support will reduce in 2022 which could leave incomes stretched and push up unemployment, especially if energy prices remain high. Central banks may find they suddenly have no option but to pull back on the liquidity tightening commentary. If they don't pull back, the 'catch' could come into play. Markets may start to believe that inflation could stick around for much longer, leading to a further re-pricing of risk as the year develops.



A worker inspects high density grass as it comes out of a vertical farming machine. (Credit: George Frey / Stringer, Getty Images)

Macro

Salman Ahmed
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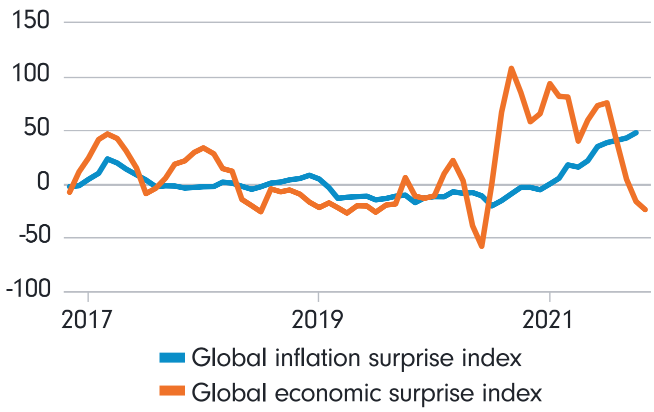
The Catch-22 dynamic

The coming year will be defined by a number of key decisions taken by policymakers around the globe. The major central banks will have to decide what to do about higher inflation, which we believe will be stickier than they currently expect. Their choices will be especially tricky given growth momentum is starting to slow rapidly.

In China, authorities must decide if, when, and how to support the property sector. And the current energy crisis will force governments everywhere to weigh up how to mitigate the volatility that the green transition will bring. All in all, we believe policymakers will face Catch-22 dynamics in 2022.

Chart 1: Stagflation is a growing risk



Source: Refinitiv, Citi, Fidelity International, October 2021.

The final shudders of the Covid-19 pandemic will work their way through the global economy in 2022 (barring the arrival of a yet more dangerous variant), before the disease becomes endemic, a manageable but permanent feature of life. Emerging countries may lag behind due to lower vaccination rates. But once the acute demand and supply mismatches have ebbed away, central banks are betting that inflationary pressures too will subside.

Inflation will prove more resilient

However we think inflation will prove to be more resilient in this cycle and there are several factors that could stop it falling back to pre-Covid levels once the pandemic has ceased causing disruption. These include rising wages for the lowest paid, increasing housing costs in the US, a jump in inflation expectations, and climate-change policies.

The structural disinflationary forces emanating from heavy debt loads and demographics remain in place but cyclical forces bumping up inflation may, in our view, prove more persistent than transitory.

Central banks are already starting to face Catch-22 type choices about whether to prioritise propping up growth or keeping a lid on above-target inflation. The margin for error will be fine, making the probability of policy mistakes high. But even here, the Federal Reserve and the European Central Bank - under pressure to keep real rates negative to support the ongoing fiscal drip-feed coupled with incredibly heavy debt burdens across the board - will find themselves constrained in attempts to keep inflation in check. Fiscal support will fall in 2022 in the US and Europe as pandemic measures are wound down. However, fiscal deficits will remain wide compared to pre-pandemic trends given the shift in politics in favour of structurally higher government spending.

Managing the costs of transition

The mammoth task of transitioning to a low-carbon economy will naturally result in times when demand outpaces supply for certain key inputs as structural capex trends incorporate a world of higher carbon prices. The current energy crunch shows the knock-on effects this can cause to prices of both old and new economy inputs especially when inventories are running low.

Governments around the world will have to balance the political costs of higher prices now against the consequences of acting too slowly. This will become a recurring feature over the coming years and will define the speed of progress and capital reallocation. On the positive side, private capital allocation, especially towards decarbonisation technologies, is likely to become increasingly relevant to macroeconomics and policy as well.

China's three mountains for reform

Meanwhile China is facing its own crucial policy decisions as its new growth model comes into shape. Slowing growth following a post-pandemic boom is being exacerbated by a decisive attempt by the Chinese government to tackle inequality by reforming several parts of the economy, most consequentially the property sector. The so-called 'three mountains' (healthcare, education, and property) will all face Catch-22 type dilemmas in 2022, as macro costs of the profound regulatory shifts come to the fore.

We expect the negative impacts on the sectors will last several more quarters before bottoming out in the event that Beijing continues to sit on its hands, while the hit to GDP will last longer given the lag with which these effects act on the wider economy.

However, there are already tentative signs that policy might be starting to ease. Whether and how fast this becomes a concerted effort to support the property market and broader economic growth will have an outsized impact on economic growth in China and the rest of the world in 2022.

This brings us to our macro read for the coming year: catching the virus in 2022 may be less of a concern than in 2021 or 2020, but 2022 has its own catch ready for global policy and the economy.

Multi asset

Henk-Jan Rikkerink
Global Head of Solutions and Multi Asset

Waiting for more certainty

The current business cycle is far from over and we are optimistic about the outlook for equities over a 12 to 18-month horizon. Growth will be solid and earnings respectable this year, barring major catastrophe. However, growth momentum is slowing, while valuations and positioning give cause for concern.

The Global Macro team, whose views are a key input in our asset allocation decisions, have highlighted increased risks from policy uncertainty, stickier inflation, and the slowdown in China. Weighing this all up, we begin 2022 with a neutral view on equities. We expect volatility to increase in the near term and are watching for clarity around the macro situation or oversold market signals to change our view.

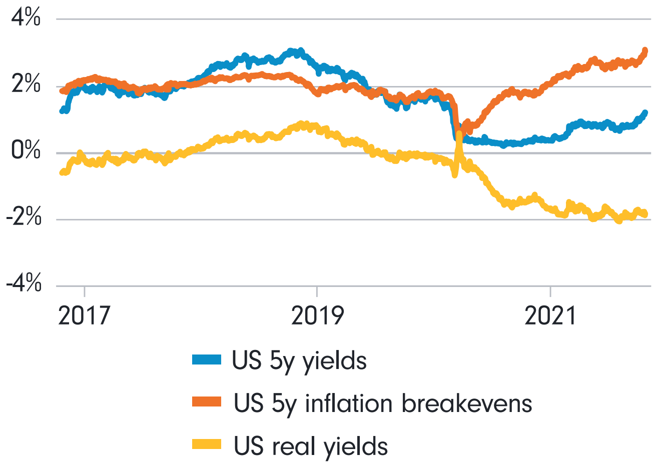
Vaccines drive performance

Within regions, we expect developed market equities to continue their recent outperformance in 2022, largely due to lower vaccination rates and tightening monetary policy in emerging markets. We expect the US to perform strongly, especially in the event of equity market volatility, due to its defensive nature, supportive monetary and fiscal policy, and strong earnings. Japan too looks well placed to have a good year as vaccination rates pick up. We are more cautious about the outlook for Asia excluding Japan. China is the elephant in the room and reading the tea leaves on the policy path from here is difficult.

Challenging outlook for US Treasuries

In fixed income, we expect US nominal (but not real) yields to increase in 2022, due to the Federal Reserve tapering asset purchases and higher inflation prints, making the outlook for US government bonds challenging. We are more positive about the outlook for UK gilts - we think the Bank of England's hawkish rhetoric is a mistake and that higher yields and steeper curves will have a negative impact on an economy already under stress from higher prices. The end of the furlough scheme could also hurt the labour market. Either the Bank of England will be forced to back down, or slower growth from higher rates will feed into gilts and flatten curves.

Chart 2: US nominal yields should increase in 2022 but real yields will stay depressed



Source: Refinitiv, Fidelity International, October 2021.

Defaults should remain low

In credit markets, investment grade bonds are currently less attractive on a total return basis. Spreads are tight and total returns are low, and we see little sign they will improve any time soon. Fundamentals are also weak compared to history. Even if they do improve, this would be offset by a deterioration of credit quality, in our view.

In high yield, defaults should remain exceptionally low. Liquidity is still plentiful and the demand for yield is strong - supportive factors that we expect to continue. Some specific sectors offer value, such as energy, and spreads may compress further from here. The asset class's lower interest rate sensitivity is also appealing in an environment where government bond yields may rise.

Some specific sectors offer value, such as energy, and spreads may compress further from here.

The team takes a positive view of the US dollar in 2022 for its defensive properties, as well as the backdrop of fiscal spending, Fed tapering and slowing growth in China. However, we expect the euro to perform relatively worse - there is less scope for rates rises at the European Central Bank this year.

Alternatives may offer defensive option

There is uncertainty in the air as we head into 2022. Given the team's view that real rates will remain very low throughout the year, and therefore government bonds will perform poorly, alternatives continue to be an attractive option for defensiveness in multi asset portfolios, especially renewable energy projects given the recent energy market ructions. They often come with index-linked contractual cash flows that are less correlated to equities and bonds.

Equities

Romain Boscher
Global CIO, Equities

On course for a soft landing

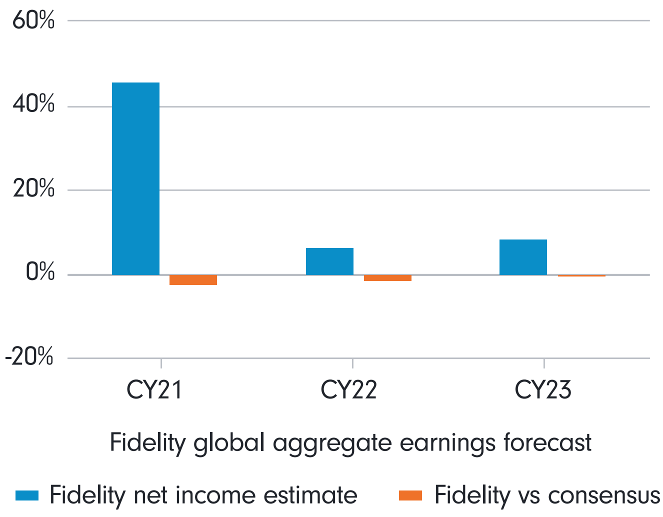
The fast bounce back in earnings growth and equity market returns over the past year was always going to peter out. That process has started and will continue through 2022. The question is whether we will have a soft or hard landing. At the moment, a soft landing looks more likely for equities, but a number of risks could drag the market into something more unpleasant. In this climate, having a robust portfolio biased towards quality is key.

Tipping point has been reached

The economic whirlwind in 2020 and 2021 has effectively created its own cycle: a very short and sharp reopening cycle has occurred within the longer, traditional business cycle, and it's not clear how these forces will mingle throughout 2022. Most of the headwinds though relate to the reopening cycle.

In the wake of a sharp recovery, as restrictions were lifted and initially aided by easy base effects, growth was always bound to slow. That tipping point has been reached and will continue through 2022, but we think that the overall balance of risks will tilt towards a soft landing rather than a hard one.

Chart 3: Weaker but more normal earnings growth



Source: Fidelity International, IBES, 15 October 2021. Note: Consensus estimates based on IBES MSCI World forecasts.

A range of risks

The primary risks at the moment are slower earnings growth, higher inflation and interest rates, disrupted supply chains, high debt levels and the regulatory storm in China. Some of these risks are more transitory, while others have the potential to become structural headwinds. For example, strong demand for certain goods and services driven by the economic reopening and supply chain bottlenecks are transitory, but wage inflation and climate change policies could be tenacious drivers of inflation.

Covid-19 is turning into a more persistent drag on growth; vaccines are proving effective in breaking the link between infections and hospitalisations but not in stopping cases altogether - the virus is here to stay. And just as growth is slowing down, policy support is starting to be rolled back.

The withdrawal of policy accommodation will be a delicate balancing act for most central banks including the Federal Reserve, whose credibility will be regularly tested by the market. Investors will have to assess the Fed's commitment to its new flexible average inflation targeting framework (FAIT) if prices keep rising. We expect interest rates to rise around the world throughout 2022, but this shouldn't pose too much of a problem for equities as long as we remain in a world of historically low (and negative) real yields with low nominal rates.

The bigger risks for equity markets are high valuations and narrow leadership. Valuation multiples are high, but not unprecedented considering the limited alternatives. Valuations are, however, near the top end of the spectrum on several measures, which could invite a correction. Market leadership is concentrated in a small group of stocks and any weakening of sentiment could lead to a rotation at the expense of mega cap names.

Investors should also monitor the trajectory of China. Not only is it a big market in its own right but it was also among the first in and first out of lockdowns, and the first major market to show signs of earnings fatigue. Its performance in the coming months may indicate how things will play out in developed markets.

Chart 4: Forward valuations: priced for perfection?

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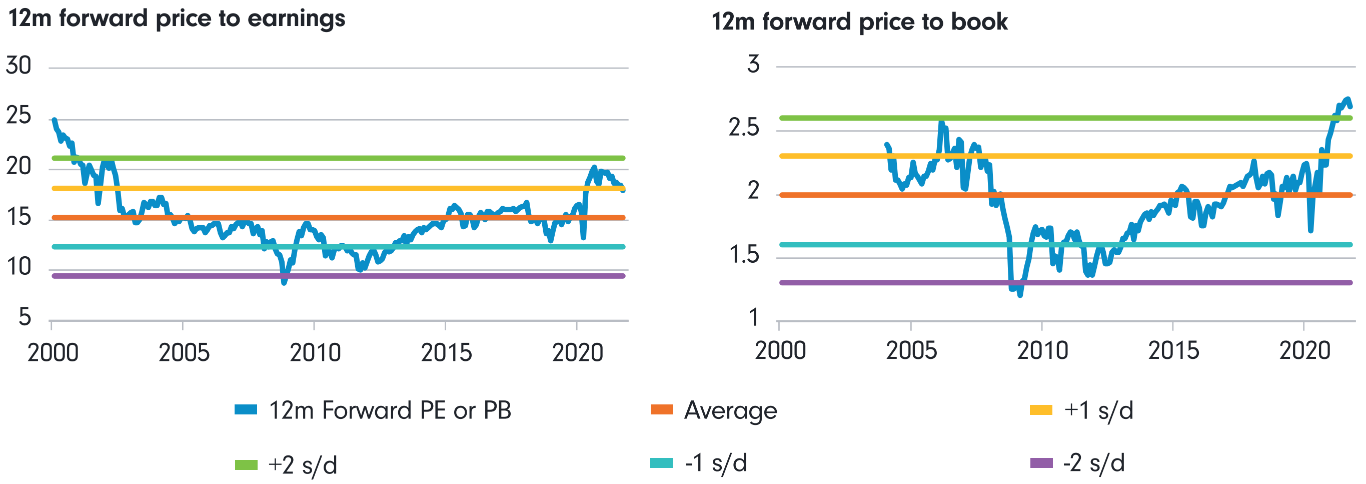


Source: Refinitiv, October 2021.

Sustainability test

Sustainability is going to be a test for much of the market in 2022. With commodity prices elevated, there is likely to be a performance drag for high ESG performers and a temptation to compromise on sustainability considerations in order to benefit from high energy prices.

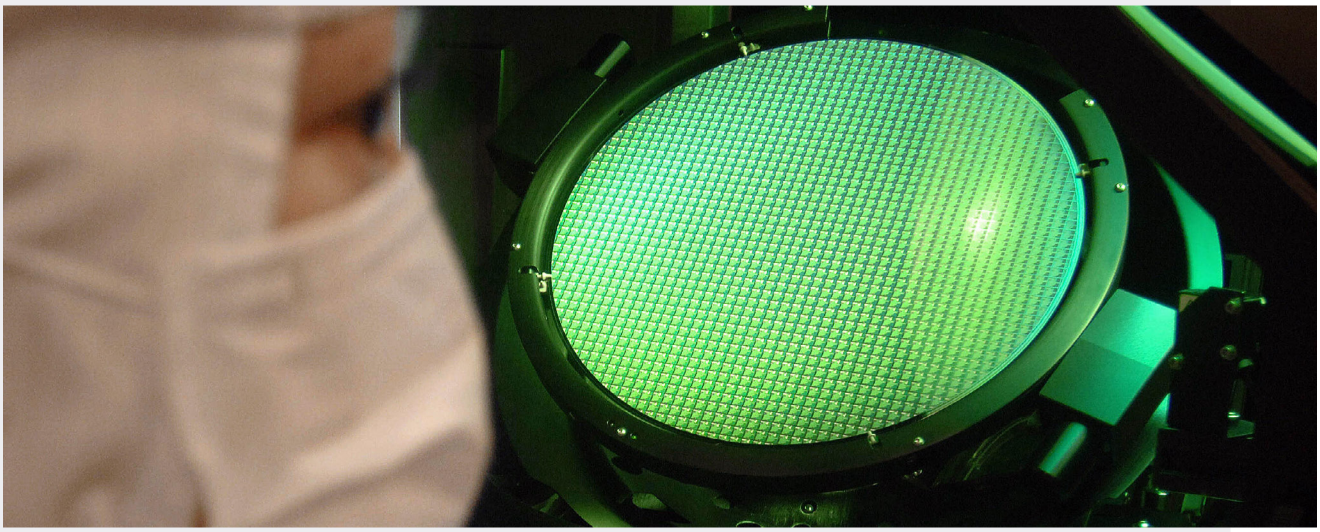
Investors who pick the better operators within the energy sector or those showing the most potential to transition to net zero, as opposed to shunning the industry altogether, may have an advantage because their engagement often encourages positive corporate behaviour while avoiding skewed portfolios with concentrated risks. This approach also complements a bottom-up investment strategy.

Building resilience into portfolios

A soft landing appears to be the most likely outcome for equities in 2022. Nonetheless, given the confluence of risks, we think it prudent to build more robust portfolios with a quality bias, limited leverage and not too much exposure to China. There is a stronger-than-usual fear of being disappointed, so we would avoid regions that are priced to perfection and highly dependent on growth.

We are selective within value stocks, preferring cyclical and industrial names but remaining cautious on banks. It's still uncertain whether there will be a lasting rebound in bank stocks given their exposure to a potential default cycle if rates rise and the fact that real rates continue to be negative.

We are also cautious about growth stocks with the most expensive valuations, such as high-end technology and software. Instead we prefer tech opportunities in emerging markets, where good value has emerged following market corrections in 2021.



An engineer checks a 12-inch wafer, used for the fabrication of integrated circuits. (Credit: Sam Yeh / Staff, Getty Images)

Fixed income

Steve Ellis
Global CIO, Fixed Income

Don't get bearish on duration yet

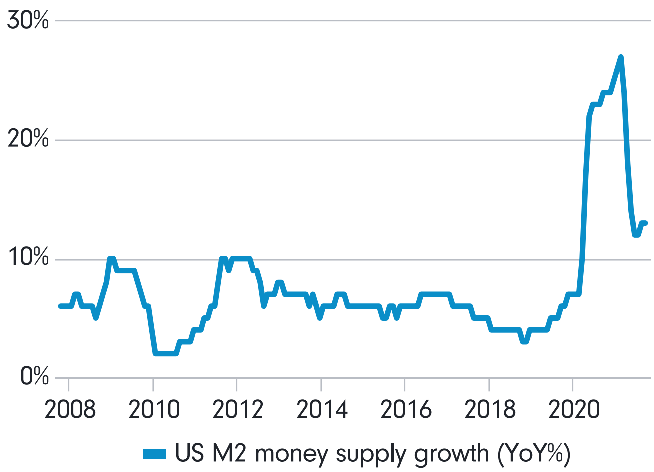
Record debt levels mean central banks cannot normalise aggressively.

Central banks face an economic war on two fronts in 2022. Inflation is back, while growth has slowed following the post-Covid rebound. While investors can expect some tightening to occur, policymakers cannot allow real interest rates to rise too high, due to large overall debt levels, and will intervene if necessary. This should mitigate the risk of a fall in bond prices caused by rising yields, meaning fixed income investors should not be too bearish on duration.

Inflation is back (and here to stay)

While money supply growth has fallen from its early 2021 peak, it remains historically high. This is likely to continue to pass through to prices. A big difference between today and the period after 2008 is that, back then, money supply was continuously drained as banks parked liquidity back at the Federal Reserve to rebuild capital buffers. Today, bank balance sheets are relatively healthy, so Fed stimulus has added substantially to the stock of money. On a global basis, central bank liquidity has been the main driver for risk assets in the wake of the pandemic, with $17 trillion of credit created in 18 months.

Chart 5: Money supply growth remains elevated



Source: Refinitiv, Fidelity International, October 2021

Couple this with supply bottlenecks and the reining back of globalisation and conditions are ripe for inflation being less transitory than some have hoped.

Fed tapering could create near-term volatility

Rising inflation puts pressure on central banks to tighten policy. The Fed has hinted at plans for a quick taper of asset purchases by mid-2022 and indications are that rate hikes could begin in 2023, earlier than previously signalled. Alongside the Fed's taper commitment, the US Treasury is expected to rebuild the reserves it holds in the Treasury General Account, which it has been running down since early 2021. This withdrawal of stimulus could create short-term volatility in bond markets, including rising Treasury yields and widening credit spreads.

Huge debt levels mean central banks need to keep rates low

Nonetheless, conditions are unlikely to tighten as sharply in 2022 as many fear. Even in the face of structural inflation, central banks will need to keep interest rates low for a protracted period, at least until the end of the decade. The reason is the scale of public and private debt, which combined hit a new record of $296 trillion in 2021 (more than 350 per cent of global GDP) according to the Institute of International Finance. Fighting inflation no matter the cost, as the Volcker-led Fed did 40 years ago, is simply not an option in 2022. Allowing refinancing costs to balloon would risk a spiral of defaults, depressing economic growth and making it harder still to service debt payments. Central banks will therefore need to ease off tightening if credit spreads widen too much, and duration risk should be less than if policymakers were free to normalise more aggressively.

Growth is also a concern

Central banks will also be keeping an eye on growth. Economies are past peak growth following the rebound from the pandemic, and continue to face supply bottlenecks and higher energy prices. There are reasons for optimism. The 'Build Back Better' agenda promises further fiscal stimulus in several countries, while bank lending, which has been relatively subdued since the early days of the pandemic, could pick up in 2022. Though this is dependent on vaccines holding the line against Covid-19 and the recovery continuing, albeit at a slower pace.

More capital could be directed to green growth

One consequence of increased bank lending could be more liquidity directed towards issuers with stronger sustainability credentials. Banks are under pressure to reduce the climate risk of their loan books. The European Banking Authority has said banks are already raising prices for and denying loan requests from some high-carbon emitters.

Fiscal support could follow a similar path. Major sovereign issuers like Germany and the UK have now entered the green bond market, issuing debt to fund sustainable infrastructure spending and other green activity. The green bond market is growing quickly but needs better standards, more liquidity, and competitive pricing to become mainstream. In the meantime, integrating sustainability considerations within an investment process can help identify issuers best placed to make the net zero transition.

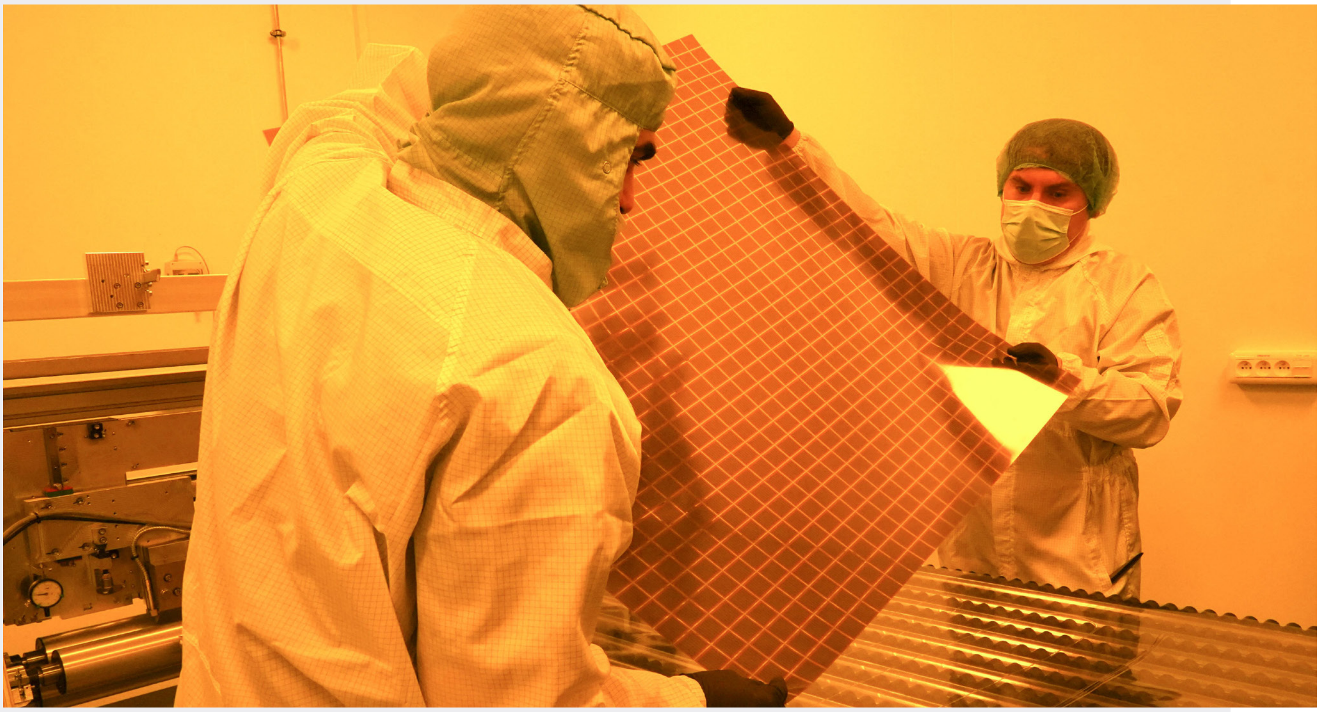
A weaker dollar could boost emerging markets

Finally, we expect the dollar to track towards a longer-term weaker trend in 2022, which could be positive for emerging markets, despite some having to raise rates already in the face of higher inflation. The Fed may have struck a more hawkish tone in 2021 than both the European Central Bank and the People's Bank of China, helping the dollar strengthen, but the twin budget and current account deficits remain a long-term drag on the US currency.

Income will matter more than capital appreciation

Against this backdrop, where can fixed income investors find returns in 2022? Credit spreads have little room to tighten further, which puts greater emphasis on coupons. A possible exception would be if market conditions caused spreads to widen, as happened with Asia high yield bonds in the wake of the Chinese company Evergrande's debt crisis. This kind of scenario could create buying opportunities given central banks' strong incentives to keep the system liquid.

If yield rises are capped, it will be important to focus on income and find assets trading at an attractive yield. That implies a bias to high yield bonds, where the default rate for US issuers has stayed below 1 per cent this year, although investors should not get too bearish on investment grade either. Nominal yields are likely to stay at or near current levels, despite inflation becoming more persistent than first thought, because real yields will have to be driven lower and lower to keep refinancing rates manageable.



Solar panels manufactured using groundbreaking perovskite technology. (Credit: Bjanek Skarzynski / Contributor, Getty Images)

Real estate

Neil Cable
Head of European Real Estate Investments

Coming of age

Real estate is entering a new age. Inflation has become a factor again, the 'new normal' for office use is still unclear and the low-carbon transition is changing the relationship between landlord and tenant.

A new age

After a long bull run in European real estate markets, almost uninterrupted by Covid-19, we may be on the cusp of a 'third age' for the asset class. The 'first age' was the period up to the 1980s, when there were no reliable indices and little cross-border investment. The second age is from the late 1980s to the present day in which global indices are standard and real estate has become a financial product via structures such as mortgage-backed securities. The third age looks set to be one in which achieving net zero emissions becomes the defining factor governing usability, ability to let and profitability.

Of course, the 'normal rules' will still apply - the balance of supply and demand, the ability of tenants to pay rent, depreciation and obsolescence, and even the 'wow' factor which makes a tenant want to occupy a building.

However, of the three themes emerging for 2022, only one is a 'traditional' factor - inflation. The others are game-changing features of the market which will require completely new ways of assessing the asset class. Each brings costs, risks, and opportunities, but the impact of getting them wrong could be significant.

1. The inflation dragon

The dragon of inflation, having been slayed by central banks in decades past, is threatening to rear its head again. If that happens, real estate may keep pace and therefore provide a useful hedge. When prices rise in the general economy, companies' revenues (in nominal if not 'real' terms) tend to rise and rents do too. In continental Europe in particular, virtually all leases are automatically indexed in line with inflation (usually CPI) which can give investors additional comfort.

Two factors, however, make it dangerous to assume all properties benefit in such scenario. First, if open market rents in a particular location don't rise along with 'indexed' rents, tenants will simply vacate a building when the lease expires to take advantage of cheaper rents elsewhere. Second, property has historically kept pace with moderate price rises, but if inflation spirals out of control (e.g. 10 per cent or more), property tends to be less correlated. Investing in good buildings with high environmental standards in markets that aren't oversupplied and letting to tenants with sustainable business models will be crucial to withstanding persistent inflation, even if rents in general are rising.

Real estate investment trusts are showing the way in which the subsector make-up may change for private sector funds.

2. Changing use of buildings

Real estate professionals used to talk in near-certainties about certain aspects of the market: what made something prime as opposed to secondary, whether certain cities were always 'in demand' from certain types of companies (e.g. financial services in London); or how much investment a building might need to be upgraded in future (e.g. the lifespan of air conditioning units).

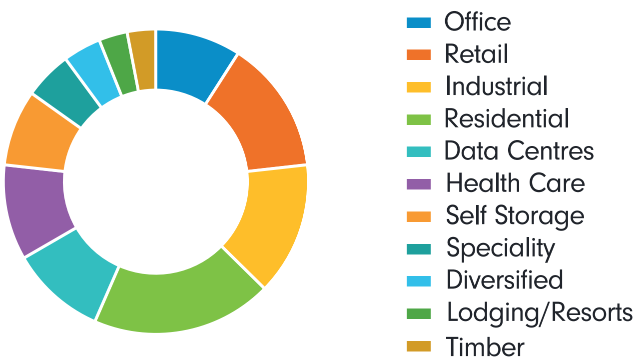
This was partly because society tended to use buildings in the same way - we all worked in offices, goods were manufactured in warehouses, we bought things in shops. In recent years, we have bought ever more online and less in the high street, and large warehouses at motorway junctions have effectively become the 'new retail'. Now the question is how far offices will be affected by new hybrid working patterns post Covid-19. Will these shifts in behaviour create permanently lower structural demand?

Similarly, the ever-increasing use of technology, not just for shopping but for communicating, saving and 'zooming' from home, increases the need for more, and more efficient, datacentres close to cities to ensure reliable speeds. We're all getting older - we need more and different types of leisure to keep us fit, different types of living and care in old age, and more healthcare facilities.

None of these trends is new (even 'working from home' was growing at a rate of 4-5 per cent per year before the pandemic), but the trends are rapidly accelerating as the world adjusts to a post-pandemic state. It takes time to buy and sell property, so there is an urgent need to start diversifying portfolios now, to ensure exposure matches a modern economy where people and businesses use buildings in very different ways to the past. Indeed, real estate investment trusts are showing the way in which the subsector make-up may change for private sector funds (see chart 6).

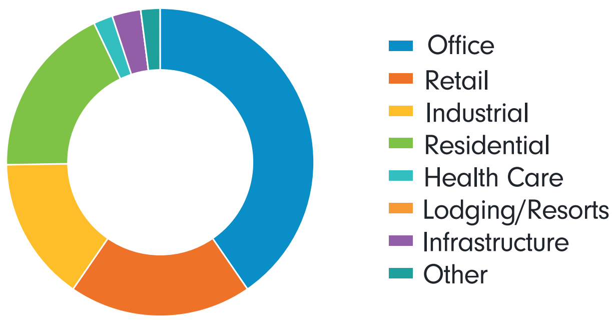
Chart 6: Public markets show what private markets may look like in future

Public markets already adjusting to the future (Nareit REIT Index composition)



Source: Asreit, as at 15 October 2021. Nareit index excludes infrastructure.

Private real estate funds need to move faster (MSCI Global Annual index)



Source: MSCI Global Annual Index, December 2020.

3. Net zero

Real estate is central to achieving the Paris Climate Accord targets designed to limit global warming to 1.5 degrees. The 'easy wins' to reduce emissions - installing efficient lighting, adding smart meters to manage energy use better, or recycling waste - are marginal, and the sector must now navigate not only removing gas boilers, but also working out what to replace them with.

The best real estate fund managers have historically been brilliant negotiators and experts in contract law. In essence, the landlord's obligation has been to provide a building, and a tenant's to pay the rent, with the relationship entirely based on the lease agreement. But things are changing.

What if the tenant is a careless polluter of the environment? Should the landlord care and can they even do anything if the tenant is meeting their obligations under the lease agreement? What about the tenant who is 'clean' themselves, but deals with a munitions company or a coal miner in its supply chain?

Historically, these areas were nothing to do with the landlord. Now they are becoming central to whether the building is a successful investment or not because investors are starting to demand that the 'impact' (environmental but also social) is measured, monitored and improved. The path to net zero needs to be demonstrated with clear improvements every year, not just as a distant policy aspiration.

It is therefore becoming acceptable to engage with tenants about their environmental activities, policies, or targets, irrespective of their obligations under the lease. Most net zero targets have been set for 2035, 2040 or later, but these mask the urgency of the action needed now. With the risk of buildings becoming 'stranded' in the future (e.g. if they don't meet stricter 'green' regulations and are not permitted to be let out to tenants), investors cannot afford to wait.

Despite cost and technology challenges, continuing to be successful tomorrow means starting to reposition holdings today, both for the low-carbon transition, and in the nearer term to cope with inflation and changing building use.