Psigma
Investment Management

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# View from Psigma

## Outlook for 2022 - The Great Balancing Act

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### Here we go again

We're probably starting to sound repetitive, as these words have surely appeared in many of our previous years' "Outlooks" over the last two decades, but as we stare into our crystal ball and attempt to plot a course through the year ahead, "things" strike us as being extremely "uncertain". We're sure such a forecast is particularly useless to all of you reading this latest update and would further unhelpfully note that "uncertain" does not have to be translated as a purely negative or indeed a positive term; in fact, we see myriad reasons for both optimism and concern as we head into a new year.

However, with the medical situation remaining precarious, government policy around COVID impossible to forecast, the outlook for economic growth questionable, lasting inflationary pressures weighing upon the minds of central bankers, and most asset valuations expensive, we must think harder now about the levels of risk we are employing across client portfolios than we have for a long time. At the same time, we must always remember that the extraordinary monetary policy actions of the last decade and an era of persistently low interest rates have created a significant amount of money that requires a home, keeping asset markets supported and asset valuations elevated.

### The great balancing act

The easiest way for us to describe the coming year(s) of a decade that we have long suggested would be the "Turbulent Twenties" is as a great "Balancing Act". There are four main subjects that dominate our thinking as we weigh up what risk we are willing to take within our client portfolios. The first surrounds the persistency of the COVID virus and the potential willingness of governments around the world to pursue actions that we all hoped were consigned to the past. The next concerns the ability for those same governments to spend money to enliven their economies in a world of historically high debt levels. Linked to that thread is what support central bankers can serve up to help their respective economies in a world where the inflation dynamic appears to have shifted higher for the first time in decades. Finally, in terms of financial markets, there are two main questions that dominate our investment strategy: can the era of unbridled complacency carry on as we progress through this decade? And when will the cohort of cheaper investments that we can find triumph over those which are demonstrating some of the greatest excess ever witnessed in financial market history?

As today's introduction suggests, there's clearly a lot to evaluate as we "ring the bell on" 2021 and enjoy a (probably socially distanced) break over Christmas, so in this outlook we will tackle each of the core subjects raised already and suggest what we think is an appropriate balance for investors to strike in their portfolios going forward.

### Not gone, not forgotten

For those of us who hoped that the COVID crisis was increasingly becoming a historical issue, news from across the Channel and the revelations over the "Omicron" variant have clearly demonstrated that sadly the virus continues to dominate the economic outlook. Whilst it is too early to suggest what damage the new variant will wreak upon the domestic and international economy, it is obvious that the natural reaction of politicians appears to be "panic early, think later". Let's hope that the early decisions taken in the UK are not a first step backwards on a path back to full lockdowns. Our interpretation is that the "hurdle" for lockdowns is certainly higher in the UK than other countries, most notably in Europe, based upon our government's previous policies and the world-leading vaccination programme and subsequent booster drive that has been implemented here. But we cannot be sure, and clearly the approaches adopted across many European nations are a stark reminder that we are "not out of the woods yet". Our best hope is that the new variant does not continue to spread the alarm it has in its early stages, that vaccinations continue to limit the number of hospitalisations and deaths, and that we limp on through the long winter without drastic limitations imposed again upon our daily lives.

## Economic volatility to continue

Quite obviously, the medical situation will drive the global economy, much as it has through a volatile year for economic activity in 2021. Overall, the economic experience this year has been positive, with the first six months of this year enjoying a rapid rebound in economic activity, as economies reopened, and vaccinations provided the global economy with a necessary shot of confidence in the arm. However, the late summer and early autumn saw growth slip once again as the emergence of the "Delta" variant hit various sectors of the economy and stultified overall economic activity. However, as the year has entered its final stretch, growth once again accelerated, and until very recently we were confident of finishing this strange year with a flourish. As hard as it is to forecast the year ahead, our core view would be that the winter will be "bumpy", but growth will pick up again in Q2 2022, before growth gradually tails off towards the end of the year, with pent-up demand starting to expire and the impacts of the troughs and recoveries of the COVID-influenced economy starting to normalise towards trend levels of growth. Trend growth rates are likely, in our view, to be less impressive than many presently hope that they will be, as the abilities of governments to spend upon yet more stimuli is checked by the simple fact that they broadly have no money and an enormous amount of debt. Governments' financial states have gone from terrible to disastrous over the last two years; surely this will act as an impediment to future spending plans?

## What can governments do?

Of course, despite the parlous state of their finances, governments around the world are not about to embark upon a path of frugality; the word "austerity" has been consigned to the history books, never to be mentioned again, but any expectation that governments can continue to spend using a blank cheque book, as they have over the last eighteen months, is surely wrong. We should therefore expect growth rates to slip and possibly stagnate in the next couple of years, unless there is a material improvement in companies using their large cash piles for higher rates of research and development. Whilst such a trend would be welcome and a massive positive for the global economy, the evidence remains that companies would for the most part rather enrich themselves and their shareholders, so the greater likelihood remains for hyperactive central bank policies to continue in their attempts to try and calm the choppy seas created by ever-growing waves of government debt.

As we sit here today, in an ever-evolving medical and economic situation, central bankers are tentatively moving away from the gargantuan support packages that they have put in place for the last eighteen months, to help governments, companies and consumers through the economic shock forced upon us by the COVID crisis. However, with economic growth now positive and many of the world's economies having clawed back the lost economic ground created by the various lockdowns and limitations imposed, central bankers are under pressure to pack up their tools and go home. The pertinent question is, how well can the global economy chug along without the central bankers continuing to chuck fuel upon the economic engine? We expect that this will be a question we can evaluate properly in the year ahead.

## Is inflation the game changer?

The difference between the situation that central bankers find themselves in now compared to the years immediately following the Great Financial Crisis of 2008 is that we now quite clearly have an inflation problem. Excuses might be made for this period of rising prices, but even the most ardent "deflationist" must admit that right now the price of nearly everything we need to live on is going up and in many cases, prices are going up materially (and certainly more quickly than governments and central banks might freely admit). This could impact upon the central bankers' ability to resort back to aggressive monetary easing, if the economy were to slow once again or bond markets were to start to have trouble digesting the enormous amount of bond issuance that governments will need to continually create in order to match their unbalanced spending promises. This is a pernicious situation and a trap that we have long worried that central bankers might fall into; inflation might need to be tamed through rate rises and a cessation of quantitative easing, but the last thing that cash-strapped governments can afford is less support and rising borrowing costs on their teetering debt piles.

This "Catch-22" leads us to some troubling conclusions; all things being equal, higher quality fixed rate bonds are likely to be poor investments in the coming years (although there will hopefully be an opportunity presented to acquire at higher income yields), whilst the potential for a "policy error" around inflation is high. Central bankers might claim to be impotent in the inflationary battle, as they would fairly argue that they can't fix global supply chains that have become discombobulated by COVID and balkanised in a world of reduced trust, but this misses the point that their lasting largesse has created a demand shock whereby many consumers all want more of the same things at the same time. Inflation is currently both a supply-side and a demand-side driven phenomenon. In short, despite their painful protestations, we are worried that central bankers are "way behind the curve", even if rate rises are expected in both the UK and US in the next twelve months, and that they should have moved their economies out of the emergency room much earlier. The fact that they haven't and their obvious timidity in acting decisively on inflation makes us worried they are storing up inflationary issues for the future and we would urge investors to protect their assets against such a possibility. This is exactly what we are doing in our client portfolios, as even if hopefully inflation numbers start to drift down through 2022, we expect them to remain at relatively elevated levels (by comparison to the last decade).

## Obvious value but will it be recognised?

If we are right and the key macroeconomic inputs to our investment process provide little certainty as we head in to 2022, how can we structure our client portfolios and attempt to make positive returns in an unpredictable year? The key message to all our clients is that, as we sit here and cast our investment nets around the world, we are comforted by the opportunities that are on offer to investors willing to take a longer view. Undoubtedly, the actions of central bankers and governments have created enormous distortions in markets, leading to excessive valuations and the prospects of poor returns in the future from some of the more fashionable investments of the last few years. It could well be that core investment indices languish in the coming years, as the very positive returns of the last three years are digested.

However, it is also very hard to sit here today, in a world of elevated asset valuations across both public investment markets and all private assets, and argue that certain equity markets, such as the UK's FTSE All-Share that trades on roughly 12 times next year's earnings and a dividend yield of 4%, are expensive. Similar arguments can be made for positive future returns from markets such as Japan and Asia, which trade on sensible relative and absolute valuations, whilst offering the prospect of future earnings growth from the Asian economic engine.

The issue from a relative performance perspective is that one could have made such an argument for those cheaper markets for over five years and seen the comparative trajectory of the US market, which trades at historically expensive multiples, exhibit the traits of one of Elon Musk's rockets. The question that many have tried to answer, with many losing their jobs as they have been wrong (they would argue early), is when the historical trend of "mean reversion" might take place and "value" areas of global equity markets consistently outperform. Certainly, there have been flashes of improvement in recent times, such as the vaccine-inspired rally around the turn of last year into this one, but such periods have been fleeting and a "reversion to trend" of previous winners triumphing again has quickly reasserted itself.

How do we balance our long-held philosophy of contrarian investing alongside such an entrenched pattern of expensive growth companies winning? The answer is that we do not bet too much on either "value" or "growth", but rather select those sectors or investments from both sides of the divide that we consider having the best balance of risk and reward. Whilst we like some of the cheaper value sectors and unpopular regions, we also have a bias towards more popular sectors such as infrastructure and renewable energy technology, both of which have been fashionable because that is where the governments will continue to spend our money in the coming years. Whether a company is considered to be "value" or "growth", we strongly believe that in the coming years the key determinant for individual corporate success will be how companies manage to control profit margins. Profit margins are currently extraordinarily wide, as until recently wages have been low, commodity prices have been under control, corporate taxes have been falling and borrowing costs almost non-existent. Now that all those factors have changed or are changing, 2022 could be a year when the outlook for overall corporate profitability becomes less impressive and selectivity becomes increasingly key.

## Are there any opportunities in bond markets?

As we have suggested, there is an air of complacency over equity markets, which might be misplaced given the more difficult outlook for the year ahead, at a time of high valuations. The same could be said for fixed interest markets. In most cases, investor confidence reigns and yields are very low. The relaxed attitude is possibly justified by the simple fact that the prospect of companies defaulting is very low in today's environment of zero interest rates and the absolute willingness of investors to refinance companies' debt at basically any price. We don't expect this to last through the years ahead as surely some discipline will return to markets, as central banks row back their stimulus packages, interest rates start to rise and "inflation uncertainty" starts to dominate investors' minds. As with equities, it is not a case of despairing but thinking differently. We can still identify a range of attractively priced corporate and consumer loans, with low possibilities for default and inflation-plus yields that might be vital in the coming years. While equities have been the obvious beneficiary of most of 2021's "risk-on" environment, we continue to admire the risk and return characteristics of a range of specialist bond investments.

## Emerging markets to reward investors

Outside of developed world equity and bond markets, we are attracted to the relative value opportunities on offer in the emerging world. Investors have rightly become more concerned about the short-term prospects for Chinese growth and regulation, as well as the fear that the developing world will take longer to recover from COVID. We can sympathise with these arguments, but as we look further out into this decade, we believe that the growth trajectory of Asia is strong, and the valuations of many investments adequately compensate our clients for the potential risks we are taking through such investments. This will be a key area of focus as we progress through next year.

## Conclusion

There is plenty for investors to think about as they sit down for their Christmas dinners. As we have detailed today, the next year ahead is predictably unpredictable, but we expect significantly more volatility as the great tectonic plates of the economy, monetary policy and asset valuations grind together through 2022. With the situation around COVID continuing to add to the range of risks in the global economy, it is right to be on our guard. The shifts in the key macroeconomic factors could easily lead to the occasional "earthquake" across financial markets and vicious swings in sentiment. We are not worried by volatility; in fact, we welcome it. The opportunity to buy certain investments at cheaper prices is exactly what we would like. As we have consistently said for the last twenty years, we believe that a combination of attractive long-term investments and shorter-term tactical trading opportunities, thrown up in the volatility we envisage, is a sensible solution to the challenges ahead.

Thank you for all your support and we wish you a healthy and happy end to the year.

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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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