BLACKBEE

pollinating great ideas

Outlook / 2022

Investors move into transition year

Economic Renaissance

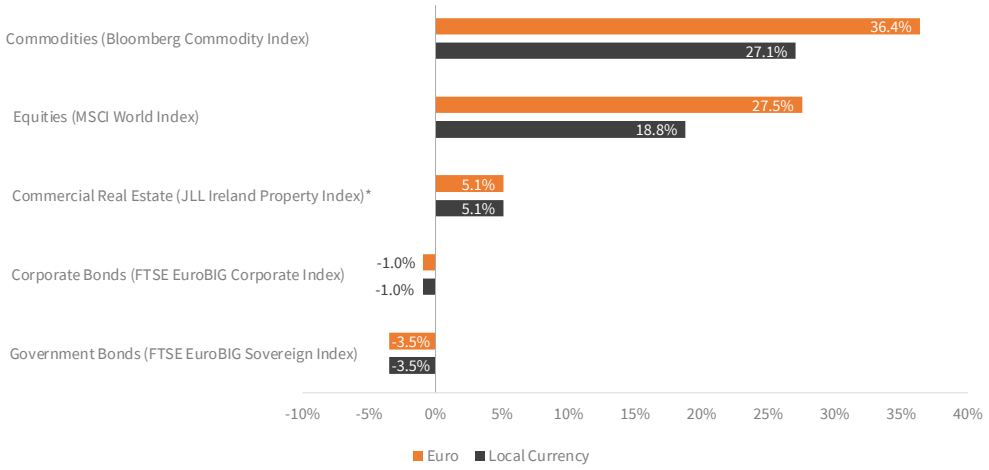
Equities and commodities powered ahead in 2021 thanks to the combination of a stronger than expected economic rebound and continued loose monetary policies.

Investment Market Review – Economic renaissance drives investor returns higher

Looking at chart 1 it is clear that investors fared well in 2021 with the riskier asset classes such as equity, credit and commodity markets strongly outperforming cash deposits and safe haven assets such as government bonds. The positive news around a series of COVID 19 vaccines in late 2020 had already set a positive tone for markets entering 2021.

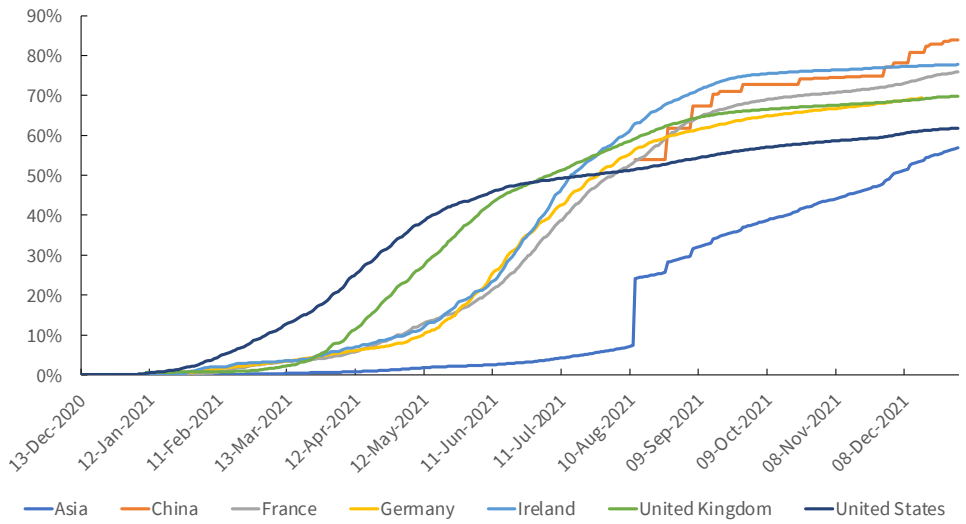
As vaccine penetration rates climbed through the first half of this year (chart 2) it facilitated the reopening of many of the largest global economies, providing a strong sense of optimism that the recovery path back to a pre COVID economy was a matter of 'when' and not 'if'.

Chart 1: Risk Assets outperformed again in 2021



Source: Bloomberg, JLL, December 2021, JLL return refers to 12 month return to end Q3 2021

Chart 2:
Vaccination penetration rates accelerated in 2021, particularly in developed economies



Source: ourworldindata.org, December 2021 - refers to percentage of total population vaccinated in each country/region

Economic Renaissance

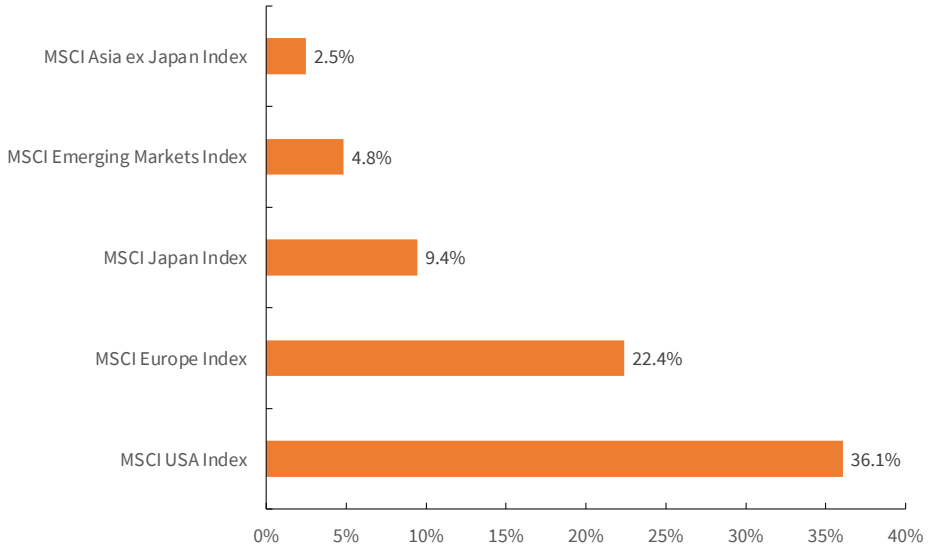
Inflation returned with a vengeance in 2021, cementing the recovery in H2 but leading to greater uncertainty in H2.

2021 was also the year where inflation returned with a vengeance as price increases across many economies reached levels not seen in up to forty years. The combination of a sharper than expected economic rebound and a lack of readily available capacity in many areas was the driving force behind the higher prices. Inflation's reappearance helped cement investor confidence about the economic recovery in the first half which consolidated investors' gains. However, its persistence led to some volatility later in 2021 as investors' attention switched to what this meant for central banks' loose monetary policies, a bedrock of the COVID market recovery since April 2020.

The renaissance across the global economy produced dividends in terms of improved market fundamentals in equity, credit, commodity and real estate markets. Nowhere was this more evident than in equity markets where global stock market profits grew by a whopping 50% in 2021 with the growth in cash flow also supporting credit markets. Commodity demand also rebounded much more sharply than initially expected by investors although real estate fundamentals were slower to exhibit the recovery with COVID restrictions having a visible impact on workers' return to offices and physical spending on goods and services.

Developed equity markets performed best in 2021 led by the US stock market (see chart 3) which made successive highs helped by its exposure to the technology sector. Outside of developed markets the tale was more mixed with Asian and emerging markets finding the going tougher as the year went on, hobbled mainly by weaker vaccination progress (which meant a more chequered reopening of economies), a slowing Chinese economy (including a regulatory crackdown on the technology sector there) and deteriorating investor sentiment hurt by Evergrande's default in China and the debacle surrounding the Turkish lira.

Chart 3: Developed equity markets massively outperformed in 2021*



Source: Bloomberg, December 2021 *Returns in euros

Inflation's impact on market action in 2021 was also visible in a strong performance from commodities (particularly oil and copper), a pedestrian performance from government bond markets (which tend to struggle as the economic growth/inflation vista improves) and in somewhat of a resurgence in equity market sectors (such as 'value' sectors of the market like energy, materials and even financials) which heretofore had lagged since markets bottomed in March 2020.

Uneven Recovery

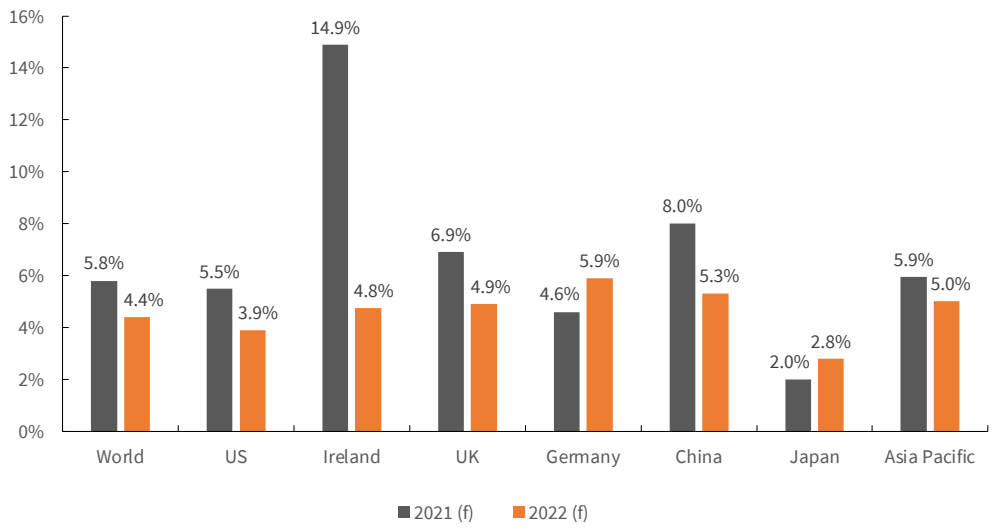
Global economic growth is likely to slow in 2022 albeit from high levels but the recovery remains uneven across the globe.

Global economy – Uneven economic recovery to continue amid complicated outlook

We still hold a constructive view of the world economy as we move into 2022 while acknowledging that the recovery remains an uneven one hindered by varying degrees of vaccine penetration and economic reopening.

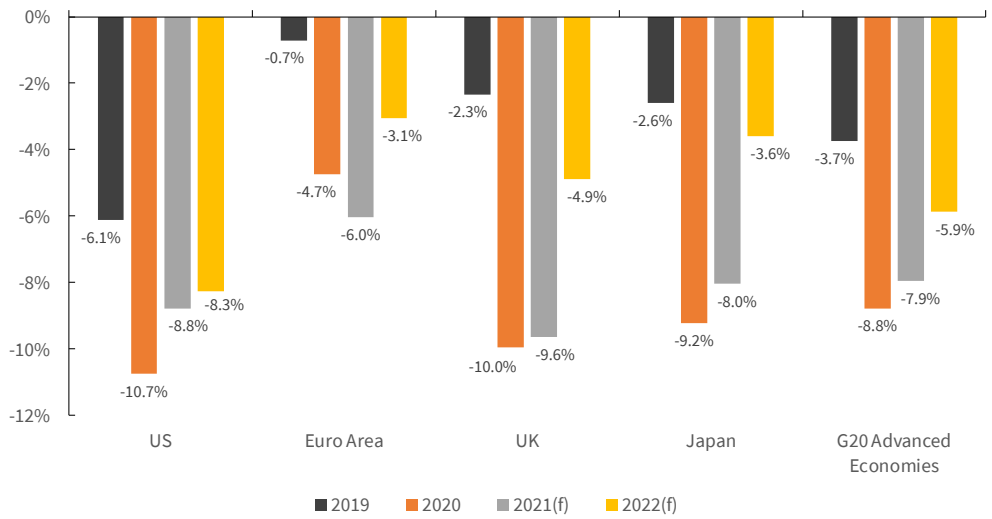
For many developed economies, 2022 should represent the year where they close in on pre COVID levels of GDP and this natural restoration of consumer spending, employment and business investment remains the key factor underpinning growth forecasts this year (chart 4). In addition, monetary and fiscal policies should still remain supportive (albeit less so compared to 2021) while the stock of savings accumulated over the course of the pandemic (estimated at $5.4 Trillion or around 6% of world GDP by Moodys Analytics last year) remains another key support.

Chart 4: At a global level GDP growth is forecast to slow from high levels in 2022



Source: Bloomberg, December 2021

Chart 5: Fiscal spending should support economic growth again in 2022, but less so than in 2021*



*Source: IMF, December 2021 *Refers to Cyclically Adjusted Government Balance*

Uneven Recovery

Elsewhere however the recoveries in Asia and many emerging markets have lagged as a result of ongoing negative impacts from the pandemic as well as supply chain bottlenecks. The Chinese and Japanese economies are perfect examples of this phenomenon – growth slowed sharply in the second half of last year as COVID case numbers rose again and manufacturing was hindered by supply chain issues. Latterly this has also become visible in slowing European economic indicators. Overall, we believe these negative issues could linger again in 2022, curbing the recovery potential for the world economy as a whole. In addition, the omicron variant is the elephant in the room that could also curb growth rates in 2022. As yet we don't know enough about omicron to assess how much of an economic impact it could have. On one hand we are encouraged by the initial data showing that the incidence of serious illness appears to be lower compared to the Delta strain, but this optimism is balanced by its greater transmissibility. This greater transmissibility could result in the temporary seasonal reintroduction of restrictions.

We are optimistic though that any new restrictions wouldn't have the same economic impact as those of the initial COVID wave, thanks in large part to vaccination penetration (in addition to recently introduced booster programs) coupled with the growing adaptability of businesses and consumers to get on with day to day life that has come with living with this virus for nearly two years.

From a domestic perspective, the Irish economy should continue to outperform in 2022. The defensive nature of Irish exports provides a very useful economic shield against omicron risks (as it did during the first COVID waves in 2020) and although activity in the domestic economy is exposed to any short term downside risks from the new variant the high level of vaccine penetration in Ireland and the quick rollout of a booster program should help mitigate these risks somewhat.

The rise in inflation across the world created plenty of headlines last year and is something which we think investors will have to contend with again in 2022, albeit perhaps to a lesser degree. The bottlenecks in everything from freight rates to oil prices that became painfully evident in early 2021 have yet to ease and if anything became more entrenched through 2021. This has led inflation to broaden out across most economies. Ultimately, we believe inflation rates will remain elevated until current supply logjams ease while more and more episodes of rising wages (usually a good harbinger of inflation) also suggest inflation is set to remain 'higher for longer'.

Will central banks tighten monetary policy in 2022 to choke off inflation? We believe there is potential for some monetary policy tightening in 2022 to counter inflation and also in recognition of the fact that many large developed economies no longer need the sort of 'emergency' monetary policy that the first COVID wave required. However, where tightening does happen it will be gradual so as not to jeopardise ongoing recoveries.

Furthermore, episodes of tightening will very much be dependent on individual economic circumstances. For example, we believe that monetary policy should tighten in the US but remain loose in Asia to take account of both economies' differing outlooks. Overall, our view is that any monetary tightening is more likely to be a factor for financial markets rather than the economy in 2022.

Charts 6 and 7 show market implied interest rate expectations in the US and Euro area. In the US we believe it is reasonable to assume that the Fed's taper will be completed in the first half of 2022 and this will open the door to rate hikes in the second half of the year which may well boil down to the impact omicron has on the US economy. At present chart 6 shows that roughly two interest rate increases of 0.25% are priced in for 2022.

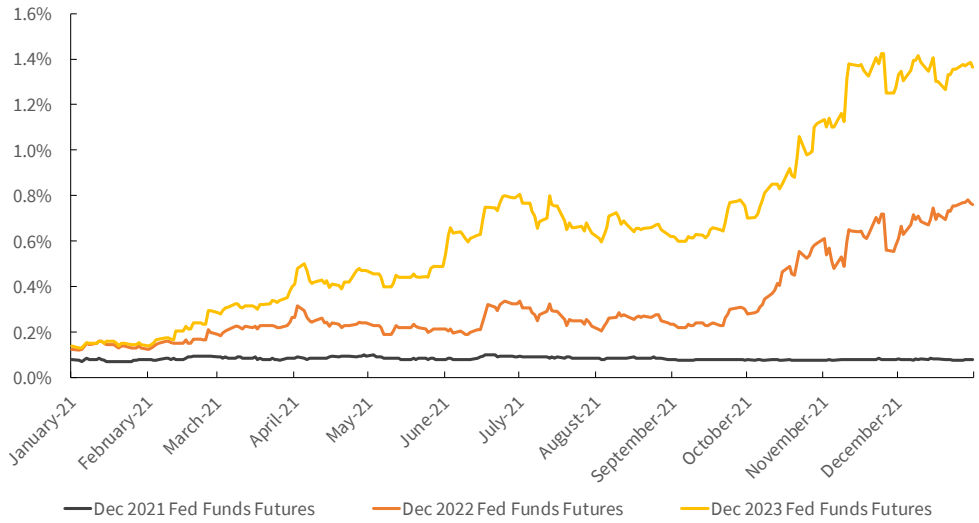
We are optimistic that omicron won't have the same economic impact as earlier COVID waves with vaccine penetration representing a major risk mitigant.

Interest Rates Outlook

The direction of monetary policy will differ across economies - policy is likely to tighten in the US but remain largely unchanged in the Euro zone.

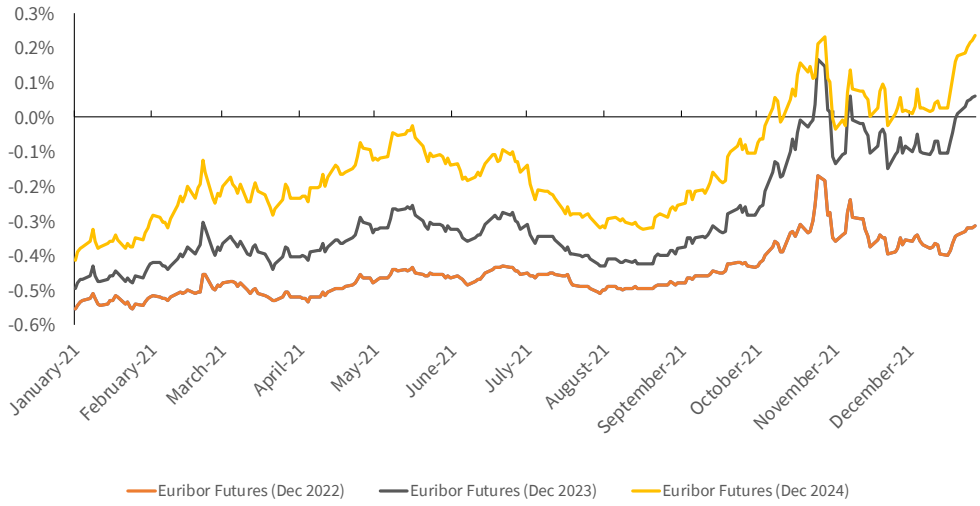
In the Euro zone we see the monetary policy dynamic as very different. We believe interest rate increases are unlikely in 2022 because quite simply the Euro zone recovery is still very unbalanced and interest rate increases at this point could well endanger it. In our view, the symmetric 2% inflation target introduced in its July 2021 monetary policy review also gives the ECB a higher threshold of inflation 'pain' before activating tighter monetary policy. As we can see in chart 7 market implied measures suggest rate hikes in the Euro zone are unlikely for the next couple of years and we would broadly agree with that sentiment.

Chart 6: Markets are currently indicating approximately two US interest rate increases in 2022 and in 2023



Source: Bloomberg, December 2021

Chart 7: Investors are only expecting 1-2 interest rate increases in the Euro zone by the end of 2024



Source: Bloomberg, December 2021

Growing Pains

In light of our views that the cyclical economic recovery can continue, it stands to reason that asset outperformance can also persist in 2022.

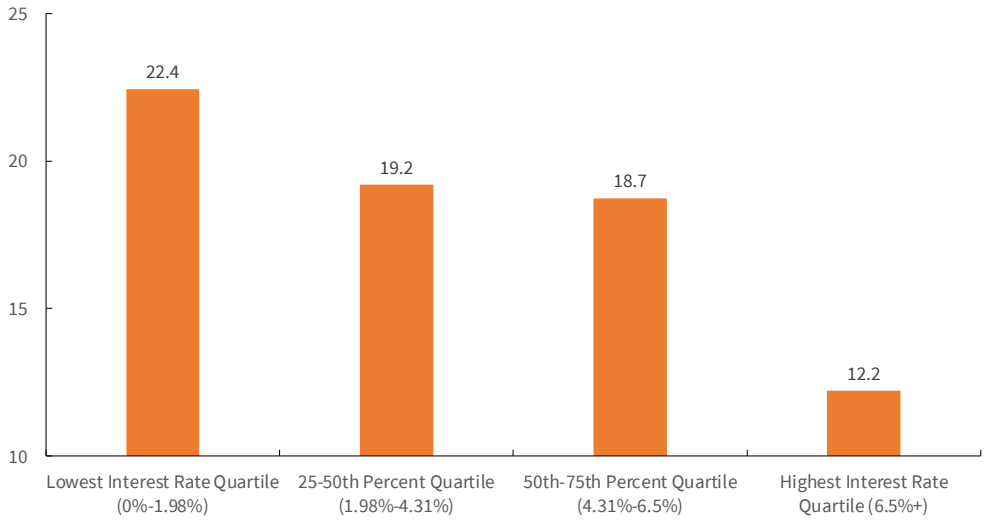
Investment Markets – Outlook favours risk assets but tighter Fed policy could give investors 'growing pains'

From a business cycle perspective, risk assets like equities, real estate, credit and commodities typically outperform during economic recoveries, something investors have seen first-hand in recent times. Given our base case that the cyclical economic recovery can continue in 2022, it stands to reason that we believe real asset outperformance can also persist.

The lack of a credible alternative way of generating income and returns from cash deposits and government bonds is another factor in risk assets' favour this year. Although interest rates may move up in certain economies in 2022, we believe deposits and government bonds are destined to produce very low to negative returns for some time yet once inflation is taken into account.

Where our risk asset views are somewhat more cautious however is on the potential returns investors can earn from liquid investment markets in 2022. Generally, our view is that returns from equities, real estate, commodities and credit will be more modest than those seen in 2020 and 2021 and they may well come with more volatility than we saw last year. Our basis for this is simple – asset valuations tend to be slower to expand as monetary policy tightens. We can see evidence of this in chart 8 based on US data over the past seventy years – as interest rates (the US Fed funds rate in this example) move higher, this tends to be consistent with lower P/E multiples and vice versa. In addition, credit markets have also tended to benefit from lower spreads (higher valuations) as central banks have purchased mortgage and corporate bonds during the various crises over the past fifteen years. With the US Fed set to pull back from these markets in 2022 thanks to its taper, we believe there is little further downside in credit spreads which will make the job of generating returns in 2022 that bit more difficult.

Chart 8: Interest Rate Regimes and US Stock Market P/E Ratios, 1954 to Present*



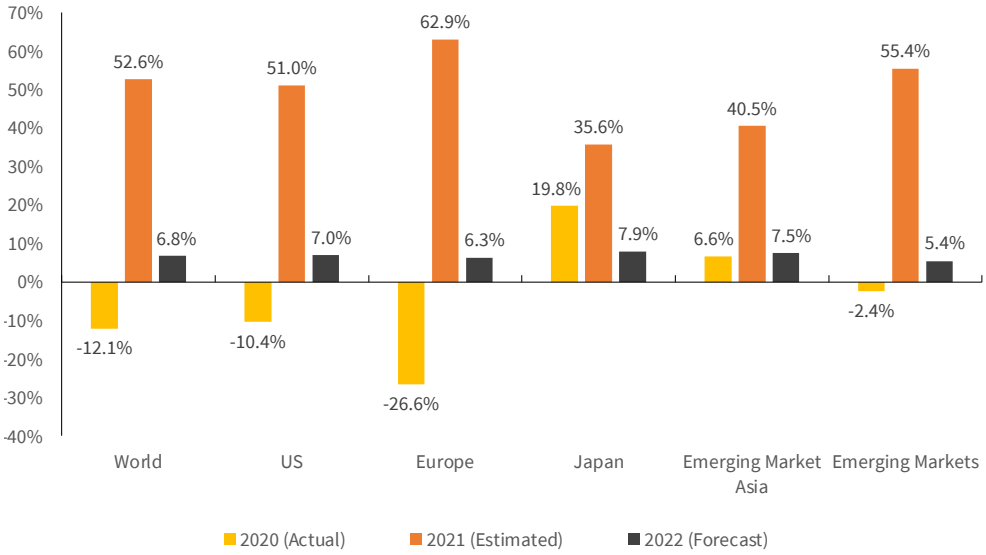
Source: Shiller Database, St. Louis FRED, December 2021 *Average P/E during each quartile

Stock Market Growth

As we begin to move along the path to a maturing recovery and tighter monetary policy in 2022 (thanks mainly to the US Federal Reserve) we also feel the scope for investor uncertainty is greater. Investors got a flavour of this in the second half of 2021 and we feel that the US Fed's taper and possible interest rate hikes could create some further pockets of volatility in 2022.

For diversified portfolios of public equities and real estate we believe that mid to high single digit total returns are realistic this year. Looking at chart 9 we see that stock market profits are currently forecast to grow by 6-7% this year. Assuming little room for multiple expansion as we are would suggest returns of this scale are achievable by stock markets in 2022. On the commercial real estate side of things Irish prime yields generally sit in a 4-5.25% range right now (prime European yields are slightly lower) which should also be able to support mid to high single digit returns. In credit markets yields are lower again which mean returns could struggle to reach low to mid-single digit returns in 2022, even with a favourable macro backdrop.

Chart 9: Stock Market Profit Growth Forecasts



Source: www.yardeni.com, December 2021

Tighter monetary policy is likely to be more of a factor for markets than the economy in 2022, putting more emphasis on fundamentals as a driver of returns this year.

Unfortunately, savers and conservative investors appear most likely to suffer from very low returns assuming our base case scenario plays out this year. As we noted earlier, we believe it very unlikely that the European Central Bank will increase interest rates this year or even next, condemning savers to another year of zero nominal deposit returns and potentially heavily negative returns once inflation is taken into account. Unless economic growth and/or inflation deteriorates significantly, we see little upside for government bonds in 2022 either although they may still have a role to play in portfolios should the economic outlook mood darken more than we expect.

Summary

We believe 2022 will be a transitional year for investors - risk assets are still likely to outperform but returns may be lower. In contrast, returns for bonds and deposits will remain under pressure.

Overall – Maturing economic cycle capable of driving market further gains in 2022

In our view, 2022 could well be a year where transition is a key theme. From an economic perspective, global economic growth is likely to transition to a lower pace albeit one which is still strong in a historic context and one which allows many economies to get back to pre COVID levels of GDP. Although the new omicron strain of COVID and supply chain issues represent downside risks we are hopeful these challenges can be overcome.

Another transition is the growing realisation amongst investors is that inflation is back and here to stay and needs to be factored into decision making about investor portfolios as soon as possible if investors (and even savers for that matter) are to maintain their purchasing power.

The final transition is that of the unwind of the extraordinary fiscal and monetary support which has characterised the global economy and investment markets for much of the past two years. We believe the unwind will be gradual, but it will begin in 2022. In our view it will have little immediate impact on the recovery trajectory for the global economy but could be more of a factor for financial markets.

All of these transitions suggest that the path for markets in 2022 may be less straightforward than it was in 2021. We also believe that the upside for investors may be more modest in 2022 compared to last year, particularly as markets adjust to tighter US monetary policy. But ultimately, we see enough potential in the global economy this year to fuel further market gains for risk assets and to ensure they continue to outperform cash and government bonds in 2022.

Disclaimer:

Certain statements contained within this document may be statements of future expectations and other forward-looking statements, which are based on management's current views and assumptions, and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. In addition to statements which are forward-looking by reason of context, words such as "may", "will", "should", "view", "see","expects", "plans", "contemplates", "intends", "anticipates", "believes", "estimates", "predicts", "potential", or "continue" and similar expressions typically identify forward-looking statements.

By their nature forward-looking statements involve known and unknown risks and uncertainties because they relate to events and depend on circumstances that may or may not occur in the future. As such, no forward-looking statement can be guaranteed. Undue reliance should not be placed on these forward-looking statements.

Subject to applicable law requirements, we disclaim any intention or obligation to update or revise any forward-looking statements set forth herein, whether as a result of new information, future events, or otherwise.

This document is for information purposes only and shall not be treated as giving any investment advice and/or recommendation whatsoever.

These materials are directed only at relevant persons and must not be acted upon or relied upon by persons who are not relevant persons. Any investment or investment activity to which these materials relate is available only to relevant persons and will be engaged in only with relevant persons.

Figures in this document may have been rounded, this could result in percentage changes differing slightly from those provided in such reports. We have exercised utmost diligence in the preparation of this document. However, rounding, transmission, printing and typographical errors cannot be ruled out. We are not responsible or liable for any omissions, errors or subsequent changes which have not been reflected herein and we accept no liability whatsoever for any loss or damage howsoever arising from any use of this document or its content or third party data or otherwise arising in connection therewith.

BLACKBEE®

BlackBee Alternatives
City Quarter, Lapps Quay,
Cork, Ireland

T: +353 (0)21 206 1710
E: invest@blackbee.ie

Copyright © 2021 BlackBee, All rights reserved.

The BlackBee logo (the "logo") is a registered trademark and may not be reproduced by any means or in any form whatsoever without written permission. The name 'BlackBee' is a registered trademark and as such may not be reproduced by any means or in any form whatsoever without written permission.

Blackbee Alternatives Limited is an unregulated entity.

Registered Office: City Quarter, Lapps Quay, Cork

Images Shutterstock/Unsplash unless otherwise stated.