Outlook for 2022: Expect the Unexpected?

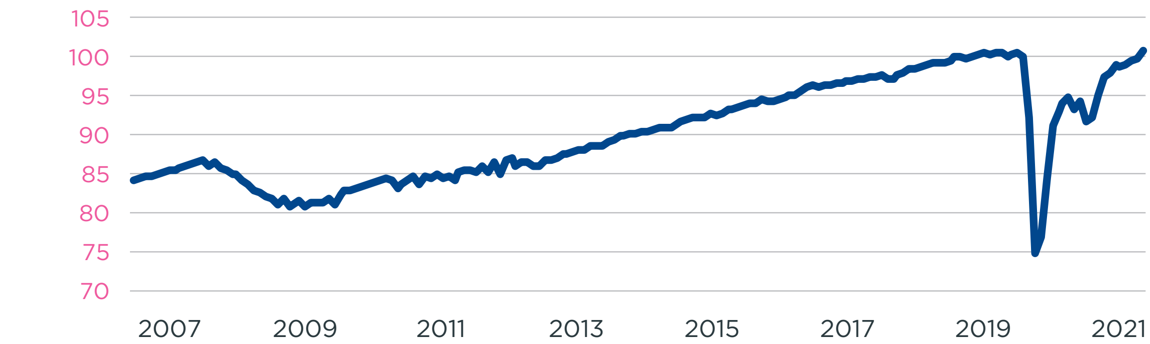
Alasdair Gill, Head of Equities at XPS Investment, reviews the markets of 2021 and assesses what is in store for investors in 2022 as the world's economies try to shake off the impact of COVID-19, whilst grappling with inflationary forces that took hold during 2021.

Will the economic rebound continue into 2022, or be stymied by rising energy prices and continued uncertainty brought about by the pandemic fallout? Will we finally see material change in the way investors assess sustainable companies?

Recap on 2021 – the economy

The UK economy performed well after a slow start, with the economy plunged into a second lockdown in the early part of the year. Despite this, GDP growth reached 6.8% for the year to November 2021[1] (see chart 1) and importantly GDP is now 0.7% above its pre-pandemic level. Other economies similarly bounced back, notably the US also grew by 6% and is forecast to get back on track with its pre-pandemic trajectory[2].

Chart 1: UK GDP Monthly Index, November 2021



Source: GDP Monthly estimate, ONS, 14 January 2022

So what should trustees be focused on?

We expect some market turbulence in 2022 as economies get to grips with the post-pandemic world; key areas of focus should include:

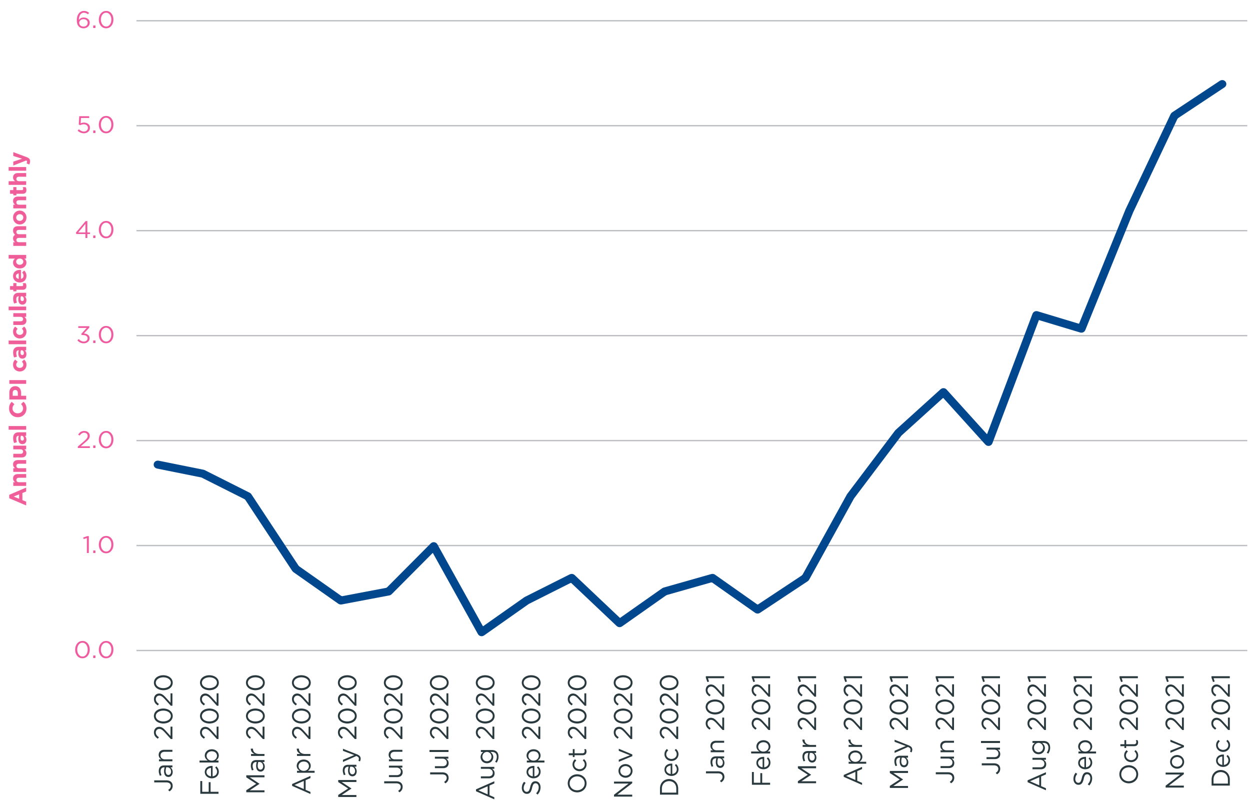
1. **Reviewing your exposure to inflation** and how this risk has been hedged;
2. **Consider the impact** of rising interest rates on your portfolio;
3. **Review your exposure to risk assets** – are they focused in the right areas to benefit from the economic recovery?

[1] **Source:** Office for National Statistics (ONS), 14 and 19 January 2022
[2] **Source:** The Economist, 'The World in 2022', 29 December 2021

Inflation – back with a vengeance

Inflation was the key economic story in 2021, with UK CPI rising to 5.4% in December 2021, the highest 12 month rate since its creation in 1997 (see chart 2)[3], fuelled by the recovery after the first COVID lockdown in 2020. This was largely driven by transport and housing costs which had been impacted by the huge rise in gas prices in Europe (up around 400% over the year), and petrol (up by 29%)[4]. Other supply shortages, such as computer chip supplies, contributed to a slowdown in the production of consumer goods such as new cars, which in turn gave rise to an unprecedented rise in the price of used cars (see chart 3).

Chart 2: UK CPI 2020-2021



Source: Inflation indices, ONS, 19 January 2022

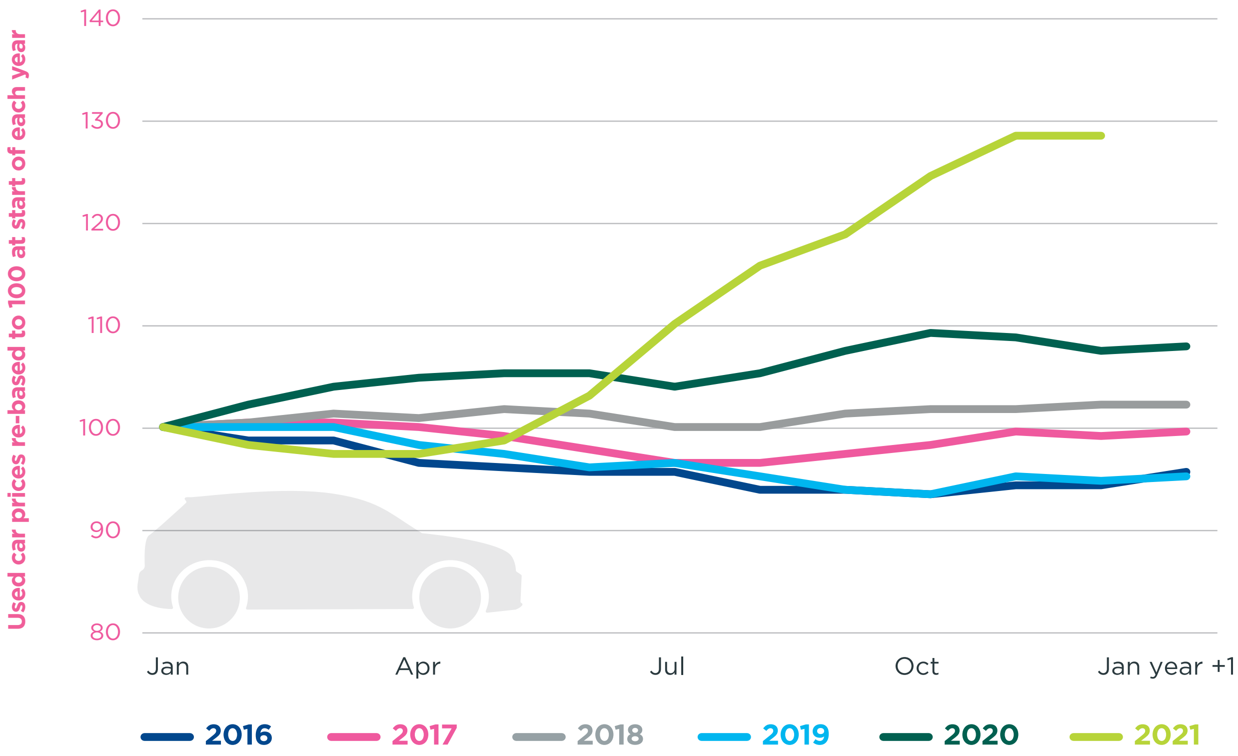
Whether this inflation increase is transitory, or more longer lasting, is the subject of much debate in the markets; whilst some of the increases are unlikely to be repeated and so should result in inflation falling back in the second half of the year from the current level, there are some elements (such as household energy costs) that we believe will keep inflation above the Government's 2% target for some time to come. We would therefore urge pension scheme trustees to ensure they understand their inflation exposures and ensure these are appropriately hedged.

Are you hedging more inflation than you think?

We have noted with some clients that liabilities with pension increases capped at 2.5%, for example, start to look more like 'fixed' liabilities if inflation is persistently high, and so hedges constructed a few years ago may be over-estimating a scheme's inflation exposure. Expect to see more on this over the year.

[3] **Source:** Office for National Statistics (ONS), 14 and 19 January 2022
[4] **Source:** World Bank Commodities Price Data (the pink sheet) – 2 Dec 2021

Chart 3: Used car prices rose by 31.3% between April and November 2021



Source: Inflation indices, ONS, 19 January 2022

Interest rates – finally set to rise?

Interest rates also finally 'turned the corner' and started to rise towards the end of the year, with the Bank of England finally raising rates at their December meeting to 0.25%[5] (from the historical low point of 0.1%). Longer term yields also rose over the year, with UK 20-year gilt yields rising by around 0.5%. However, much debate continues to rage about whether this is the start of a longer-term tightening cycle, or whether the UK economy is too fragile at this stage. Some readers may recall the last similar rise in inflation in 2011 was not accompanied by rate rises in the UK, whilst in the Eurozone, rates were increased, which ultimately pushed the Eurozone into recession.

The level of debt in the economy, and pressures on household incomes in the UK due to energy price rises could lead the Bank of England to be very wary of material rate rises in 2022. However, as the economic activity has recovered it would seem reasonable to expect short term rates to revert gradually to the levels seen before the start of the pandemic (around 0.75%). In addition, it is important to remember that long dated gilt yields (which are of more relevance to longer term investors) have tended to move largely independently of short-term interest rates. Hence, we believe that pension scheme investors should also be wary of 'betting' on interest rate rises through deliberate delays in implementing liability hedging.

As the economic activity has recovered, I expect short term rates to revert gradually to 0.75%, the level they were at pre-pandemic.

Alasdair Gill
Head of Equities, XPS Investment

[5] **See:** https://www.bankofengland.co.uk/monetary-policy-summary-and-minutes/2021/december-2021

Equity Markets – defying gravity?

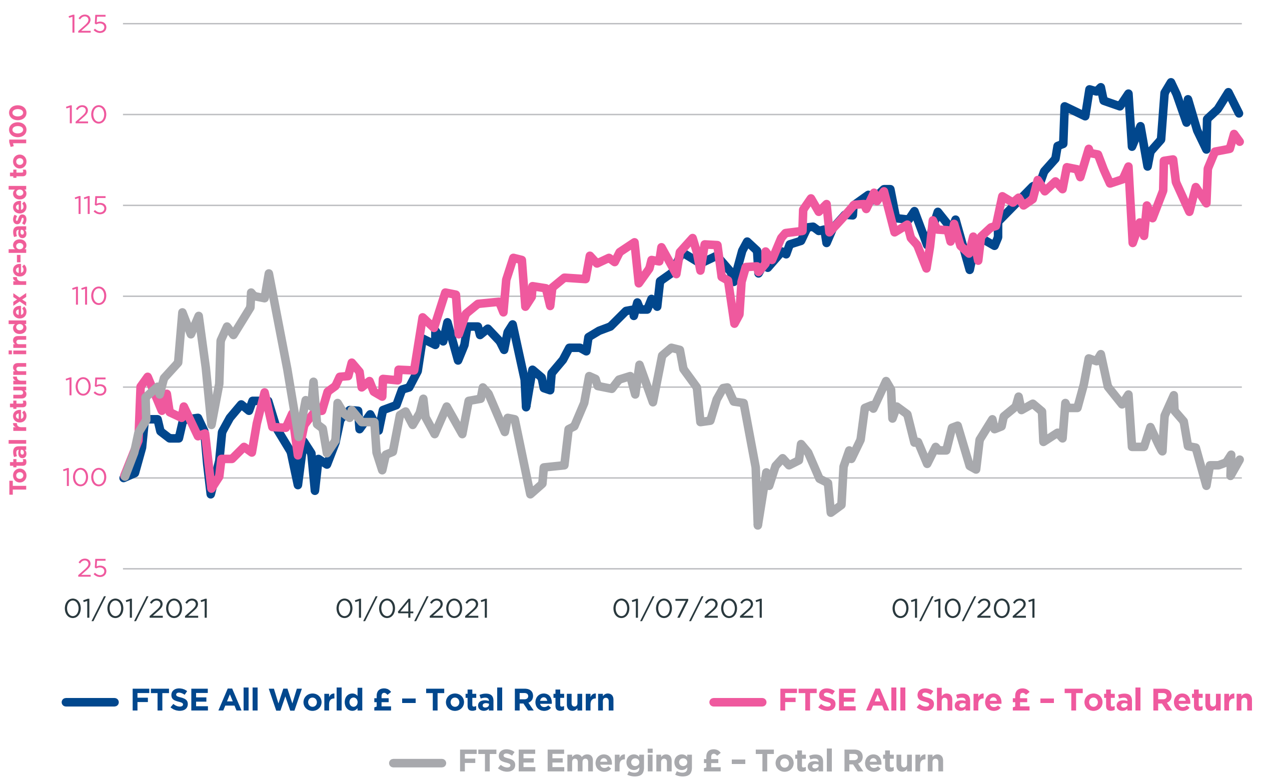
Finally looking at the equity markets for the year, we saw a very healthy return from most Developed markets (see chart 4), again led by the US, where the S&P was up 27%, with Europe up around 20%, and the UK also managed double-digit returns. However, emerging market equities, as can be seen from the chart only managed a total return of 1.0% over the year, delivering the worst underperformance over developed markets since 2013. The stronger dollar, relative lack of COVID vaccines and supply chain issues all had an impact. This leaves EM stocks trading at attractive valuations (12x 2022 forecast earnings compared with 18x for developed market stocks).

How will this play out over 2022? At XPS we had taken a view that developed market equities looked overvalued towards the end of 2021, as the current bull market looks 'long in the tooth' (see chart 5)[6]. This continues to be our view, although we are very conscious that some market participants (particularly retail investors in the US) have recently been shown to be relatively 'price agnostic' and could continue to buy on any stock market dips. It is therefore very brave to be betting against such a potential 'wall of money'.

That said, an unexpected event could easily trigger a sell off, and so institutional investors should continue to exercise caution and ensure their portfolios remain well-diversified and that risk exposures are sized appropriately.

It will also be important to understand how your investment managers are positioned at this point – we would expect managers to be positioning their portfolios to take account of the longer term trends emerging from the lockdown (such as the increase in home working), as well as the continued focus on managing the risks of, and looking to benefit from the move to a low carbon economy.

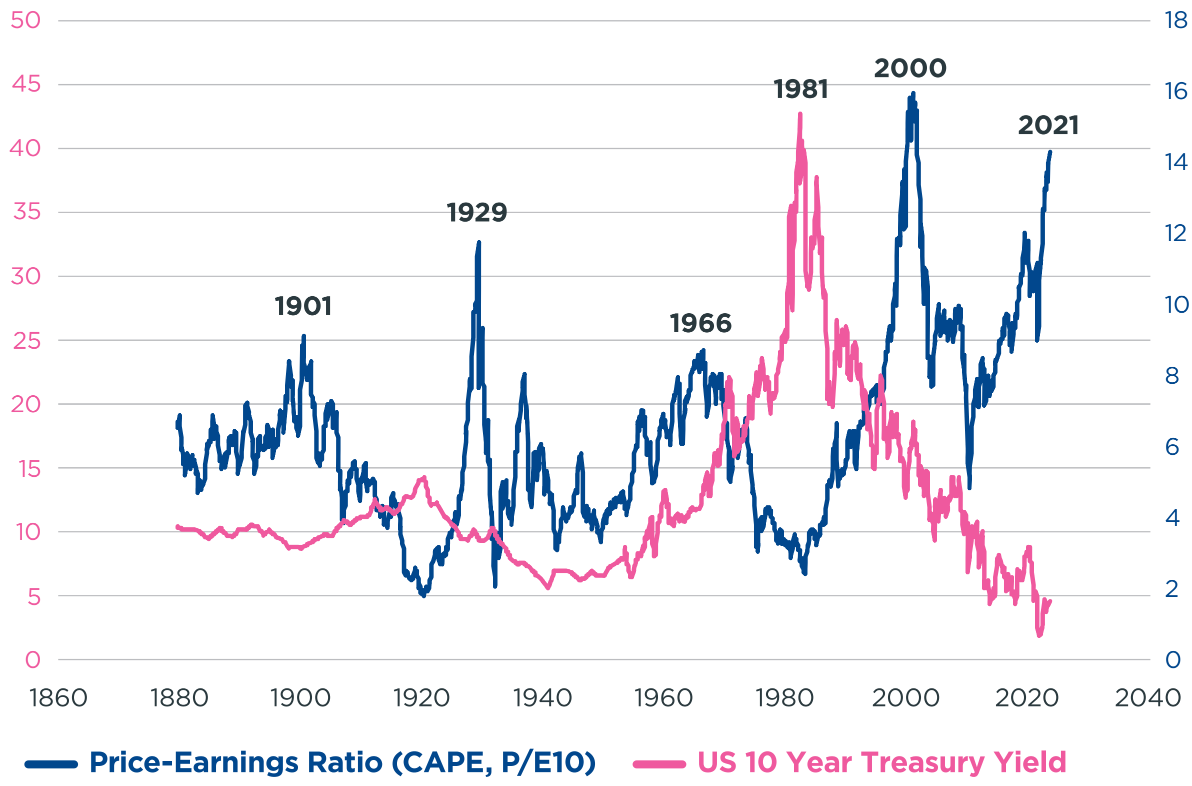
Chart 4: Equity returns year to 31 December 2021



Source: Refinitiv

[6] Cyclically Adjusted Price Earnings ratio for the S&P and long-term interest rates. Source: Yale School of Management (som.yale.edu)

Chart 5: Cyclically Adjusted Price Earnings Ratio and US Interest Rates



Source: Yale University Dept of Economics

Conclusion: Expect more of the unexpected!

In truth, modern markets have not endured a pandemic of the proportions we have seen over the last 2 years, and we will all need to navigate this 'new normal' without any economics textbooks showing us the way.

The pandemic has accelerated societal change (such as home working and shopping) and shown the power and importance of the pharmaceutical industry and healthcare systems. It has also shown the limitations of 'de-globalisation' – we need to co-operate as one to tame such a pandemic and to tackle the other huge global issues such as climate change.

More widely, new technologies will continue to disrupt established industries, and new innovations such as cryptocurrencies and blockchain technology will emerge before we really understand fully how they will impact the economy. Trustees will need to remain vigilant, pay close attention to how their portfolio is positioned in relation to these new themes, as well as the risks being taken in their portfolios, and strap yourself in for another roller coaster of a year in 2022!

Summary

Asset markets have had another positive year in the main, buoyed by a continued recovery from the worst of the pandemic, despite headwinds of inflation and rising interest rates starting to emerge.

- **Trustees will need to focus their attention** on the impact of this rise in inflation as it affects scheme liabilities, and in particular their inflation hedging.
- **They also need to consider the impact of interest rate rises** both on their existing matching portfolio and hedging strategy, as well as any more growth focused assets that have a fixed interest component.
- **Finally, growth portfolios will need reviewing** to ensure they are well positioned to benefit from the emerging economic themes which were accelerated by the pandemic.

For further information, please get in touch with **Alasdair Gill** or speak to your usual XPS contact.

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