Psigma
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View from Psigma

Five Key Themes for 2022
Valuation Commentary

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Introduction

2021 proved to be another positive year for investors, following a surprisingly healthy year in 2020 and a strong recovery in 2019 from the market turbulence of 2018. Therefore, for three years in a row, despite myriad challenges and a range of different economic conditions, asset markets have posted solid gains, and the expansion in both prices and valuations could well mean that 2022 is a more difficult year for investors.

As we wrote in our Outlook for 2022 back in December, we believe that there are major tectonic plates currently grinding together in the global economy and financial markets that will likely lead to a more volatile year for investors. The good news is that many asset markets have already started to price in a less benign economic and monetary environment, and plenty of opportunities exist for investors. In our commentary today, we will discuss the "Key Themes" that investors should focus on in the coming months and years and outline how we believe portfolios should be positioned for a potential regime change across markets in 2022

2021 – All was calm, all was bright

In the Becket household I am furiously trying to extinguish the persistent singing of Christmas carols. Repeated renditions of Silent Night are unnecessary in mid-January and the "all is calm, all is bright" quote was certainly more relevant to investors last year than we believe it will be in 2022. It is simply extraordinary that we saw such a positive year for equity markets in 2021, despite economic turbulence, the ongoing medical crisis and inflation that was far higher than most economists had expected all mixed together in what could have easily been a toxic cocktail for markets to swallow. How can we explain this disconnect between the rewards offered to investors at a time of increasing risks? In one word: liquidity. In 2021, we saw the lingering effects of gargantuan government giveaways during the COVID pandemic combine with an unprecedented amount of central bank money flooding into capital markets, supporting prices and spurring valuations on to historically abnormal heights. Whilst the party was good at the time, we should question what the hangover might feel like, as this dynamic alters and a "regime change" comes about in the coming months. This brings us neatly to the first two of our five key themes: inflation and monetary policy.

Key Theme 1 – Inflation:
The heat is on, but for how long?

In an update last year entitled The Heat is On, we outlined our views on inflation and why we felt strongly that inflationary pulses would set the tone for markets through the remainder of this decade. What was interesting was that at the end of last year, even though headline inflation rates screeched higher through 5% in the UK, US and Europe, markets simply didn't care. Traditional market sensitivities to inflation went into reverse and left us scratching our heads as to why the expected patterns failed to appear. Part of the answer was, again, liquidity; there was so much money sloshing through markets that no inflation-sensitive asset sold off. The other factor was timing, and it is obvious that the inflationary impact upon markets was delayed, with the start of 2022 being grim for those normally negatively exposed investments (such as long duration government bonds and expensive "growth" equities) that performed surprisingly well in the inflationary conditions at the end of 2021. If we're right and inflation is the fulcrum for financial markets in the period ahead, what happens next? Our view remains that inflation will remain higher than we have become used to in the post-financial crisis years since 2008. Wage settlements are comfortably higher, price pressures in supply chains persist and commodity prices remain elevated.

In the short term, however, we are questioning whether we will see a whole year of inflationary angst, as there should be some soothing of inflationary pressures as we progress through 2022 – which does raise questions over whether central banks are right to be suddenly talking tough on inflation.

Key Theme 2 – Central Banks:

Talking the talk; Can they walk the walk?

Of course, there is a major difference between threatening to tighten monetary policy, as the US Federal Reserve and Bank of England have done, and aggressively following through with action. Financial markets and the central banks in the US and UK are implying that we will see three rate increases this year, leading to interest rates finishing the year on both sides of the "pond" at around 1%. Such promised levels are way below anything we experienced before 2008 and hint at how much has changed in a slower global economy, which has become choked by extremely high debt levels. But given how addicted to ultra-low rates and monetary support our hyper-financialised economies and investors have become in the last few decades, we are far from sure that any sustained tightening of monetary policy will be achievable. Can the global economy survive through a period of "cold turkey"? Will markets roil up at the retraction of the abundant liquidity constantly served up in recent years by the central banks? At this point, we just don't know, so we cannot project what effects might take place when the "punchbowl" is removed; but we do know that this will be different to the easy money environment of the last three years. We also worry that this new direction of monetary policy might just be about to take place as the economy starts to slow back towards trend growth levels, as the early recovery from COVID-19 starts to fade.

Key Theme 3 – Global Economy:

Great expectations: Are they realistic?

Interestingly, nobody else appears that worried about economic activity; the clear expectation is that the economy will be vibrant in the year ahead. We agree that the start of the year will see a continuation of the healthy recovery of 2021, even if the headiest days of this cycle are behind us. But as we come towards the second half of the year, we are concerned that consumer and corporate "pent-up" demand will be exhausted and inventories will have been restocked, just as both the fiscal and monetary impulses neutralise or go into reverse. As we have written before, such fears about stuttering growth could be allayed by a virtuous investment cycle by companies with higher levels of capital expenditure, but this is something that has been promised for over a decade, without ever really materialising. As we look towards the end of the year and the start of 2023, our base case is for levels of growth not wildly different from the low and slow pattern of the last decade, albeit with higher inflation uncertainty. If we are right and the consensus is too optimistic then this could provide a nasty "wake-up call" for investors and calls into question whether the central bankers really can normalise interest rates to tame inflation.

Key Theme 4 – Financial Markets:

Trading places in a "regime change"

We expect this year to be very different to 2021. We are not forecasting the same buoyancy in equity markets that was enjoyed last year, even if we think there are grounds for optimism in many different investment regions and themes. Assuming inflation remains elevated and central bankers do start to tighten monetary policy, we would expect a continuation of the early-year bond yield rise (and price damage). Given that the risk rally of the last three years has been built upon the foundations of ultra-low bond yields and zero interest rates, as well as the tidal wave of liquidity provided by hyperactive central banks, any change in this regard should lead to a different market environment. We could see a reversal in the fortunes for the expensive US equity market, which has dominated all global peers in the last decade, benefitting from the easy liquidity environment in the US and the attractiveness of certain growth companies that are major constituents of the US equity market. We do not necessarily believe that such investments will be disastrous in the coming years, but that the prospects of other markets, including select emerging markets, the UK and Japan could finally start to catch up to their fashionable US counterpart.

Key Theme 5 – Active Management:

A change in fortunes

Much has been made of the structural disappointment of active equity managers over the last decade and certainly 2021 was challenging for many global stock-pickers. The key issue last year was the omnipotent performance of a very small number of very large companies in the US and Europe, which have become investment "darlings" and trade at extremely high valuations. Many active funds tend to have a broader spread of companies and have lower weights in very big companies; historically, this has been a winning strategy. However, the last decade has seen an intense period of the big getting bigger and most other investments growing slower in their shade. We think that the conditions are set for a change due to the shifts we are likely to see in the liquidity framework, with interest rates rising and with valuation gaps between the en vogue and the unloved at record margins. This is another reason why we expect the future to be "different" and, despite all the concerns mentioned today, think the future for investors is rife with opportunity.

Conclusion

Whatever happens in the year ahead, we do not expect it to be boring. We haven't even mentioned the rising geopolitical temperature or potential political flashpoints in the coming year, subjects we will return to in the future. As we have outlined, the outlook for inflation, interest rates and economic activity is uncertain and could provide a different backdrop to that which investors have become accustomed to for the last 13 years. We welcome the challenge and the opportunity to make positive returns in global asset markets that are heavily distorted and with significant discrepancies in comparative valuations. We will attempt to do this by keeping to our core balanced and diversified approach, by thinking differently to the consensus and increasing our focus on investments where the broad lack of interest from investors has created an exciting chance to benefit from a contrarian view.

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For further insights from our CIO Tom Becket check out the Psigma Voice, our communication platform providing you with a variety of investment and market commentary.

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