A Year of Optimism

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For a third year running, I find myself ritually confined to the study on the quieter days of the festive season to reflect on what might lie in the months ahead. Last year we had said that after a torrid year, 2021 would likely be a Year of Healing and whilst not every single prediction has borne out, on balance our assessment has proved to be fairly accurate. So, what then to make of 2022? In short, we think that despite many potential threats to any forecasts we attempt to make today, there is sound reason to suggest it will turn out to be a Year of Optimism.

INFLATION

The hottest topic of conversation in recent months has been around rising inflation and speculation on the ensuing policy response from Central Banks. Inflation should be taken seriously indeed as ultimately it is a universal stealth tax on wealth. Ronald Reagan once said, "Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man". Little surprise then that the word strikes fear into the hearts of many investors old enough to remember the seventies and eighties. But is inflation really here to stay?

The spike in inflation in 2021 was primarily the result of an exceptional surge in demand for goods which has far outstripped the ability of the supply side to keep pace. Continued disruptions to supply chains owing to the pandemic has continued to wreak havoc resulting in a combination of delivery delays, stock shortages, and consequent increase in prices. While inflation has proved to be longer lasting than initially thought, the prices of some goods and services that have seen the largest gaps in demand and supply, such as used motor vehicles and clothing, have already started to normalise.

We anticipate demand to gradually shift from manufactured goods to services as the pandemic hopefully fades over the course of 2022, which in turn will ease the current pressures on supply shortages of goods.

Another key contributor to the current high inflation is soaring energy prices. Here again there is reason to be optimistic that this will at the very least stabilise, albeit at higher levels, in the coming months with new production capacity scheduled to come online thereby relieving inflationary pressures.

Rising wages can of course result in much stickier inflation and is a cause for concern. The labour market has been baffling economists though. Unemployment data across most developed markets suggest there is ample supply of workers, but this contradicts survey data that shows businesses have been struggling to fill vacancies. We think this simply signifies a dislocation between the jobs that are currently available, the wages on offer, and the willingness of workers to accept them. As financial support packages from the State come to an end, this dynamic should swing back into balance. We therefore think it is unlikely that wages will prove to be a lasting source of inflationary pressure. Having considered all these factors, we are of the opinion that inflation is likely to ease over the first half of the year and settle at or around the 3% mark over the long term, which is of course higher than what we have become accustomed to in the last decade.

POLICY RESPONSE, SENTIMENT AND ECONOMIC GROWTH

Monetary policy error is a key risk for investors and the global economy in 2022. Ultimately, we anticipate inflation to abate by the second half of the year, but uncertainty around the timing and rate at which inflation will eventually settle down to, means central banks are vulnerable to either overreaction or complacency. If they move too quickly, they risk cutting off a hard-fought recovery, if they react too slowly they risk losing control of inflation.

In any event, both fiscal and monetary policy looks set to tighten in 2022 and this will have knock on implications on economic growth and financial markets. Going forward fiscal spending will play a lesser role and is increasingly likely to be funded by the taxpayer. Central Banks are also signaling an end to the quantitative easing that they had embarked on during the pandemic. The Fed started to taper its asset purchases in the final quarter whilst the Bank of England will conclude its quantitative easing program altogether at the end of the 2021. This

will then pave the way for future interest rate hikes to combat inflation. The ECB is also expected to cut back on its Bond purchases but will most likely hold off from rate hikes for a bit longer.

On the other hand, a period of sustained low interest rate environment has allowed Governments in developed countries to maintain high levels of debt because the cost of servicing that debt has remained minimal for nearly two decades. If rates were to rise rapidly or by too much, it may call into question their ability to service the debt. Indebted Governments the world over would benefit from a healthy dose of inflation which will have the effect of reducing the real value of their debt. Although Central Banks are meant to be apolitical, you can hardly blame us for a degree of skepticism if we assumed that they could be complicit in letting inflation run at slightly more elevated levels than in recent history. Our view therefore is that although we are likely to see interest rates go up, they are likely to be gradual and measured. We do not see a return to pre-financial crisis average of between 3-5% any time soon.

Policy response to the pandemic has been hugely supportive and has helped shore up balance sheets for both households and corporates alike. We enter 2022 with household savings at all-time highs, debt servicing costs at all-time lows, housing market in rude health and consumer sentiment continuing to improve, which is a very different scenario to the aftermath of the financial crisis. These factors will no doubt continue to encourage consumer spending and we are likely to see a switch towards services as we put the pandemic behind us and learn to live with the virus. Similarly, corporate earnings and margins have flirted with all-time highs across the developed world supported by strong growth in sales and debt servicing costs at all-time lows. Whilst there may be some deceleration in sales compared to 2021 and a modest increase in debt servicing costs, the overall trend is expected to continue. We also expect more companies to re-invest capital instead of embarking on share buy backs, initially to rebuild depleted inventories but also to bolster supply chains that have shown a weakness during the pandemic.

THREATS ON THE HORIZON

Inevitably there are threats to this central scenario, some of which we might be able to anticipate and then there are those that we have no way of foretelling now. So, what are the ones we should continue to keep an eye on?

We have previously alluded to the fact that Central Bankers getting monetary policy wrong is a key risk to investors in 2022. It is no surprise that the next most obvious one comes from the virus, newer mutations of the virus could turn out to be resistant to the existing clutch of vaccines causing extended disruptions to movement of people and goods into 2022, which in turn will feed through to further inflationary pressures. There is, however, cause for optimism as therapeutics start to join vaccines in the battle to contain the pandemic. It is also becoming evident that in a very connected world, leaders of countries that have managed to get on top of their vaccination programs need to take a more united approach to helping countries who do not have the resources or wherewithal to fight the pandemic if we are to collectively win this war.

Threats to energy price stabilisation comes primarily from climate and climate change. An unusually harsh winter could deplete energy reserves quicker than it can be replenished and stringent zero-carbon targets could hamper any new traditional (and perhaps quicker) sources of energy coming on to market. Escalating political tensions in the Middle East owing to Iran's belligerence and its nuclear ambitions also has the potential to precipitate an energy crisis.

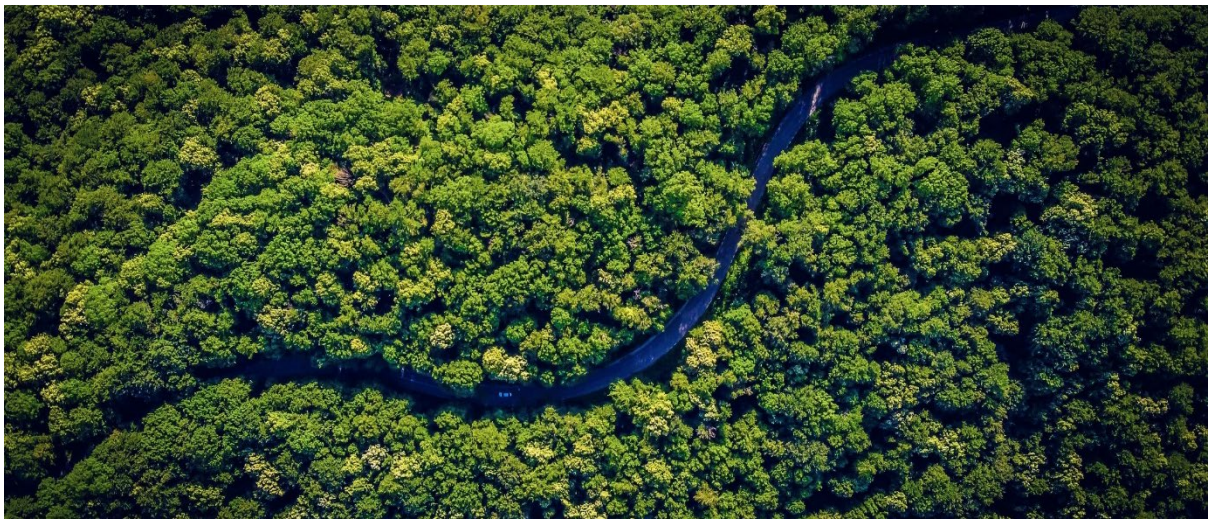
Chinese policymakers meanwhile are attempting to rebalance their economy away from property investments and toward consumer spending and new technology manufacturing. This transition will need to be managed carefully and could present a downside risk to global growth.

Finally, regional power play, whether it is Russian aggression on the Ukraine border or the prospect of a military conflict between China and Taiwan, each on their own have the ability to trigger serious economic sanctions from the West and/or result in a full-blown trade war which in turn would significantly impact global trade and hamper growth. It doesn't really bear speculating about the consequences if these unconnected events sparked off in tandem. Closer to home, there are important elections taking place in France and the US which will no doubt shape the future domestic, foreign and trade policies of those countries and may also have some bearing on international trade if protectionist policies are pursued.

LONG TERM TRENDS

In our outlook for 2021, we touched upon some of the long term trends and our views on these have only been further cemented over the course of the year. The technology sector has seen tremendous advances over the last two years and whilst that may slow down a fraction after a rapid surge in the embracing of technology over the pandemic, the trend is firmly set to continue over the rest of this decade. We also anticipate corporate spending on modernisation and automation to rise significantly as companies address some of the supply chain issues by reshoring manufacturing. It is worth noting that technological innovation is a disinflationary force that has the effect of improving efficiencies and suppressing wage growth. We anticipate continued growth in this sector specifically with advances in 5G, rise of Artificial Intelligence, the advent of Metaverse and demand for semi-conductors.

We believe that healthcare innovation is another area set to accelerate further and the industry is likely to become more personalised, focused on preventative care and more digital. We think wearable monitoring devices and reliance on robotics for the provision of basic care are just some areas that have tremendous potential for development.



The financial impacts of the transition to net-zero have already started to show in 2021 in the form of rapidly rising commodity prices and increased volatility. If this is not properly managed, the transition to net-zero risks an extended period of high commodity prices, which would exert upward pressure on inflation and act as a drag on economic growth. Government action forcing individuals and businesses to embrace green technology and pay for the cost of pollution/emissions could also have an impact on inflation. Given the sheer scale of investment required, estimated to be $150 trillion globally by 2050, the path to net-zero is one of the most crucial long-term trends of the next decade and will create significant investment opportunities in green technologies such as carbon capture, battery storage and renewable energy sources.

CONCLUSION

The consensus among economists is that Global GDP Growth will slow from 6% in 2021 to somewhere between 4-5% in 2022, which remains a healthy figure by all accounts. We anticipate inflation to ease over the first half of the year and settle at a slightly higher figure than seen in the last decade. Consequently, we expect modest rises in interest rates but are of the view that they will remain well below long term averages. The single biggest risk to economic growth and consequently investment returns come from when and where inflation will ultimately settle and the policy response to it.

Strong growth and a relatively high inflation environment bode well for Equities, and it looks set to deliver another year of positive and above average returns, albeit at lower levels compared to 2021. In an inflationary environment, companies that have pricing power tend to do well, as do commodities and materials, and companies dealing in them. Gold and inflation linked government bonds can also provide a hedge during times of volatility. Cash unfortunately is the asset class that suffers most at the hands of inflation and whilst it provides important liquidity when financial markets are volatile, holding on to excessive cash is a sure-fire way of losing value in real terms. The asset managers we work very closely with continue to share many of our views and take these into account when constructing and managing bespoke investment portfolios for our clients. We couldn't possibly end this note without yet again reminding our clients of the two most important factors when it comes to investing, diversification and time in the market.

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