Investment*Update*

17 December 2021

This year was remarkable; so is the range of possible outcomes for the next one

It's been a stellar year for profits: 2021 is on track for a 52% rise in average global earnings. Some of this was anticipated a year ago, a function of the rebound from 2020's annus horribilis. Much of it was not: in December 2020 consensus estimates were for 2021 profit growth of a 'mere' 26%. Commentators that spent last Christmas fretting about the baton-pass from "hope" to "growth" – from a market buoyed on generous and loose fiscal and monetary policy and the prospect of mass vaccination to one driven higher by real earnings – were wrong. We didn't anticipate how strong profits would turn out to be, but we are glad that we became more bullish then as we saw the risks diminish.

The big worry for 2022 is the potential trade-off between growth and inflation, for a corollary of 2021's growth bonanza has been steeply rising prices. US inflation has reached a three-decade high and there is an unusually wide fan of possible outcomes from here for investors to be alert to. The new, highly mutated Omicron strain of COVID-19 adds to the uncertainty. We end the year placing a higher premium on earnings visibility, global sector leaders and investments underpinned by structural themes for which the ebb and flow of the business cycle is therefore a little less relevant.

Still, surveys of business confidence are strong, the labour market is booming, household balance sheets are in rude health, and corporate cash piles are precipitous (especially in the UK). Global fund managers are holding an unusual amount of cash too, and the risk of chokingly high borrowing costs is low. In other words, we believe that the risk of a recession is low and that means so is the risk of a bear market. Meanwhile, markets already reflect a reasonable amount of pessimism and consensus profit expectations for 2022 are beatable if economic growth remains above average, which we and the consensus expect. We expect equity returns to moderate, but not to disappoint investors.

A year to remember: growth

Before discussing the outlook for 2022, it is worth looking back a little more at 2021; we believe that there were quite a few remarkable developments that will make it a year that lasts longer in investors' memories than most.

Facilitated by ground-breaking vaccination programmes, we experienced the sharpest economic 'V' since modern records began: a staggeringly deep recession followed by a staggeringly rapid recovery in global GDP within just five quarters. The vast majority of economists had to revise up their 2021 forecasts in the first half of the year, particularly for the hardest hit countries in Europe, such as the UK. The astonishingly strong profit growth detailed above, despite rising input costs, was driven by the surprise boom in growth.

However, consumer behaviour, and therefore the composition of the recovery, has been highly unusual. Consumer spending on services, which typically recovers very quickly (in the three previous recessions it barely contracted in the first place), is still below water today. Meanwhile, consumer spending on goods, which typically lags, recovered after just three months and is now c.15% above pre-pandemic levels.

This meant that many companies touted as so-called COVID recovery stocks, such as airlines and cruise operators, underperformed in 2021. Although there are some diamonds in the rough, many of these companies have quantifiably low-quality business models and/or balance sheets, a factor that only tends to outperform in the very early stages of an economic cycle, which we are long past. This time last year we saw danger in seeking out companies lacking structural or fundamental drivers with investment cases solely reliant on the COVID recovery. We see the same today.

A year to remember: inflation

The unusual composition of the recovery is a major reason why 2021 will also be remembered for the year inflation spiked to its highest level since the early 1990s, despite wage growth and medium-term inflation expectations staying relatively contained. This caught investors by surprise: HM Treasury's panel of forecasters thought a year ago that inflation would end 2021 at 2%; economists worldwide surveyed by Bloomberg thought US inflation would be 2%. UK CPI inflation was 5.1% in November 2021, 6.9% in the US. We didn't start the year envisaging this either, but we noted the building risks in the summer, when market-based measures of inflation expectations were suggesting a fairly rapid fade. In hindsight our above-consensus inflation forecasts were still a little timid.

In part, the surge has been about fuel prices as they responded to economic activity recovering so quickly: energy has accounted for c.60% of the rebound in advanced economy inflation in 2021. Overall, excess inflation is primarily about the unusual composition of spending. Consumer goods inflation rose in line with spending on goods. Demand here has fallen sharply, and it is difficult to see how consumer goods inflation could stay elevated for too long without the demand. Meanwhile services prices, for the most part, didn't fall with demand in 2020. But services prices are also likely to remain sticky as demand recovers. In other words, high inflation in consumer goods is unlikely to fully pass over to high inflation in services as spending normalises.

A year to remember: interest rates
Despite surging inflation, long-term bond yields remained relatively low. The yield on the 10-year US Treasury has risen by less than half a percentage point year-to-date; the 10-year gilt yield has risen by less still. In fact, bond yields have risen by less than what most strategists predicted when they had no idea inflation would spike the way it did. And that's something else that investors might remember 2021 for: monetary policy and financial conditions, as well as underlying structural forces, are much more important for asset prices than the short-term contortions in economic conditions.

The main threat from inflation is the negative impact monetary tightening could have on asset valuations as central banks try to combat it. Corporate profit growth, in aggregate, rarely fails to exceed the rate of inflation over the long term (even in the 70s and 80s). As central bankers remained calm, so too did bond yields. Longer-maturity bonds also remained subdued as the structural forces which have driven real (inflation-adjusted) interest rates over the last forty years remain in place (e.g. rising income inequality and excess savings, falling growth and productivity, etc.).

A year to remember: China
Turning to emerging markets, 2021 will be remembered for the year Xi Jinping completed the transition from consensual to personal rule in China. The 14th Five-Year Plan and various articles in the state-owned media made clear what we had been gleaning from the official rhetoric for a couple of years: President Xi wants to intervene much more in the allocation of capital, holding back the services and property sectors to leave more resource for high-tech manufacturing. This doesn't make China uninvestible, but it does introduce greater uncertainty around future profits and requires greater compensation for political and regulatory risk. As we end the year with the usual important policy conferences, we note that the rhetoric has softened a touch, particularly on lending and the property sector, which should support growth in the second half of 2022.

A year to remember: ESG
2021 will also be remembered as the year the investment management community finally started walking the talk on environmental, social and governance (ESG) factors. In the 2019 vintage of the biennial BNP Paribas ESG Global Survey 0% of the respondents envisaged 75% or more of their portfolios integrating ESG by 2021. Yet in the 2021 survey 22% had integrated ESG into at least 75% of their portfolios, and a further 34% believe they will in the next two years. We're very much in this camp, integrating material ESG risks into our direct equity, bond and fund manager research. We do this not because of any moral imperative – most of our clients do not instruct us to act this way on their behalf – but because the evidence suggests that many ESG factors are material to companies cost of and return on capital. We are particularly proud of our award-winning work in engagement with the companies we invest in and we look forward to sharing more details of this work in 2022.

The alpha and the Omicron
Our core assumptions for the year ahead could be rendered moot by question marks around the severity of the Omicron variant. It isn't yet clear if Omicron is more transmissible than Delta, nor if it results in more severe disease (although a South African study of 78,000 cases gives tentative hope).

It does appear to be at least partially vaccine-resistant, and therefore may have moved the target to be considered fully vaccinated to three doses. The UK leads the field and has given 30% of the population a third jab, but most other G20 economies are far short of that. The politicization of vaccine hesitancy has also left some countries unlikely to achieve herd immunity via this route.

Thankfully, vaccines aren't the only defence anymore. The anti-viral Molnupiravir pill has been shown to reduce the risk of hospitalization by 30%, and the similar Paxlovid pill looks to be even more effective. Assuming regulatory approval, by next year a combined 11.7 million courses of treatment are due to have been delivered to the US. For comparison, there were about 2 million COVID-related hospitalisations in the US in 2021. Nearly 100 developing countries have also been granted permission to produce more locally.

The government restrictions introduced so far won't severely impede economic activity. High frequency data, such as restaurant bookings, have dipped, suggesting people may be curtailing spending on social activities. But over the past two years the impact on GDP from people regulating their own behaviours wasn't huge. Still, it could delay the normalisation of inflation (as discussed above). In turn, this raises the risk that central banks may offer less support. Of course, greater disruption is possible, or a more transmissible but less severe variant could outcompete Delta and lead to a faster normalisation of spending, more stable growth and lower inflation.

At this stage, the discovery of the new strain simply adds to the unusually broad spread of possible inflation, interest rate and profit outcomes that

caused us to take a slightly more neutral stance in the autumn.

The year ahead: growth
Prior to the latest wave of infection, investor forums were ululating with the word stagflation. Inflation is plentiful, of course, but we find very little meaningful evidence of economic stagnation. The PMI surveys of business confidence – an excellent three to four-month leading indicator of growth – are at a level consistent with good economic growth, and decent profit growth. Japan's services PMI has risen above the 50 growth/stagnation line for the first time since the beginning of the pandemic. The Eurozone composite PMI (combining manufacturing and services) has moderated, but is still at a level associated with continued profit growth. An equivalent US survey of service sector firms reached a record high in November. Rathbones' proprietary leading economic indicator, which tells us what global GDP growth is likely to do over the next four months, painted a similar picture: the post-lockdown rush is behind us and growth is moderating, but it is still likely to remain above average in 2022. This is useful as global GDP correlates very strongly with global earnings.

For sure, as we set out last quarter, the expansion has entered a more challenging phase. Risks posed by the uncertainty around supply chains, inflation, bond yields and now Omicron must be navigated. But profit forecasts have already been reined back hard: earnings per share are expected to barely grow between September 2021 and March 2022. Full year earnings forecasts have decoupled from the economic outlook, and are below the growth rates consistent with average GDP growth. Investor sentiment has also taken a knock: Goldman Sachs' aggregate sentiment measure has fallen below the 50th percentile for the first time since the pandemic, again decoupling from the macro data, with which it usually correlates.

The second half of the year could be challenging as past changes in borrowing costs, which feed through with a lag, could start to hinder both economic and profit growth. But the first half of the year is likely to prove more fruitful if the reaction to Omicron doesn't become more stringent.

The year ahead: inflation and monetary policy
While inflation has been driven primarily by some extreme movements in around a quarter of the items in the inflation basket, stickier measures of inflation have risen sharply over the last three months too, suggesting inflation pressures have broadened. The outlook for inflation is therefore highly uncertain, and we believe that building a certain degree of inflation resilience into security selection is still important.

Our base case is for global inflation to fade meaningfully from the spring, but to remain elevated. Base effects, such as the recovery in hotel prices, will fade as we move on from the anniversary of their trough. Energy prices should ease as the supply of crude oil starts to outstrip demand. Some bottlenecks in the supply of microchips, freight and energy have non-COVID drivers and judging how long they are likely to linger is very difficult. But shipping costs have been receding on several key routes (the Freightos Global Index is lower than it has been since July). Other supply chain pinch points are also showing signs of easing, such as increased Asian chip production.

Moreover, technology has kept core goods inflation below zero for most of the last decade. The price of televisions may be up 10% over the last year, but over the last 10 years annual TV inflation has averaged -16%. Technology can still be used to make things more efficiently at a lower cost, and more normal patterns of goods inflation should reassert themselves over the medium term. But, again, in the short term there is still considerable uncertainty, and much depends on a resumption of normal spending patterns, which could be stalled by Omicron. If school closures result, a drop in labour force participation could antagonise wage inflation, which our analysis suggests is benign at present.

Central bankers have been clear that there is little they can do to stem the unique causes of today's inflation, but that they are more mindful to tighten policy as output and employment is strong. Rising rates would ordinarily be a headwind to valuations, but markets are already pricing for a substantial number of rate hikes (two to three in the US, three to four more in the UK and even, incredibly, one in the Eurozone). Both the Bank of England and the US Federal Reserve made surprisingly hawkish policy changes at their December meetings and both bond and equity markets were unperturbed.

Historically, equities have tended to rally strongly as we approach the first hike of the cycle, but unprofitable companies commanding large valuations are at risk (indeed they have already generally fallen by about a third this year). Profitable technology companies, however, need not be avoided. We have written before about how we do not see markers consistent with historic "bubbles". Even if bond yields were to rise relatively sharply, their valuations would still be relatively attractive. For now, given their pricing power and earnings visibility, we expect these so-called "all-weather winners" to continue trading at a premium. But if Omicron and supply disruption eases while inflation and growth remain elevated, we expect other sectors, particularly outside of the US, to come back to the fore.

The degree of uncertainty means any outlook for the year ahead should be taken with more than the usual pinch of salt. While we are confident that the recovery is strong enough that none of the risks from these uncertainties are likely to choke it off, a focus on companies with visible and durable earnings growth is warranted.

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