Tatton
Investment Management

Tatton Outlook 2022

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Overview

In broad terms, we expect normalisation to be a key theme of 2022. For all the disappointments of this year's stop-start global recovery, no one can doubt that business and consumer sentiment – as well as general ease of living – improved substantially from the depths of the pandemic.

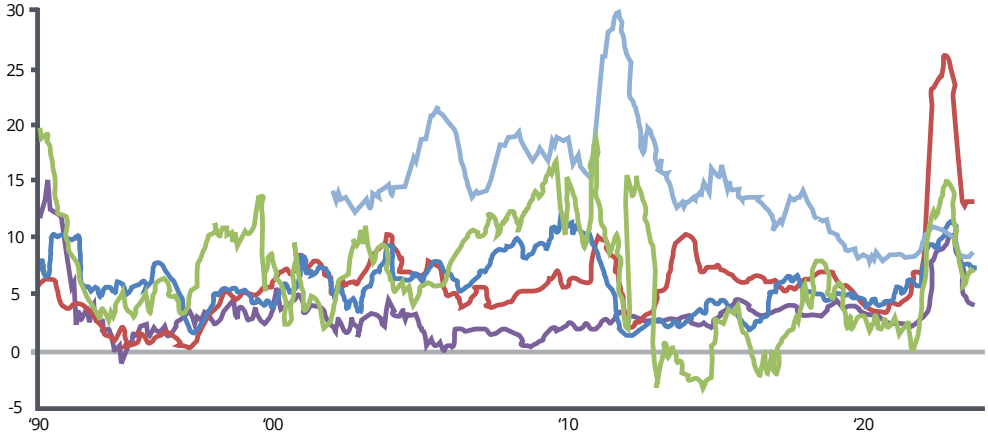
The bottom line is that, barring any further catastrophes, improvement should continue next year. We expect spending at the individual and corporate level to grow as movement of goods and people gets closer to pre-pandemic levels. Monetary policy is set to tighten along with the cyclical recovery, as the world's central bankers have already suggested.

Normalisation and recovery do not mean smooth sailing, however. The last few months have seen extreme supply shortages across the world, geopolitical tensions and, most recently, the emergence of a new, more infectious COVID variant. We discuss these in more depth below, but note they are all symptoms of a drawn-out recovery. These will take some time to filter through – and we expect supply constraints and Omicron-like scares to continue in the earlier parts of 2022.

For capital markets, teething problems could bite. Impressive returns over the last 21 months pushed up equity valuations substantially. Recovery growth has brought them down in the last quarter, and growth is expected to make good on those valuations eventually. Still, optimism is 'priced in' for many assets. Bad news could therefore shake market confidence, and with emergency policy support set to wind down, that could create volatility in the coming months.

MAJOR MONETARY GROWTH

Local currency, year-on-year % change



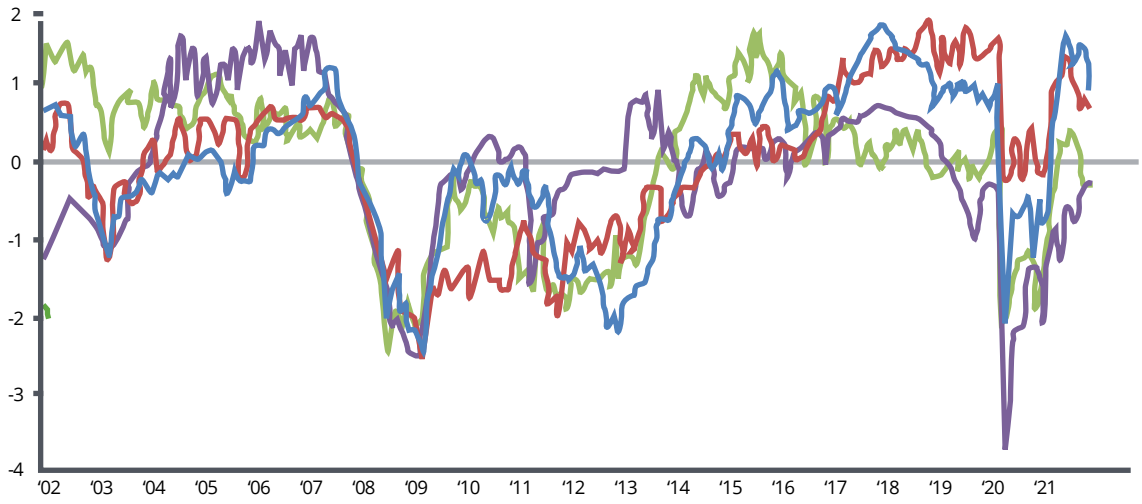
Source: Factset, Tatton IM, Central Banks US M2 CHINA EURO UK JAPAN

Ultimately, we are still waiting for the self-sustained portion of the recovery – when central policy support gets replaced by business and consumer confidence, and the economy can run on its own steam. Once that happens, it should restart the cyclical rotation in markets – pushing investors away from the COVID superstars (such as big tech) and into those assets and regions most attuned to global growth.

This should benefit equities and commodities, with the latter also helped by the acceleration towards green infrastructure. It is a negative for bond values, which are likely to be weighed down by the withdrawal of monetary support. A resurgence of damaging COVID infections and further restrictions would clearly be bad for any growth prospects. Strangely though, some have suggested that Omicron could turn out to be good news. If the early (and uncertain) reports that the strain is more contagious but less severe turn out to be true, it could mark a natural end to the pandemic. For our central case, the cycle will continue next year regardless, but we remain selective in where we think will benefit.

CONSUMER CONFIDENCE - MAJOR NATIONS

Normalised z-scores



Source: Tatton IM, Factset, Eurostat, Gfk, US Conference Board, Japan National Agency

US EUROZONE UK JAPAN

2021 Wrap-up

Below, we give a brief wrap-up of 2021, before outlining our expectations through a regional and sectoral breakdown.

This year saw the fastest global vaccination programme in history, record growth figures and the highest inflation numbers in decades. At the same time, the global economic recovery spluttered and stalled at key moments, growth was uneven across the world, and new coronavirus outbreaks kept us in the COVID scare spiral. Pandemic woes continued to dissipate in capital markets and the global economy, but the transition ultimately proved more painful than anticipated. Supply chain problems were keenly felt in the second half of the year, while the surging Omicron variant reminded us that things can quickly take a bad turn.

A year ago, we warned equity markets might struggle to replicate their 2020 performance – even if growth proved strong. But we also thought that the median GDP forecast was too cautious (putting 2021's global GDP below 2019's) and that sustained monetary support gave markets space to capitalise on positive surprises. As it turned out, global output reached 2019's level (on an annualised basis) by mid-year, while equity markets climbed higher. In dollar terms, the S&P 500 is now worth double what it was at its lowest point in March 2020.

The first quarter was a classic cyclical rally in equities, combined with rise in government bond yields (or conversely, a fall in bond prices). Q2 was better for bonds – after investors became convinced that monetary stimulus would not be taken away – but cyclical stocks and wider equity markets still benefitted. Returning confidence allowed consumers to release the impressive savings built up during the months of emergency fiscal support.

The second half was a different story. Optimism waned after another wave of COVID cases and worldwide supply shortages. US company profits remained strong in Q3 though, leading to yet more outperformance by American stocks. Just like earlier in the pandemic, the big winners were the Silicon Valley tech giants. US stock indices subsequently did extremely well, though the performance was much worse for equal-weighted baskets (with less exposure to big tech).

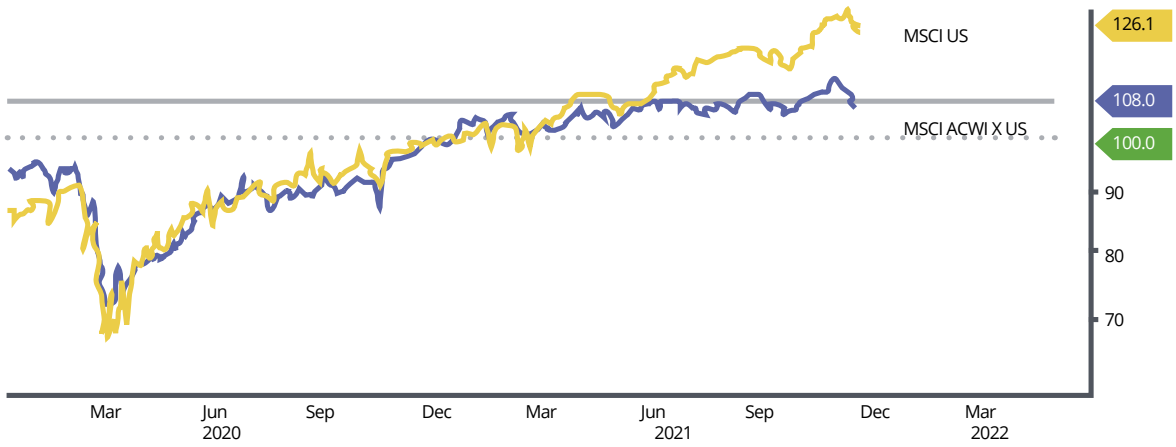
High savings and healthy pension pots led many workers to hold off for better jobs or retire altogether, in what has been called "the great resignation"

Supply shortages were a huge part of the problem. Fragile supply chains and a host of one-off issues meant factories struggled for materials. Issues were compounded by a shortage of workers – as we vividly saw during the UK's fuel crisis. High savings and healthy pension pots led many workers to hold off for better jobs or retire altogether, in what has been called "the great resignation". Labour participation therefore remained subdued, despite falling unemployment.

All of this pushed global inflation to its highest level in decades. But for the most part, central bankers were determined to keep monetary policy loose. Policymakers calling inflation "transitory" was itself a reason why high inflation expectations became entrenched in the latter months of the year. A year ago, we were worried central bankers might make a policy mistake by tapering asset purchases or raising interest rates too soon. Now, those fears have reversed: markets are concerned policymakers will allow inflation to become destabilising. The US Federal Reserve (Fed), among others, has acknowledged that fear and moved forward its tapering timetable.

MSCI NET TOTAL RETURNS INDICES

US and the rest of the world



Source: Bloomberg, Tatton IM, MSCI:G98
MXWDU Index (MSCI ACWI Excluding United States Index) MSCI ACWI Daily Dec2019-06Dec2021

US

The US has led the way in both economic growth and stock market returns throughout the COVID recovery, although if the global growth story continues as we expect it to, this outperformance will naturally have to moderate. US asset prices have gained such a lead on their global peers it is hard not to see them as comparatively expensive. A rise in real (inflation-adjusted) interest rates would likely make this disparity more apparent for markets – causing a rotation into emerging markets or Europe.

None of this makes us negative on the US. The road to recovery is still full of perils that could send investors back to the world's largest economy – particularly if central bank liquidity dries up. In any case, US companies have enough exposure to global growth that many will benefit from a cyclical rotation. Should the recovery go ahead as planned, the outperformance of companies like the US tech giants will likely come down. Both economic output and stock market returns would, therefore, be more balanced.

Policy is still crucial to the outlook. The extraordinary support seen through the pandemic will have to wind down eventually, but the good news is that much of the fiscal stimulus agreed in the last two years is still to come. President Biden's $1 trillion infrastructure package will not begin until later in 2022, while the yet-to-be-agreed $1.7 trillion 'Build Back Better' programme will not gain full traction until 2023. However, the child tax credit extension is a big positive and should offset some fears of a fiscal cliff-edge. The US mid-term elections next year increase the chance of political spats – which could prompt further budget crises or government shutdowns. And, climate change initiatives could stoke fears of another energy crisis, should supply constraints persist. Altogether though, continued fiscal support should help keep confidence high as savings fall – lowering the chances of a downturn.

More important for investors will be the actions of the Fed. Chair of the Fed, Jay Powell, sounded decidedly more hawkish in his December press conference, and suggested bond purchases may have to be tapered more quickly than announced in November. We should expect not only a quicker taper, but that the Fed will raise rates once it is no longer buying new bonds. This is likely to happen within the first half of 2022. The Fed still has flexibility on the rates side, as it has (rather unsuccessfully) attempted to disconnect the tapering decision from rate increases.

This is far from a sudden decision (the Fed has been telegraphing as much for months) and is unlikely to constitute a policy mistake. The danger is that markets misinterpret the removal of emergency support as a sign of future hawkishness. Powell tried to address this recently, when he spoke of retiring the word "transitory" due to the misunderstanding it creates. Although the Fed may well raise rates in the coming months, it is unlikely to allow real short-term rates to turn positive next year, or soon after. Judging from bond markets, the perception is that the Fed now sees 0% real rates as the natural base. As such, while US bond yields should rise with the cycle, they are unlikely to go too high unless ultra-high inflation expectations become embedded.

UK

At first glance, there is a decent investment case for UK assets. Equity valuations are lower than elsewhere, sterling weakness increases the attractiveness of British exports, fiscal spending is on the way and the government has room to deliver more. But ultimately, long-term problems weigh on investor sentiment and it is hard to see past them.

Brexit Britain is in a weak position on financial services (the economy's old ace card), job creation and labour supply – the latter highlighted by the scramble for hauliers earlier this year. These problems are not insurmountable, but policymakers repeatedly prove unable to work around them. The government did well to plug the income gap through the worst of the pandemic, and over the past two years has promised some exciting fiscal support and investment. Unfortunately, the Conservatives' ingrained desire for fiscal constraint has prevented the government from fiscal expansion comparable to the US or even Europe. This was highlighted in recent tax and spend plans, which promised additional funding but confirmed a heavier tax burden next Spring – even as living costs spiral.

Oddly, this hesitance is matched by the Bank of England (BoE). Despite providing a huge amount of monetary support over the last two years, policymakers still seem reluctant to commit to the level of stimulus their counterparts abroad have. Worse still, the BoE recently proved itself unreliable in communications when it reversed a rate hike decision at the last minute.

We suspect policymakers are worried about sterling becoming too weak and destabilising the economy. This is a fair concern, but protecting against it could be costly in terms of lost growth. Should the dollar weaken next year, this could ease the BoE's fears and unshackle policy somewhat. If so, it could help the UK market finally take advantage of its chronically low asset valuations.

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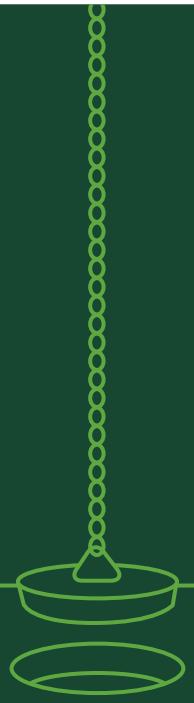

EU

The Eurozone is well-placed to take advantage of cyclical growth next year. Global growth is always a good thing for the export-heavy economy, and with lower asset valuations than the US, European equities stand to gain. Omicron scares have dampened sentiment and tightened restrictions, but it is too early to say whether these will have a long and detrimental impact.

Domestically, fiscal policy is likely to be supportive of growth. The Next Generation EU (NGEU) stimulus package allocates €750 billion to be spent between 2021 and 2023, meaning EU nations are set to receive substantial support (5% of total EU GDP) in the next two years. Half of the spending will be grants, rather than loans as in the past. More importantly, it will not be funded from tax rises in the near or medium-term, meaning that it will not constitute a tightening of fiscal policy next year. According to the European Central Bank, the NGEU could add 1.5% to real Eurozone GDP over the medium-term.

This would be a quicker expansion of fiscal policy than in the US, and could mean stronger real growth for next year. Europe has faced less inflation pressure than elsewhere (particularly Western Europe), but wages are running hot in some of the peripheral nations. The ECB has not followed other central banks in signalling tighter monetary policy (in terms of rising interest rates; the quantity of security buying is set to diminish, too) – but that could change next year if inflation pressures continue.

The caveat to this positivity, as usual, is politics. Throughout the pandemic we have seen how political obstinance can get in the way of productive fiscal policy on the continent. More recently, national interests and political differences have collided with the interests of the wider bloc – as in the case of Poland and Hungary. It would be no surprise if the same happened next year, but for the moment we see no sign of this becoming a significant problem.

China

China is another economy with decent growth prospects, subdued valuations and sensitivity to global growth that could do well in 2022.

However, the last few years have significantly increased the perception of risk in the world's second-largest economy – prompted by international confrontations and a series of significant interventions. The Communist Party has cancelled initial public offerings, tightened restrictions and made entire sectors legally unprofitable in 2021. Some western commentators have gone as far as saying that these actions have made the country "uninvestable". All of this is without mentioning the Evergrande crisis, which has been hyped as potentially becoming China's Lehman moment.

We think these labels are a little sensational. China's leadership has certainly switched its priorities from a purely growth-driven model to one that incorporates more centralised direction – and this is a key risk that needs to be recognised for any Chinese asset. But President Xi's centralisation of leadership and economic restructuring do not amount to a war on profit. Far from it – the Chinese government has worked extensively to ensure its private sector is profitable and sustainable. GDP growth and attracting foreign capital are clearly not the priorities they once were, but they are still important goals, nonetheless. Similarly with Evergrande, which the Party has allowed to fail but will certainly not allow to destabilise the wider economy.

Interestingly, China's fiscal attitude has been at odds with the rest of the world, and unlike its own previous behaviour. The 2008-9 and 2015-16 crises saw enormous boosts to spending. This year, both international and domestic commentators have been thoroughly surprised by the downright frugality of the Chinese authorities. This discipline has covered central and local government expenditure, central bank monetary policy and, most importantly, corporate regulation and oversight.

This has led to distinctly slow growth and poor equity performance, especially from China's large tech companies. The tightness impacted other Asian economies and led to serious underperformance by Chinese stocks through the year. Lately, the authorities have relented, though, and there are signs this will continue into next year. If so, China's 2022 outlook, especially in terms of surprises, has the potential to be better than 2021.

Emerging Markets

If the cyclical growth story goes according to plan, emerging markets (EMs) should benefit. But EMs unfortunately do not have the same room for manoeuvre as developed nations. Global vaccine inequality makes developing countries susceptible to COVID outbreaks, while tighter financing conditions (compared to developed nations) make it harder for governments to address the economic fallout. For most EMs, much remains outside of their control: a strong US dollar will hurt their prospects, while a weaker dollar and strong global growth sentiment will help their recovery prospects.

The factors that are in governments' control have concerned investors lately. Geopolitical tensions persist as ever, but flare-ups have caused capital flight – as in Turkey. Fear is contagious when it comes to EM investors, and if more Turkey-like problems surface it could well put a dampener on EM sentiment altogether.

Otherwise, it will mostly be a waiting game for EMs. The ingredients for a strong year are there, but optimism and capital is unlikely to flow until the Fed's tightening cycle is appropriately priced in. The good news for EM assets is that there is plenty of upside to be found, if and when that day comes.

Asset Classes

BONDS

With the recovery underway, and central banks starting to reel in support, there is not much upside for bond prices (the inverse of yields). Rising yields and tighter monetary conditions could also have a knock-on effect on other assets – causing bouts of volatility where liquidity is low.

In stark contrast to a year ago, investors are now worried central banks may be keeping conditions easy for too long. This is reflected in inflation expectations, which are rising according to survey data. This could force central banks into quicker action, but we note that other important inflation signs – inflation-linked borrowing – are not yet flashing. Positive real growth would allow central bankers to raise rates faster. Paradoxically, this could mean that good economic data might spark short-term liquidity crunches in the months ahead.

Even if policy tightens faster than expected, we suspect that the ceiling for near-term rate rises is historically low. Our research indicates that real yields, together with credit spreads, are more important than nominals in equity valuations. These are currently at historically negative levels, and central bankers will want them to (only) gradually increase as the world normalises. But they are unlikely to let them rise above the 0% level during the next year, with the focus being also on the speed of adjustment, and not just the absolute reading of real interest rates.

EQUITIES

Equities will benefit from a cyclical upswing, but not equally and not necessarily in a straight line. US mega-tech companies, including online sellers, have fared extremely well during the pandemic – partly because they are suited for the lockdown world and partly because of the pre-existing trend toward online business. How much consumer behaviour has changed permanently, and how much will return to pre-pandemic ways, is uncertain. In any case, the big tech winners are unlikely to fare as well through the next stage of the cycle as they have done.

Of course, this is dependent on the global recovery continuing as planned. Persistent supply chain problems – and new COVID variants – stand in the way of that, but the ingredients are all there for a cyclical rotation in 2022.

Rising real yields will put downward pressure on equity valuations. At the same time, central bankers will only allow real yields to rise if growth – and hence, profits – are strong. Ideally, this should mean there is enough positivity around to support stock markets even if the benchmark 'risk-free' rate changes. The flipside to this is that markets could get choppy in the months ahead if liquidity drops and we see bouts of bad news. We do not expect patches of volatility to be destabilising, but they could make things difficult in the short-term.

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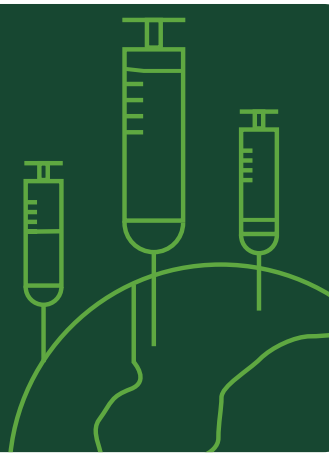

Demand for new housebuilding has been strong, however, and this is likely to continue. Not only are cyclical forces supportive for housebuilders, but there is a great deal of green construction needed,

COMMODITIES

Much like equities, we expect commodities to be supported on the whole, but with some dispersion. Supply constraints have pushed up raw materials prices throughout the year. This was true for oil too, but recently we have seen these pressures subside. If supply constraints continue to ease into next year, oil and other materials will be less well supported. This could be good news for other sectors, and economic growth at large.

However, the commodities needed for the green transition – such as steel and other precious metals – could well see strong demand as governments push forward with infrastructure plans. We expect this to be a structural pressure under those commodities. When and how it comes through is another story, though, and we cannot make firm predictions about when price pressure will come.

PROPERTY

The pandemic has been supportive for some sections of the property market, but not others. Work from home rules bolstered demand for houses, particularly in suburban areas, while demand for urban apartments fell. This trend is unlikely to reverse overnight, but we could see a steady move back in the other direction throughout next year.

Demand for new housebuilding has been strong, however, and this is likely to continue. Not only are cyclical forces supportive for housebuilders, but there is a great deal of green construction needed, even for existing housing stock. At the same time, the sector has been hit by ubiquitous global supply constraints, resulting in severe undersupply. These things take time to clear through, but we suspect we will see more of this transition in 2022.

IMPORTANT INFORMATION

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The value of your investments can go down as well as up and you may get back less than you originally invested.

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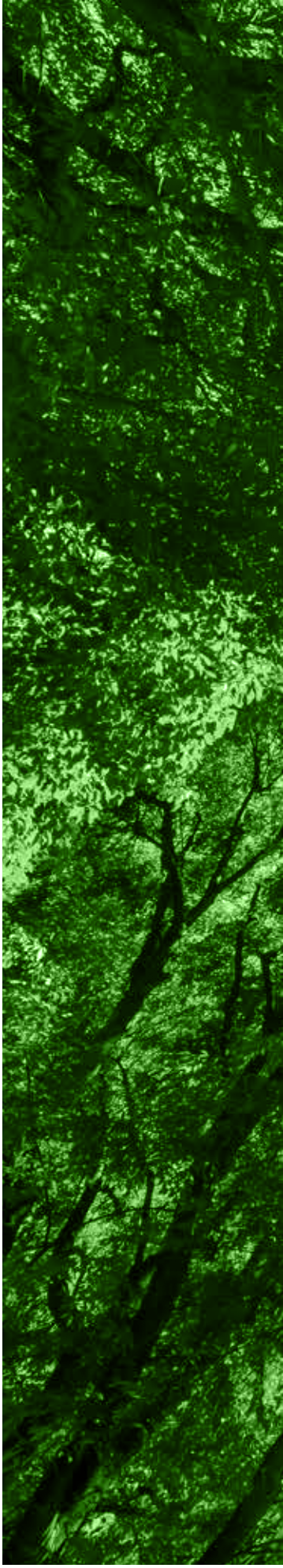

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