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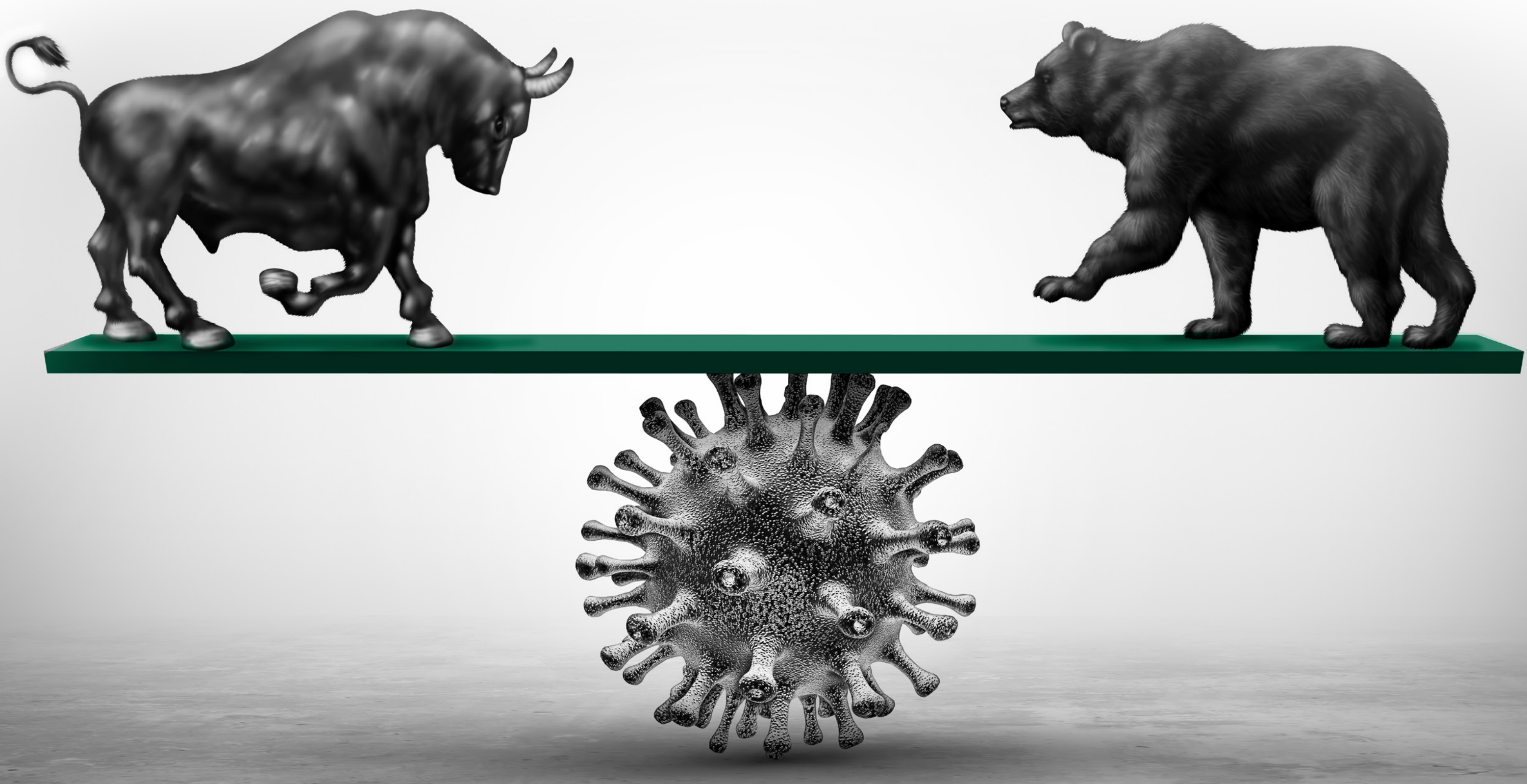
MARKET OUTLOOK 2022



The Pains of Normalization

By and large, 2021 turned out as we expected a year ago, ending with the first steps of policy normalization taken by the US Federal Reserve. For 2022, we expect this process to continue although its path will be uneven at best, not least, since the pandemic and its consequences prove to be more persistent.

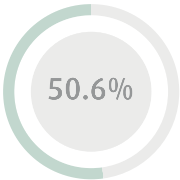
- Global growth should remain robust as post-pandemic recovery gives way to a new period of expansion
- Monetary policy will become more divergent with the Fed embarking on a gradual tightening
- Most asset classes will face material, yet not unsurmountable headwinds in the form of high valuations and reduced liquidity

2021 in review performance of major asset classes

Market index		Year-to-date
MSCI All Countries World	USD	16.3%
MSCI World	USD	19.3%
S&P 500	USD	26.0%
EuroStoxx 50	EUR	19.5%
FTSE 100	GBP	16.2%
Swiss Market Index	CHF	22.3%
Nikkei 225	JPY	5.3%
MSCI Emerging Markets	USD	-3.3%
China - CSI 300	USD	0.8%
India - SENSEX	INR	22.5%
Pakistan - KSE-100	PKR	0.5%
USD Investment grade	USD	-1.4%
US Treasury	USD	-2.0%
US Investment grade	USD	-0.9%
US High yield	USD	4.7%
Emerging Market Sov USD	USD	-2.8%
Gold	USD	-4.5%
Oil (Brent)	USD	46.8%
USD (trade weighted)	USD	6.7%
EUR	1.133	-7.3%
GBP	1.333	-2.4%
CHF	0.918	-3.6%

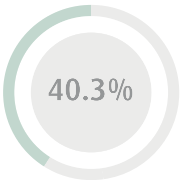
Source: Bloomberg as of 17 December 2021

Recommended portfolio allocation for 2022
(positioning of USD global balanced discretionary mandate)



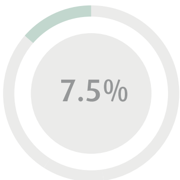
EQUITY

Region/Sector	Allocation
US	27.6%
Europe	8.2%
Japan	1.0%
EM	6.2%
Global	7.6%



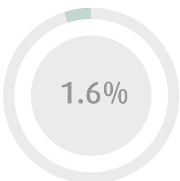
FIXED INCOME

Region/Sector	Allocation
Treasury/ABS	14.8%
Investment Grade	3.4%
Subordinated Bonds	7.1%
High Yield	4.0%
Emerging Markets	11.0%



ALTERNATIVES

Region/Sector	Allocation
Gold	2.0%
Hedge Funds	5.5%



LIQUIDITY

Region/Sector	Allocation
Cash	1.6%

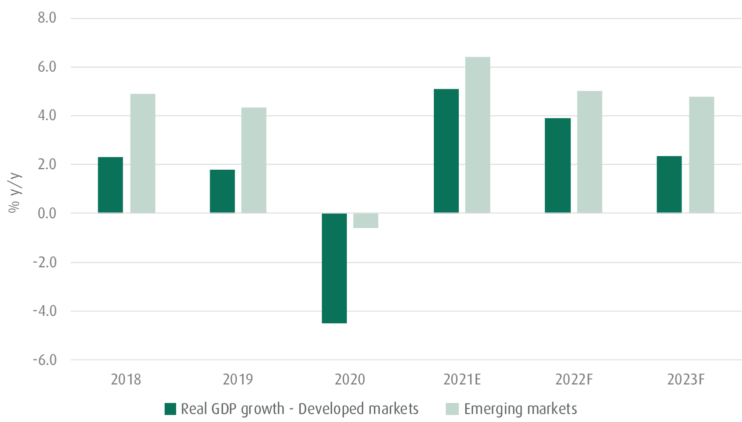
Our base case scenario: Robust but uneven growth

The uneven global recovery following the first onslaught of the pandemic continued in 2021 and there are no clear indications of a break in this pattern for 2022. Although the Omicron variant of COVID-19 as well as persistent inflation have complicated the picture, underlying fundamentals still point to robust, yet again uneven rates of expansion.

Driver	Comment	Trend	Risk Implications		
			on	neutral	off
Global GDP growth	Global growth to remain robust despite uneven trends	→	•		
Global inflation	Inflationary pressure to last into mid-2022 before abating	↗			•
Global policy rates	Only very gradual removal of monetary accommodation	→		•	
Global liquidity	Ample liquidity despite impending Fed QE reduction	→		•	
USD trade-weighted	USD with limited downside on US growth, Fed policy	→		•	

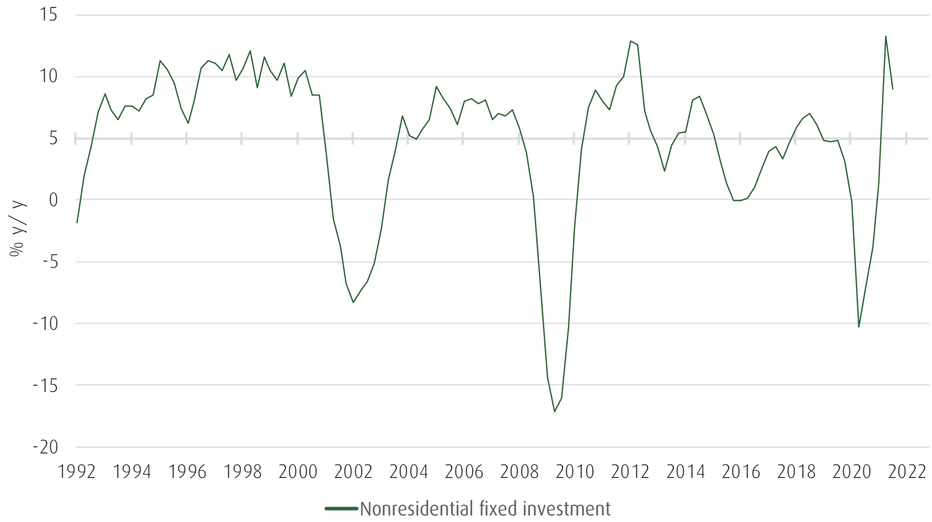
Pentup consumer demand will be an important driver in many economies as will accelerated investment to meet this demand. Much will depend on reduce tensions in global supply chains and whether early signs of improvement will be confirmed. Moderately tighter monetary policy should not be a problem for the real economy but will sustain volatility in financial markets. The pandemic highlighted old and new faulty lines and the challenges to a US-centric global order will continue.

Global: Robust growth in 2022 and beyond



Source: Bloomberg, HBZ

US: New investment cycle in the making



Source: Bloomberg, HBZ

While high inflation readings currently dominate the headlines – with some justification, of course - US activity indicators have been robust for some time and, based on leadings indicators such as the ISM surveys, are poised to remain so well into 2022.

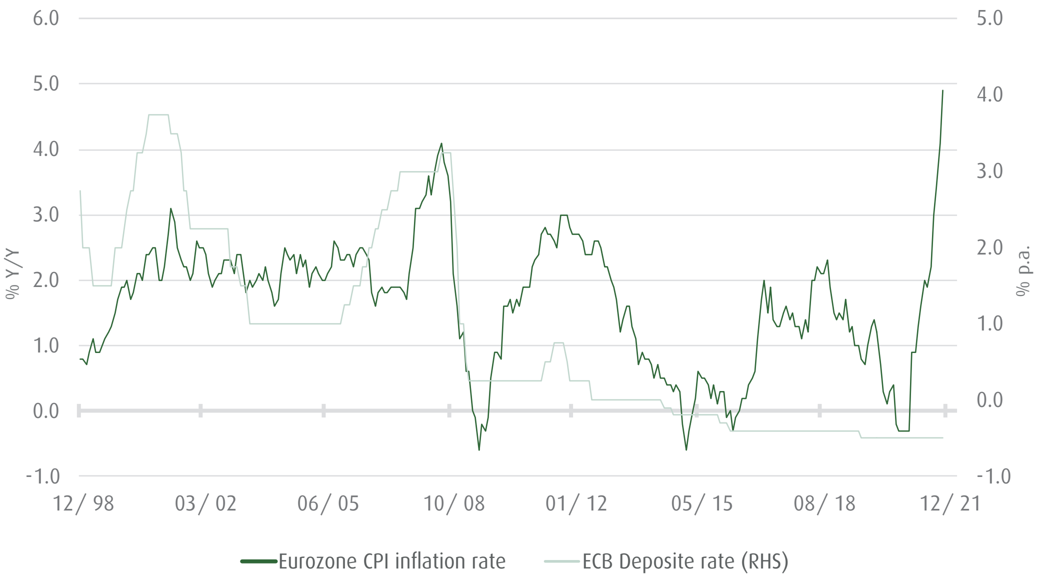
Supply chain issues will further ease, inventories need to be rebuilt and deferred demand satisfied, all of which support strong activity levels and sustained high corporate profits. With high savings rates among consumers, only a moderately negative fiscal impulse together with decent job growth round out the constructive backdrop. Inflation will peak probably mid-year but the **Fed has already communicate its determination to remove monetary accommodation and start tightening policy.** From late spring onwards up to three 25-bps rate hikes appear possible. By then, asset purchases will have ended, but the Fed is unlikely to start shrinking the balance sheet and hence the economy will remain amply supplied with liquidity. As the year will progress, the mid-term elections will move increasingly into focus. Judging from the mood in the country, the mixed performance of the Biden administration and a bias against incumbents, it looks likely for the Republicans to regain the House. This prospect alone will moderate the president's zeal to raise taxes which again will support the economy. With its unfavorable population structure, Europe was bound to suffer disproportionally from the pandemic. As was the case with previous waves, the current fifth one and the arrival of the new variant will again be a set-back for the recovery process.

With its unfavorable population structure, Europe was bound to suffer disproportionally from the pandemic. As was the case with previous waves, the current fifth one and the arrival of the new variant will again be a set-back for the recovery process.

But like in the US, underlying European economic indicators are strong which will allow for robust growth throughout 2022.

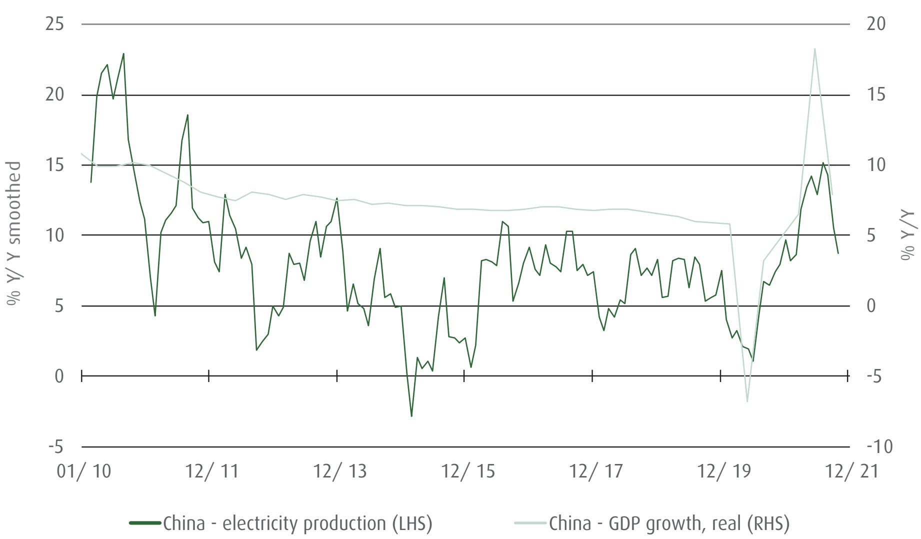
The ECB will be in no position to tighten policy in a meaningful way. It will continue to focus on fostering growth in tandem with other EU initiatives such as the EU Recovery Fund. The situation for the UK is even more complicated. The country has yet to settle its relations with the EU and faces inflation risks which cannot be solved easily even by tighter Bank of England policy.

Eurozone ECB unlikely to respond to spiking inflation



Source: Bloomberg, HBZ

EM: How low can Chinese growth go?



Source: Bloomberg, HBZ

In 2022, China's growth will moderate from the high rate expected for 2021 as measures adopted to rein in excessive leverage in the country's property sector will drag down overall activity.

With high levels of indebtedness across most sectors of the economy, policy makers will have limited room to deploy fiscal and monetary measures to shore up growth. Moreover, growth will have to compete with other policy priorities such as income distribution. The Communist Party's efforts to reassert its control over all matters of life, which featured so prominently in many recent government actions, will also continue and with limited concern about their near- and longer-term economic impact. Politics will dominate events, not least since the upcoming 20th Party Congress is set to extend the current leader's tenure for a third and potential unlimited term. Finally, the radical measures to deal with the pandemic will be tested as they have contributed to disruptions in local and global supply chains; they could be eased once the Winter Olympics are over, which the government wants to proceed without negative headlines.

Lower Chinese growth will invariably affect the rest of the world, but even at 5%, it will make an outsized contribution to global growth and impact in particular emerging-market growth positively. **In aggregate, EM economies will once again outperform their advanced peers. However, with multiple local factors at play, there will again be a large dispersion in outcomes:** many economies have already tightened monetary policy in the face of fast rising prices while all have to contend with a strong dollar, higher US interest rates and challenges related to the ongoing pandemic. Among the large EM economies other than China, India – thanks to a pick-up of investments – and to a lesser extent Russia appear well positioned to enjoy robust growth as is Emerging Asia with its large pools of consumers and strong trends in capital spending. For many highly indebted nations the pain will continue, while others such as Turkey may crack under the weight of idiosyncratic macro policies. Oil producers should benefit from sustainably high prices but will also maintain their efforts to diversify their economies.

Our Risk Scenario: Sustained inflation and more aggressive monetary tightening

For another year, risk scenarios will be skewed to the downside with excessive monetary tightening by the US Federal Reserve in response to inflation as the biggest potential negative event.

While there may be some structural reasons behind the higher inflation prints (e.g. rising home prices, higher wages due to a declining workforce), the key causes are supply shocks related to the pandemic limited in time. As a result, inflation is bound to roll-over from mid-year onwards. Other, less likely risk scenarios include one of **stagflation** in which persistent inflation meets a sharp fall in activity, or a much more **pronounced slowdown of China's economy** due to the limited ability to stimulate growth. These events, individually or in combination, would amount to a serious storm leaving markets exposed to a broad-based retrenchment.

Theme/topic	Comment	Risk Implications		
		on	neutral	off
Growth/Inflation	Entrenched higher inflation			●
Global liquidity	Accelerated reduction of global liquidity			●
Growth/earnings	Sustained negative impact of supply-chan disruptions			●
Political risk	US relations with China, China regulatory action, intra-EU tensions			●

Investment Implications:
Favoring real over nominal assets

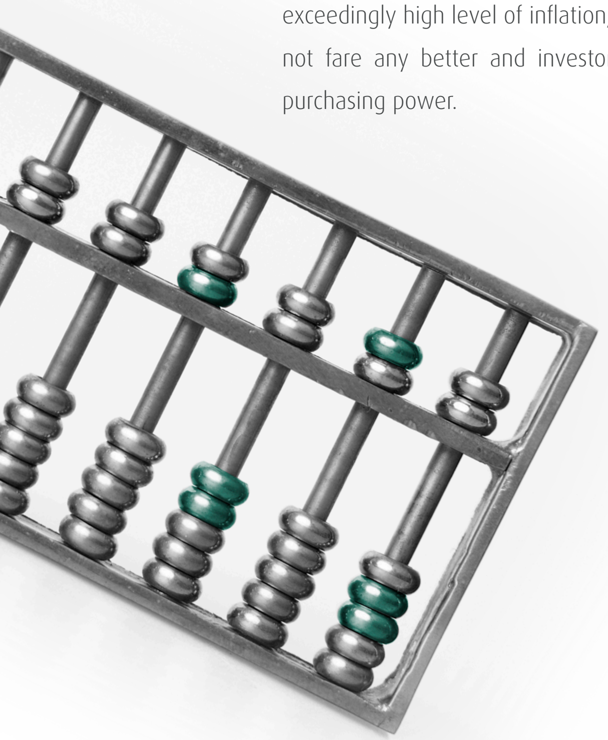
Investors just lived through another eventful year. On the positive side stand the resilience of growth in many economies despite the ongoing limits imposed by the pandemic and the remarkable recovery of corporate earnings. On the negative side, the continued underperformance of most EM assets figures most prominently, largely due to heavy-handed Chinese regulatory actions and widespread macro vulnerabilities.

Driver	Comment	Trend	Risk Implications		
			on	neutral	off
Equity valuations	High valuations tempered by strong earnings	→			•
Equity earnings	Earnings recovery to continue but growth to moderate	→		•	
Credit spreads	Search-for-yield to keep spreads low	→		•	

The challenges facing markets today will remain in place in 2022 including rich valuations across most asset classes and high levels of uncertainty due to the pandemic and its consequences.

Two factors argue, however, for overall positive, if volatile markets: robust growth and corporate earnings power. In a world of generalized negative real rates (interest rates well below inflation), the case for real assets including equities is overwhelming although the implementation is not less obvious and may require investors moving from liquid public markets into illiquid private markets.

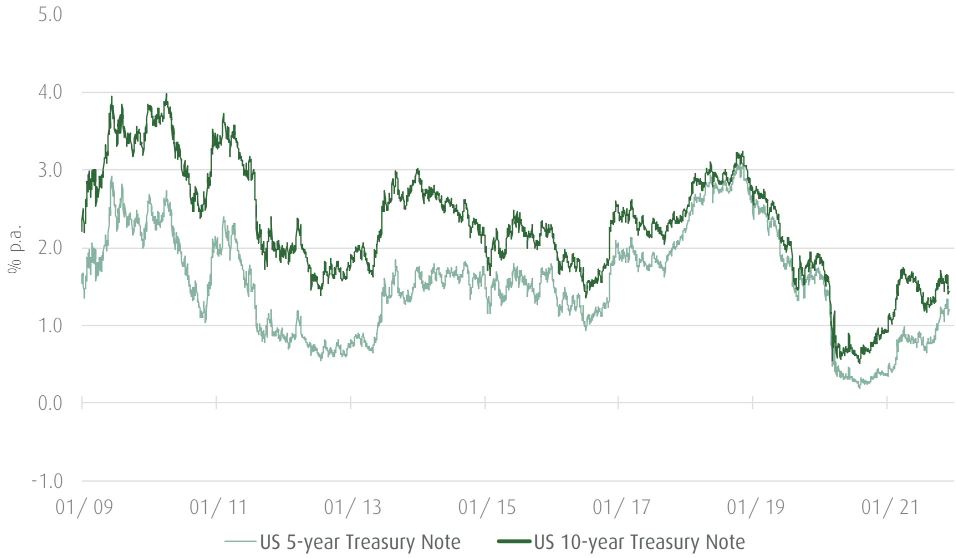
Were any of the risk scenarios outlined above are to materialize, market outcomes would be decidedly less benign and could lead in the worst case to a global bear market in equities, either due to a sharp fall in growth or exceedingly high level of inflation, both of which are obvious poisons for richly-valued stocks. Nominal assets would not fare any better and investors would need to rush into cash to protect principal although not necessarily purchasing power.



Fixed Income: Favor credit spread over duration

For fixed-income investors, 2021 was a challenging year even though returns in some sectors were better than a cursory glance as broad benchmark indices would suggest. Some of these market sectors, e.g. subordinated bonds, insurance-linked assets, and direct lending, will continue to deliver attractive returns, provided of course our core scenario holds. As rates and yields are expected to move higher under most scenarios, **below-average duration exposure remains warranted.** At any rate, investors should brace themselves for moderate returns at best. Even at current rock-bottom levels and given expected low default rates, **credit spreads offer, however, both a buffer against higher yields and a source of return.** Thus, senior loans, EM corporate bonds but also absolute return strategies should be part of diversified portfolios. US and other G7 sovereign bonds are bound to underperform, but as the spring of 2020 and more recent phases of market weakness showed, they continue to act as safe-haven assets during periods of stress and hence will continue to play a role in portfolios.

Bonds: Room for US yields to move higher



Source: Bloomberg, HBZ

Equities: Priced to perfection with little room for error

Source: Bloomberg, HBZ

Equities: diversified exposure including alternative strategies

Under normal circumstances, our core scenario would translate into an outright overweight recommendation for stocks, but **these are not normal times.** While growth and earnings will be robust for another year, markets have already anticipated much of the good news and lifted valuation decidedly into rich territory. Moreover, over the past years, markets were propelled upwards by growth stocks which benefited from very low yields; higher yields will invariably require some repricing. Finally, much of the performance since March 2020 can be attributed to a torrent of central bank liquidity. Gradually lower levels of liquidity will create additional risks for highly-valued markets.

What are the conclusions for 2022? **To avoid high valuation, diversify into cheaper markets** such as Europe and Japan as well as EM equities.

In order to reduce sensitivity to higher rates, prefer cyclical sectors such as energy and financials and lower-valued sectors such as health care. To deal with high valuations and the extreme concentration in the US market (the top ten stocks represent some 30% of the total S&P 500), use equal-weighted instruments.

This will also provide a bias to smaller market caps which are expected to outperform over the longer term. Ultimately, investors need to allocate to **hedge-fund strategies** which can offer better risk-adjusted returns in volatile markets as well as **private equity** where investors trade liquidity for superior long-term returns.

Currencies & Commodities:
Resilient USD and upside potential for commodities

A year ago, expectations of a broad-based global recovery suggested a weaker US dollar in a more risk-friendly environment. It did not turn out this way, not because of a lack of growth but because of a series of factors which simply benefited the USD. Many of these factors remain in place today and continue to argue for a resilient US dollar in 2022. For one, relative monetary policy matters and here the US Fed leads almost all G10 central banks. Concerns about rising inflation and macro stability hit many EM crosses and only a handful beat the USD, most notably the CNY. This picture too remains largely unchanged foreboding another challenging year for many EM currencies.

Commodities tend to be in favor when inflation rears its head and 2021 was no different. For the coming year, a repeat of this strong performance will depend on whether inflation will peak by mid-year or not and, not less importantly, whether China's demand will hold up. After all, China consumes 50% or more of many industrial and soft commodities. Lower activity in the property sector could represent a challenge for the likes of iron and copper.

Energy (oil and gas in particular) appears a better place to look for returns in the commodity space.

Supply is relatively tight as investment has lagged consumption for many years and the inevitable transition to a clean energy future will proceed in stages favoring first cleaner fossil fuels over dirty coal. Finally, **gold continues to function as a portfolio diversifier and a hedge against unexpected USD weakness, but returns will be modest** at best given that the US Fed has just started to remove some of its monetary accommodation.

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