The 2022 outlook

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Introduction

In history there are decades where not much happens, and there are months where decades happen. Covid-19 has had far reaching effects on how economies function, where we work and how firms do business, and that process is on-going.

While the dust has not fully settled, the early picture emerging in the post-pandemic economy is that household behaviour, labour markets, correlations between asset classes, and the sensitivity of all those factors to policy changes, have notably changed. These factors have, in turn, altered the growth and price trends in most economies, and this will have significant implications for risk and return dynamics within portfolios going into 2022 and beyond.

One of the key changes in the past year has been that higher inflation has cemented itself as one hallmark of the post-pandemic recovery and this will require a 2022 policy response by the US Federal Reserve (US Fed) and other key central banks, but the key uncertainty is around the Omicron variant. Given the heightened uncertainty around the impact of a new variant on growth, regional supply chains and the policy backdrop means that investors need to ascertain which assets are under-priced, where valuations and the growth outlook are too optimistic, and how to address equity market risk as bonds are much less likely to be a diversifier in portfolios for the foreseeable future.

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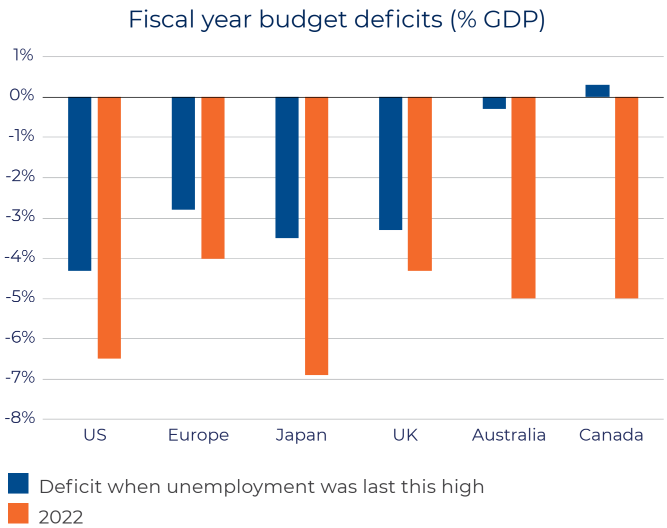
A policy of extremes, but which is more extreme?

Macroeconomic policy has been at the forefront of the global economic recovery since the 2020 trough.

Governments in nearly all G20 advanced economies ran record peace-time budget deficits, and these budget shortfalls (the orange bars in Chart 1) are still very high relative to when unemployment was last at current levels (the dark blue bars). Meanwhile, global central banks in nearly all G25 advanced economies cut rates to zero and have undertaken massive asset purchases which totaled US$6 trillion in 2020 and US$4 trillion in 2021 – this was more than double what occurred at the peak of the GFC.

Both of these policy supports have been quite extreme relative to history, and this has provided tremendous support to the economy (primarily through fiscal stimulus which stabilised the dislocation in the labour market) and financial markets (mostly monetary policy which eased financial conditions).

Chart 1: Fiscal deficits remain very high relative to unemployment



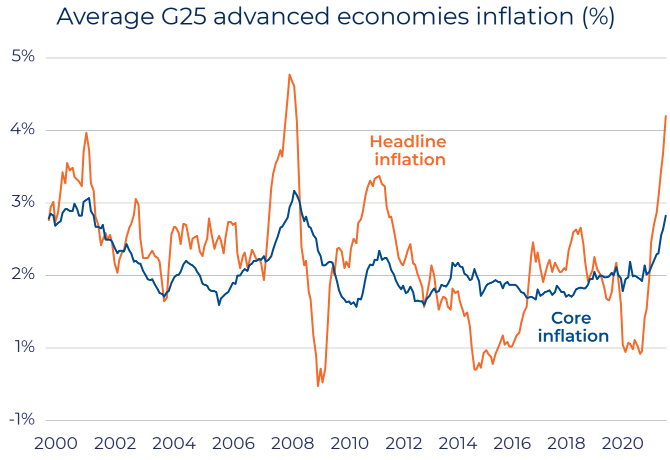
Source: FactSet, Bloomberg and UBS Australia Limited as at 4th December.

Fiscal powered supply chain constraints have seen inflation rise to 30-year highs

This policy support was so large that most economies have struggled to meet demand despite a large drawdown in inventories and this has resulted in average advanced economy core inflation rising to one of its highest levels in the 21st century (Chart 2). It's not only the rise that is worrying central banks, but the price increase has also broadened into areas not associated with re-opening. Consequently, central banks have been forced to pull forward the end of their asset purchase programs, and in some places the zero-interest rate policy will also have to cease soon.

Whilst similar inflation rates were seen during and shortly after the GFC, the difference this time around is that US unemployment, for example, is less than half the levels seen in 2009 and may hit full employment levels in coming months, whereas it took another eight years for this to be the case post-2009.

Chart 2: Inflation in advanced economies is at a multi-decade high



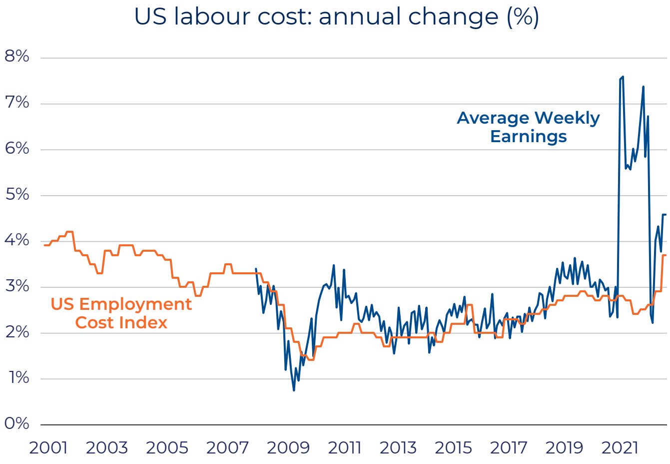
Source: Bloomberg as at 4th December 2021

Central banks' transitory view is right, sort of, but...

Central banks have claimed that the inflation rise was transitory, and in some cases (for example in energy and goods markets) it has been, as prices remain elevated despite a clear weakening in demand. The price rise in these sectors has been driven by limited production and scant spare capacity which will ultimately prove transitory. The two "known unknowns" here are when these supply issues will be resolved and some estimates have it well into 2022 , and also whether the new Covid-19 variant is set to weigh on growth or exacerbate cost side pressures, or both. While the Omicron variable at this early stage looks less virulent, it is also much more transmissible, which can impact mobility and weigh on both the production and demand sides of the economy.

Supply will continue to be a key issue in 2022 for the most important market in the world, and that is the labour market. In the US, for example, production blockages are likely to persist and collide with a permanent loss of US workers which has culminated in strong wages growth (Chart 3). Spare labour is becoming scarcer every month and tight labour markets can lead to non-transitory inflation and, as such, the Fed will need to lift interest rates to prevent the link between inflation and wages growth becoming endemic.

Chart 3: US wages growth is at elevated levels



Source: Bloomberg as at 8th December 2021.

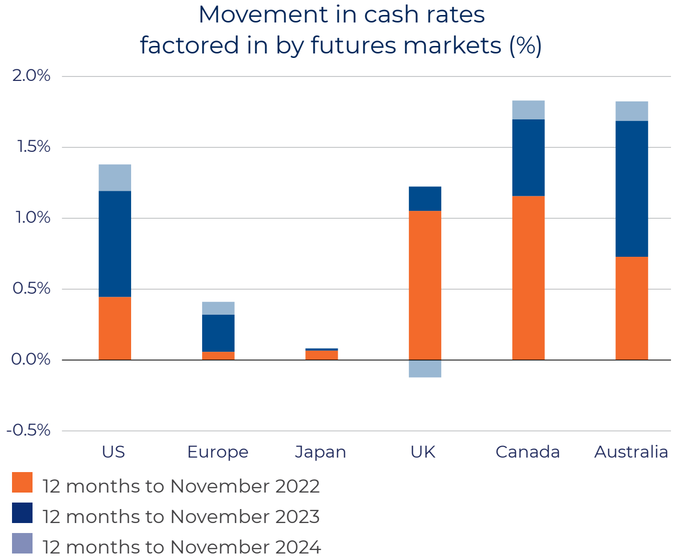
Not all hiking cycles are the same

Rising inflation has seen markets price in Fed rates lift off around mid-22 with two hikes priced for next year (Chart 4). Elsewhere, in the UK four hikes have been priced in for 2022 which seems over the odds given the seemingly brittle nature of the UK recovery where Q3'21 GDP growth was only +1.3% q/q with the result driven primarily by inventories (+0.9% of the +1.3%) and government consumption (+0.2%) rather than the private sector which should have been stronger. In addition, the Omicron variant has seen the Johnson Government reinstate a WFH request which will negatively impact mobility and growth, at the margin, which risks the BoE remaining on hold.

Similarly, markets are priced for the RBA undertaking three hikes in the next 12 months, which also seems excessive given soft domestic wages growth which is central to RBA deliberations. However, unlike the UK, Australia's 2022 growth outlook looks robust given our economic reopening, low unemployment and what is likely to be a generous pre-election Federal Budget.

While no two hiking cycles are the same, history has demonstrated conclusively that the economy and markets can withstand a well-choreographed tightening cycle.

Chart 4: Market expectations for hikes in the UK and Australia seem excessive

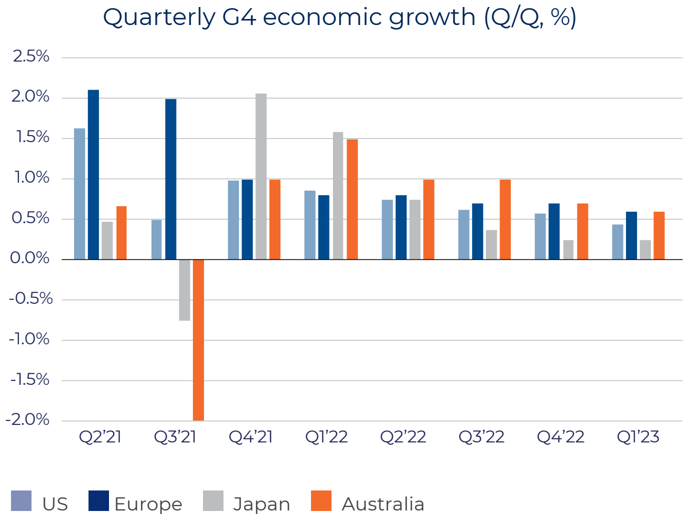


Source: Bloomberg as at 6th December 2021.

The macro economy and outlook

The anticipated 2022 central bank pullback comes at a challenging time as the global economy is slowing anyway (Chart 5). A sizable reduction in fiscal support and labour market slack is likely to see 2022 end with 'trend-like' growth in most major advanced economies, which is a large moderation from the peak growth extremes seen in 2021. Another growth challenge is China, which is seemingly going through a regime change with President Xi more interested in the distribution of growth, rather than its size.

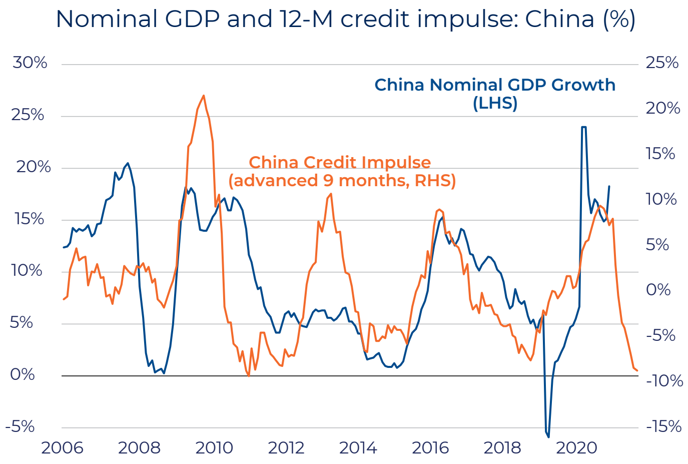
Chart 5: Regional economies will moderate back to trend in H2'22



Source: Bloomberg as at 4th December 2021.

Over the past year Chinese authorities have been tightening monetary policy which has seen China's credit impulse (the orange line in Chart 6) signal that a large and prolonged nominal growth moderation is underway. China has many vulnerabilities including its dependence on foreign semi-conductors and energy, but their total debt level (310% of GDP) is extremely high for its average living standard (US$8k of output per worker per year, relative to the US's US$65k and Australia's US$56k), which combined with its contracting labour force this decade, are long-term negatives for Chinese growth and returns.

Chart 6: China's credit impulse suggests an extended growth moderation is ahead

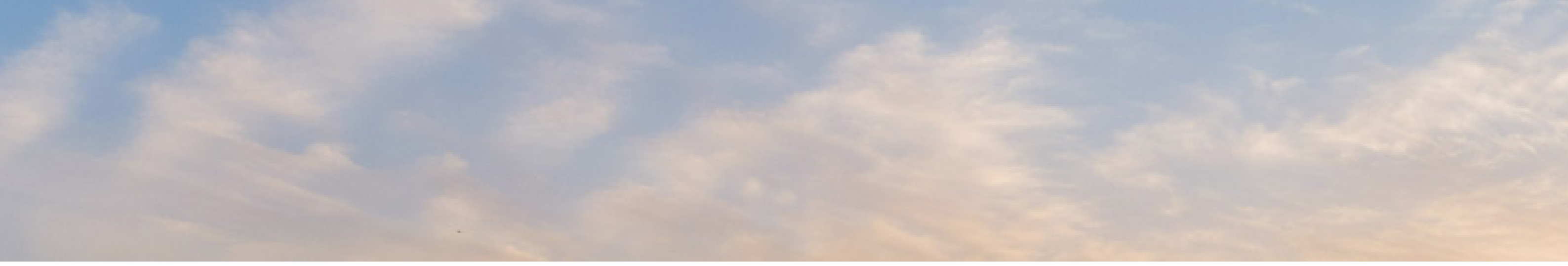


Source: Bloomberg as at 1st December 2021.

2022 will be a challenging year for returns as growth slows and liquidity tightens

Overall, 2022 is looking to be a challenging year for investors as central bank tapering, rising inflation and any subsequent policy hikes are likely to spark higher bond yields which should weigh on equity valuations.

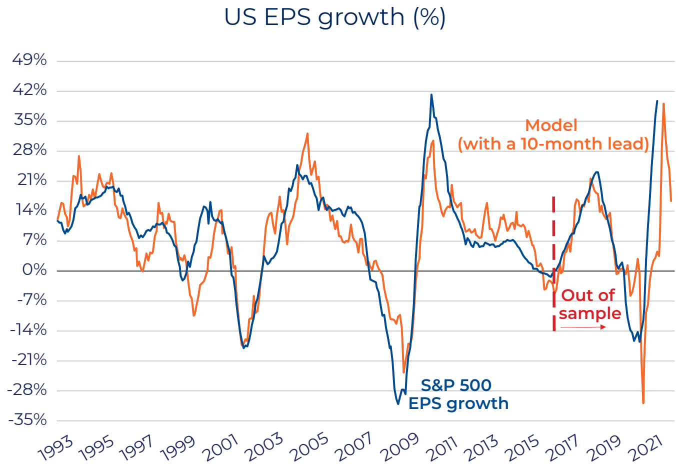
Meanwhile rising rates, fiscal policy withdrawal, slowing growth and rising costs are set to weigh on earnings growth. Accordingly, 2022 seems set to be a transitional year where the world tries to get off its stimulus addiction, and investors question the floor that central banks have put under rich asset valuations. This will mean that all investors, whether they be accumulators or retirees, will have to determine which assets are over-priced, and how they can diversify equity risk to protect the strong gains they have made over the past 18 months.



Earnings and valuation tailwinds are fading

Another 2022 challenge we see for investors is that a lot of good news has already been factored into asset prices. It is very normal for equity prices to substantially exceed earnings growth in the first 18 months of any cycle, but the difference in the current expansion is extremely high at +45% and this will have to normalise. Looking ahead, slowing GDP growth and higher cost side inflation are obvious headwinds for earnings growth and our proprietary US Earnings model says that US earnings growth will peak in February 2022 at around +40% y/y (Chart 7) and by end-July 2022 it will have fallen to around +15% y/y, but that is before the US fiscal cliff, which suggests there could be more downside risks to earnings in H2'22.

Chart 7: US EPS growth will slow considerably in 2022

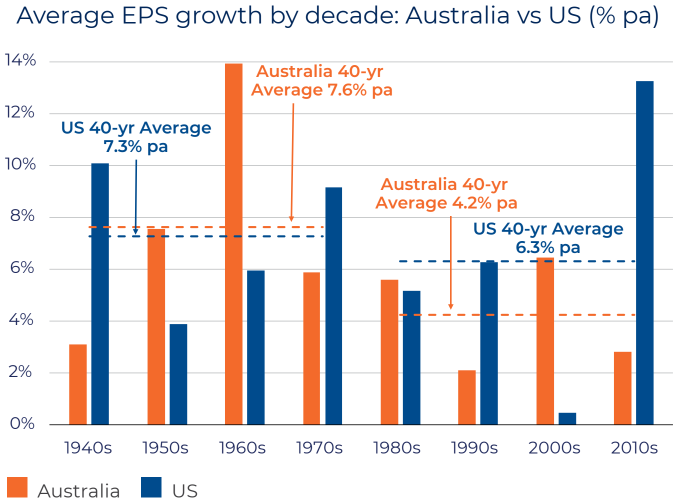


Source: Bloomberg as at 8th December 2021.

Another challenge for investors moving forward is that we believe the 40-year trend of declining nominal interest rates is now over which means EPS growth will be the primary driver of equity returns. Many may think that earnings growth in the past 40 years was above average given the prolonged tailwinds of globalisation, emerging market industrialisation, a massive surge in leverage and widespread technological adoption including PC's and the Internet.

However, EPS growth in both Australia and the US was lower in the past 40 years (Chart 8), than in the four decades prior to that. Accordingly, without the tailwind of rising valuations, equity returns (about +8% in both markets when you add dividend growth to earnings growth) would have been below long-run averages (+12% and +10%, respectively), and in the next decade all of those tailwinds will have dissipated.

Chart 8: Despite major tailwinds, earnings growth was lower in the past 40 years.

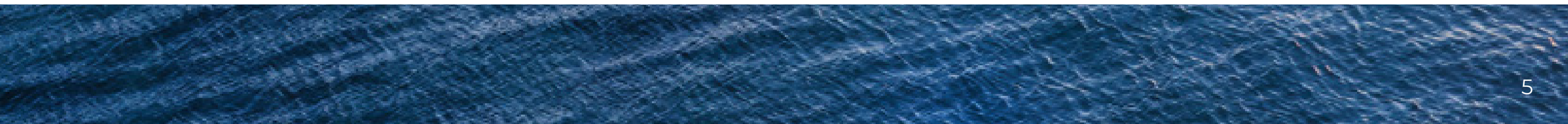


Source: Global Financial Data, RBA and Bloomberg as at 18th November 2021.

Investment and portfolio implications

A lot has changed in the past two years, and the investment environment ahead is very different than that seen since the early 1980s. Investors are facing a terrain characterised by low prospective rates of return and higher volatility and with bond yields so low, investors will not only have to identify undervalued assets, but will also be seeking new portfolio diversifiers.

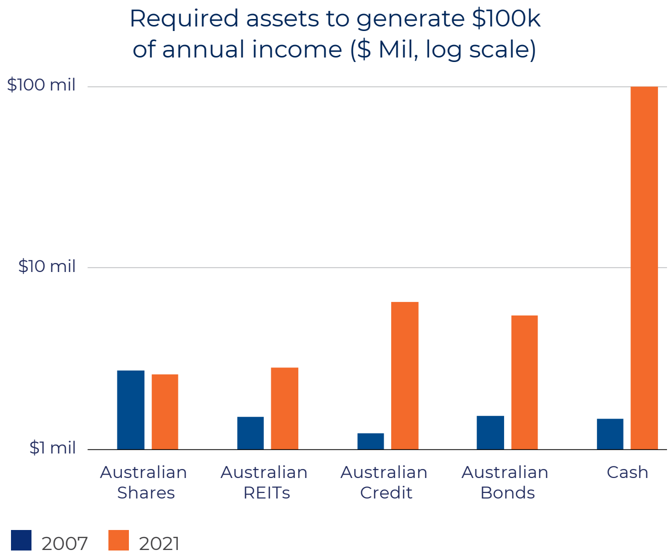
While the biggest asset for asset accumulators is still 'time', the dilemma for retirees is quite profound as central bank policy has seen yields on all income producing assets fall to record lows in recent years. In 2007, Australian retirees needed about $1.2 million to $1.5 million of funds to produce $100k of income, regardless of the asset class. Today, they need a lot more – $2.8 million in REITs or $6 million in government bonds or $7 million in high grade credit or $100 million in cash.



Quite simply, very few Australians have this level of retirement funds, which means retirees are increasingly being forced to purchase equities which exposes them to sequencing and longevity risk.

Interestingly, shares is the only asset class which needs a smaller nest egg relative to 2007 to produce 100k of income (Chart 9). Accordingly, it seems that central bank policy is forcing some investors to take more equity risk in their portfolio in order to generate the required income in retirement and this is a time that these investors may not want to take more equity risk, and therefore, the challenge for investors is how to diversify equity risk. Recall that after 2007 the equity market fell by more than -50% in 2008 and early 2009. For many decades, government bonds have fulfilled the role of portfolio diversifier, including during the GFC. But the role of bonds in a portfolio is facing increased scrutiny as this asset class is vulnerable to changes in both inflation and central bank policy (asset purchases and interest rates), and rising bond yields can impact a portfolio in three ways – capital losses on bond holdings, lowering equity market valuations and causing rotation within equity markets.

Chart 9: Central banks have limited retirees' income choices



Source: Bloomberg as at 2nd October 2021.

Consequently, we remain cautious about the outlook for significant parts of the investment universe in a world where growth is slowing, policy accommodation is being reduced, and valuations are rich. These include:

- the US sharemarket – this market is more exposed to rising bond yields given its 'growth'-heavy composition, especially in sectors such as technology and consumer discretionary where numerous high-profile names, including Tesla and Amazon, trade at extraordinary valuations;
- credit markets – there is very little running yield to compensate investors for the risk of default, and this risk increases as interest rates rise, profits decline or more debt is placed on corporate balance sheets; and
- government bonds – yields provide no income after inflation.

Consequently, we have removed assets which have poor medium term return prospects from Perpetual's Real Return Fund, including government bonds and high yield credit. Elsewhere, given the less favourable growth and liquidity backdrop, we have reduced the Fund's overall risk level, but there are pockets of value in the global sharemarket including Europe, where the economic outlook is much stronger than has been the case for the past 15 years as depressed activity from Covid-19 is recovered. This market is also resilient to a rising interest rate environment given its 'value' based index composition, governments there are providing significant income and growth support, and its central bank continues to provide ample liquidity.

The Fund's overall cash position is at the high end of its recent range because of the very low exposure to fixed income in the portfolio. There is significant optionality in holding cash as it can shield the portfolio from volatility which enables us to take advantage of investment opportunities which we expect to arise as valuations become more attractive. The Fund's cash position is balanced by a substantial risk allocation to diversifying opportunities including equity alpha and currency positions.

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