BANQUE INTERNATIONALE À LUXEMBOURG

BIL Investment Outlook

Twenty two questions for 2022

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Introduction by Group CIO, Fredrik Skoglund

Fredrik Skoglund
BIL Group Chief Investment Officer

We've come a long way since the darkest days of the pandemic, with vaccines gradually replacing the need for complete lockdowns, curfews and closed borders. The economy has also come a long way since its 2020 nadir, with 2021 delivering stronger-than-expected growth and corporate profits, thanks to a powerful confluence of fiscal and monetary stimulus. Indeed, in July this year, the National Bureau of Economic Research's Business Cycle Dating Committee judged that in the US, the pandemic-induced recession was the shortest on record, lasting only two months. Short though it was, it was definitely not sweet: it was also the steepest and, as such, the return to "normality" is not all plain sailing, and the investment world is faced with a lack of historical reference points.

Early last year, many economists predicted that the great reopening would catalyse an economic boom akin to the Roaring Twenties or, as the OECD more dryly put it, "private consumption is set to benefit from the lifting of containment measures and the concomitant fall in household saving, which finances sizeable pent-up demand (i)." After a year of being couped up at home, consumers were expected to hit the malls and spend like the Great Gatsby on his fourth cocktail, ushering in a new era of economic prosperity. However, data shows Americans and Europeans are still sitting on $2.7 trillion in excess savings banked during the crisis (ii).

The "consumer boom" scenario was rapidly confronted with supply constraints. Shortages that initially affected things like pasta and protective equipment at the beginning of the pandemic have spread to cover a wide array of things: semiconductors, car parts, ships, shipping containers, workers. This new chapter of scarcity is not the result of one big bottleneck in, say, Chinese factories or container ships. It is due to dizzying demand being met with a hydra of bottlenecks as companies struggle to piece together highly-complex supply chains which often crisscross the globe (often traversing countries which still have restrictive measures in place).

The good news is that supply-chain issues are expected to ease over the next year, opening up the possibility of more robust growth down the road. The bind is that a combination of surging demand, shortages and higher energy costs has contributed to rising inflation around the world. Both headline and core prints in many places are at the highest levels seen in well over a decade.

For now, key central banks such as the Fed and the ECB are pretty adamant that inflation will prove transitory, but markets are already betting that it is going to be stickier. This tug-of-war will be the focal point of 2022. Our base case is that inflation will moderate at manageable levels after winter as volatile energy prices retreat and as more kinks in supply chains are ironed out. However, inflation drivers are starting to broaden out and if companies meaningfully adjust their pricing and pay policies, what might have been a temporary burst of inflation could become more ingrained. In this scenario central banks would probably be forced to tighten quicker than expected, putting growth in jeopardy.

A more permanent form of inflation and monetary tightening that chokes growth are the key risks we face next year. Another risk is the fact that the health crisis still lingers; this winter will be the real litmus test as to the success of vaccination campaigns thus far, though recent medical advances, including the experimental oral antivirals from Pfizer and Merck give reason for optimism.

With this in mind, it is likely that investors will face trickier terrain next year. Growth is still intact and, while the environment for risk assets is still constructive, the rising tide that lifted all boats in 2021 is set to become a lot choppier. That said, seasoned investors know that risk always creates opportunities.

Beyond cyclical opportunities, next year we will emphasise long-term structural opportunities in areas such as digitalisation and the sustainable transition. The fight to reduce carbon emissions and combat climate change will remain at the fore next year after having been cast into the spotlight at the COP26 summit in Glasgow. We at BIL have a strong ambition to play our part in the transition to a more sustainable economy.

All the aforementioned topics will be explored in more granularity in this Outlook. To make it easier to digest, we have adopted a new format this year, choosing twenty two of the most pressing questions to put to our in-house investment specialists. I hope you will enjoy the read and that you will have a safe and enjoyable holiday period.

Macro Outlook

1) Will global growth persist next year?

Economic growth hit multi-decade highs in 2021 and we expect the expansion will spill into 2022. Peak growth has probably been achieved, but our macro outlook remains upbeat with the observed slowdown in the second half of 2021 probably representing growth that has been pushed into the not-too-distant future rather than “lost growth”.

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IMF Growth Projections
(Real GDP Change, %)

	2021	2022
World Output	5.9	4.9
Advanced Economies	5.2	4.5
Emerging Market and Developing Economies	6.4	5.1
USA	6.0	5.2
Eurozone	5.0	4.3
UK	6.8	5.0
China	8.0	5.6
Japan	2.4	3.2
India	9.5	8.5
Latin America and the Caribbean	6.3	3.0

Latest PMI data (as at 24/11/21)

	Composite	Manufacturing
Global	54.5	54.3
US	56.5	59.1
Eurozone	55.8	58.6
China (Caixin)	51.5	50.6
Japan	50.7	54.2

Source: Bloomberg, Markit, IMF, *BIL*

Winter will be the litmus test as to the success of vaccination campaigns.

But the reality is also that growth drivers are gradually being watered down. Both fiscal and monetary stimulus will be progressively pared back next year, while the initial boost that the vaccine roll-out gave to confidence is fading. Even where large swathes of the population are vaccinated, restrictions remain in place (social distancing, testing). The uneven distribution of vaccines is also problematic and there is also the risk of new vaccine-resistant strains or fading efficacy over time.

Nonetheless, the investment cycle should keep booming, with corporates and consumers alike boasting strong balance sheets, resulting in very robust demand in developed regions (as indicated by datapoints such as factory orders, retail sales and ISM indicators that are hovering above previous peaks). In theory, this implies a smooth handoff from extraordinary policy support to private activity-led growth. However, caution is warranted. Because of the unprecedented nature of the health crisis, there is no standard

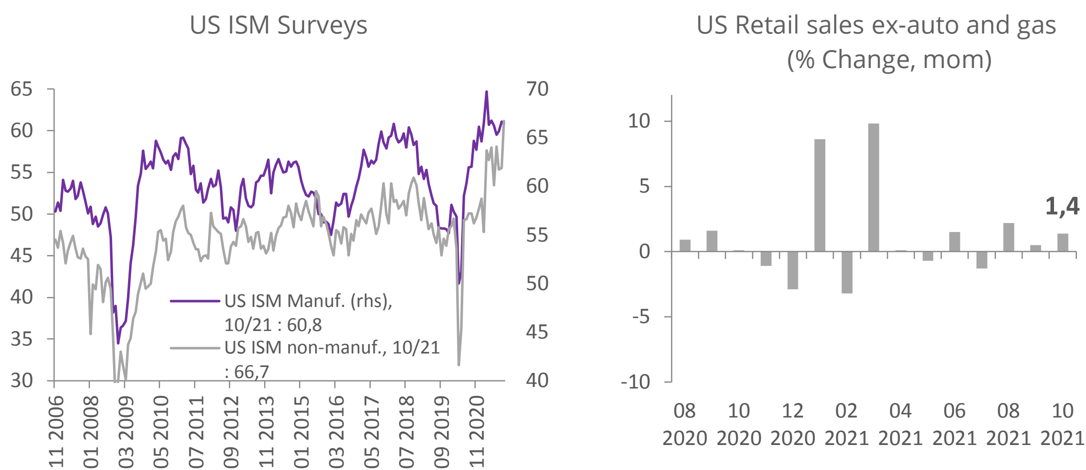
recovery playbook: supply chain disruptions coupled with strong demand are feeding into inflation, which is expected to remain sticky and settle at higher levels than we have seen in recent decades. If it continues to strengthen, central banks could be compelled to step in (or out, may be better terminology).

The total excess savings banked since the Covid pandemic began is $2.3 trillion in the US and $464 billion in the eurozone [iii]

2) What are your regional views? Where does macro strength lie?

A very uneven recovery is playing out. Aggregate output for the advanced economy group is expected to regain its pre-pandemic trend path in 2022 and exceed it by 0.9% in 2024. By contrast, aggregate output for the emerging and developing economies (excluding China) is expected to remain 5.5% below the pre-pandemic forecast in 2024. So, developed markets are definitely faring better, with the **US** at the helm. There, demand is exceedingly strong, profit growth is robust and financial conditions are still loose. Even if tensions remain on the supply side, we expect dynamism of momentum in both manufacturing and services to persist; in the latter particularly as the need for social distancing is reduced.

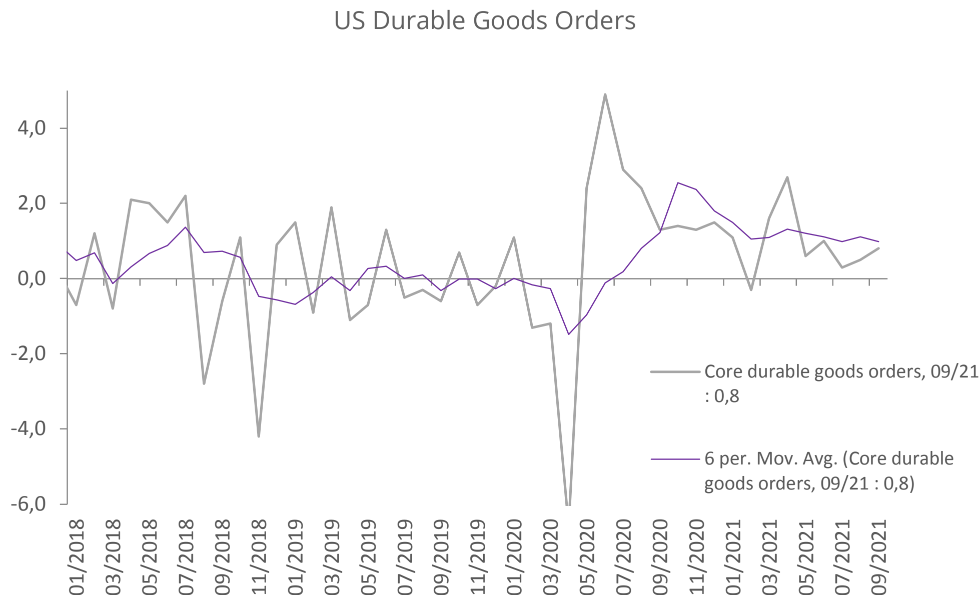
Even if tensions remain on the supply side, sentiment reports such as the ISM confirm the dynamism of momentum in both services and manufacturing.



Source: Bloomberg, *BIL*

On the goods side, businesses are well engaged in the restocking cycle to replenish depleted inventories to meet rising global demand and capital expenditure trends are expected to remain strong. Going down one step in the value chain, wholesale and retail inventories are also rising fast for both durable and non-durable goods. Of course, there are some notable exceptions – for example, the auto sector and apparel – but the overall trend is clearly up. Shipments and unfilled orders of durable goods are both on a firm upward trend across all sectors, indicating that the key issue lies with unconstrained demand driven by exceptionally high cash balances of consumers and strong balance sheets of corporates. This is important as it illustrates that inflation dynamics are more complex than just “supply side constraints”; they reach far into the domain of strong demand, usually taken care of by tighter monetary policy.

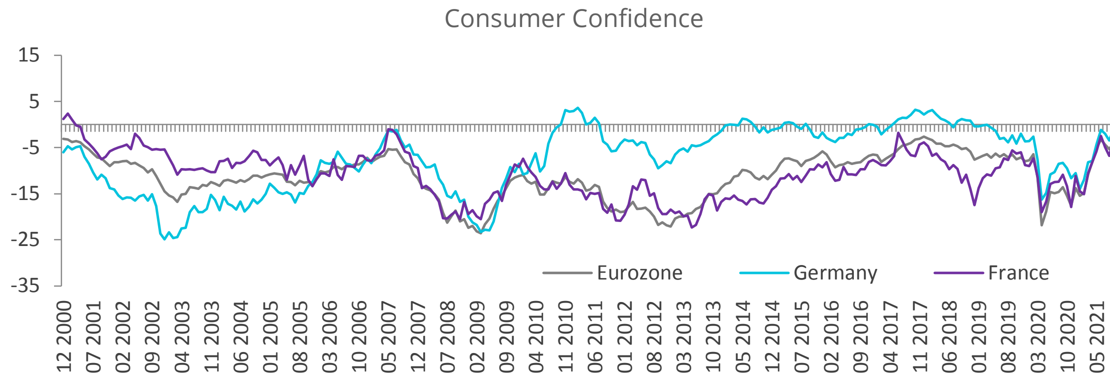
In the US, the key issue lies with unconstrained demand driven by exceptionally high cash balances of consumers and strong balance sheets of corporates



Source: Bloomberg, *BIL*

The **Eurozone**, aided by the high take-up of vaccines, returned to 99.5% of its pre-Covid GDP in the third quarter but the performance remains mixed across countries and sectors. On the consumer side, sentiment is above pre-crisis levels and the upward trend in retail sales remains quite firm and broad-based across categories, particularly services. However, European industry appears to be tanking despite healthy demand, with manufacturers in the bloc seemingly less able to cope with the supply-side issues

than their US counterparts. Much of the malaise is due to the size of the auto sector (heavily affected by shortages of semiconductors and other components) within the European manufacturing industry. Car manufacturers have said that they expect bottlenecks to persist into next year.



Source: Bloomberg, *BIL*

Last year, **China**'s economy faced a veritable onslaught of headwinds, from unanticipated regulatory crackdown on big tech to tighter policies in the highly-leveraged real estate sector, with Evergrande, the second-largest property developer in China, narrowly avoiding default. International investors are still wary and with Chinese developers due to pay or refinance tens of billions of dollars' worth of debt in the coming 12 months ($33.1 billion of onshore bonds listed in mainland China, and $43.8 billion of offshore US-dollar denominated bonds, as at the end of October), this issue will probably continue to generate noise in 2022, though we think that the risk will be ring-fenced and will not result in an economic calamity.

As such, China's economy is expected to return to its normal growth trend in 2022, probably in the range of 5%-6% for the year, under the assumption that risks stemming from the Covid epidemic continue to become more manageable.

In China, fiscal policy will play an important role in stimulating growth, together with a pick-up in consumption, while monetary policy is expected to remain moderately loose.

Fiscal policy will play an important role in stimulating growth while monetary policy is expected to remain moderately loose. Areas where we expect robust growth, in line with Beijing's ambitions, are high-tech manufacturing and green capex (given China's plan to reach carbon neutrality by 2060).

Contrary to what we are seeing in the west, consumption has been the slowest component of GDP to recover since the pandemic, with sporadic Covid resurgences dampening sentiment. The government's

zero-tolerance stance on Covid is unlikely to be substantially relaxed before the 20th Party Congress in October 2022. At this meeting, new measures to enhance domestic consumption may be rolled out. Ultimately, we believe that the capacity to consume has not been significantly damaged, and consumption growth will eventually accelerate due to increases in households' disposable income.

We are less constructive on the outlook for **emerging economies** next year. Nations that spend in haste are often forced to repent at leisure and emerging markets that stimulated most aggressively in the wake of the pandemic got no real pay-off in terms of a faster recovery. Many are now faced with tighter financing conditions and a greater risk of spiralling inflation and have therefore begun withdrawing policy support, despite having bigger shortfalls in output. On top of that, uneven vaccine distribution continues to weigh on emerging economies – whereas almost 60% of the population in advanced economies are fully vaccinated, about 96% of the population in low-income countries remain unvaccinated (iv). Lastly, it is also worth noting that next year's elections in Brazil could potentially be quite messy, inflaming volatility.

3) What's in the fiscal pipeline for next year?

In the US, pressures for more conservative fiscal policies have been amplified recently, given that the private sector is already booming, inflation pressures are mounting and the fact that there is already too much demand to satisfy. Direct fiscal support to households has been pared back (e.g. emergency unemployment benefits expired on September 6), but a significant $1.2 trillion bipartisan infrastructure bill was passed in November, which will deliver $550 billion of new federal spending into America's infrastructure over five years. The bill (v) includes $110 billion for roads and bridges, $66bn for railroads, $65bn for the power grid, $65bn for broadband, $55bn for water infrastructure, $47bn for cybersecurity, $39bn for public transit, $25bn for airports, and can be considered one political win for President Joe Biden ahead of the midterm elections.

However, Biden's party still has much work to do on the second pillar of his domestic program: a sweeping expansion of the social safety net and programs to fight climate change. The "go big" $3.5 trillion package originally proposed by Biden could lead inflation to significantly overshoot the Fed's target and affect inflation psychology with higher expected inflation potentially leading to higher actual inflation. As such, the bill (vi) being discussed has been trimmed to a more moderate $1.75 trillion but would still be the biggest expansion of the US safety net since the 1960s (vii). It seeks to expand early childhood education, tackle climate change and expand health coverage. The package, still under discussion, will not roll back President Trump's tax cuts and instead would be funded by taxes (proposals include a 15% minimum tax on corporations, a 5% tax on incomes above $10 million and 1% surtax on stock buybacks). For now, it is unclear if progressives in the House and centrist senators will sign off on the deal. Any significant change in the size or composition of the fiscal package will have implications for US growth prospects and those of its trading partners.

In Europe, unwinding the emergency spending measures governments undertook to support their economies will be a very complex endeavour in 2022 given disparate growth rates across countries.

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The impact on growth will be *partially* countered by disbursements of Next Generation EU funds which will continue up until 2026, intended to help build a post-Covid Europe that is greener, more digital and more resilient. The economic impact of a tighter fiscal stance may also be lessened by a decline in private savings.

In China, public policy will play a more important role in supporting economic growth next year. Structural reforms are likely to remain the priority for policy makers, and investment in infrastructure, especially high-tech manufacturing, is very likely to be deployed as a cross-cycle policy adjustment tool. Additionally, the Chinese government is expected to deploy policy tools and stimulus packages to avoid contagion risk from property market slowdown, even if no concrete details have been given yet. China's global ambitions in areas like technology and manufacturing give us continued reason to invest there, albeit selectively.

4) The trip wire in the system when it comes to debt is inflation and higher interest rates. With inflation elevated and rates set to rise gradually, should we be concerned?

The question is probably most relevant to the US. National debt sits at almost $29 trillion (viii) and Congress currently faces a looming December 3 deadline to avert a politically embarrassing government shutdown and the recurring risk of an economically catastrophic default on the federal government's debt. Obviously, the Fed is well aware of a potential tighter monetary policy on public debt while, at the same time, the glass half-full glass perspective is that higher inflation will eat part of the debt away.

Debt dynamics are not an urgent concern, given that we are still in an environment of strong growth.

However, debt dynamics are not an urgent concern, given that we are still in an environment of strong growth. These worries are reserved for later on in the cycle.

5) What about supply chain bottlenecks? Do you see them being resolved any time soon?

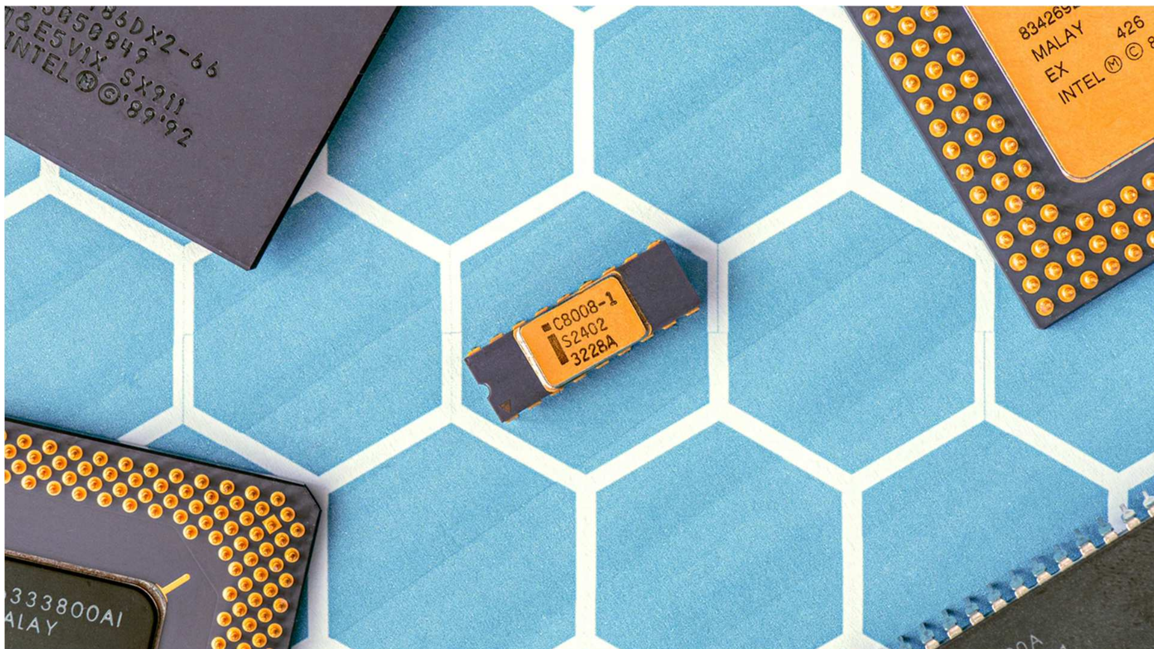
Global supply chains are still in the process of being pieced back together after being dismantled by the global health crisis. On the other hand, the reopening of economies has set off an explosion of demand that even healthy supply chains would struggle to satisfy.

In every corner of the world, companies are facing supply chain issues that have been exacerbated by other factors: China has faced power shortages and port closures, the UK faces an acute shortage of truck drivers in the aftermath of Brexit and the US faces weeks-long traffic jams at key ports.

As well as being a source of weakness and vulnerability for the global economic recovery, in the US, supply chain issues are also potentially a point of political vulnerability ahead of the midterm elections. That's probably why we have seen Biden move to secure deals with the likes of Walmart, UPS and FedEx to extend their working hours. Those three companies have announced a round-the-clock, seven-day-

week model as part of a broader effort to help clear the mismatches between booming demand and lagging supply, and alleviate shortages.

The expectation is that supply chain issues will ease over the next year. Indeed it seems likely that transportation challenges will fade throughout the first half of 2022 (should epidemiological factors stay under control) and gluts may even have started to form by the second half of next year.



We currently face a global shortage of semi-conductors, prompting countries like the US to re-think their domestic production capabilities.

6) Will supply/demand dynamics in the semi-conductor industry normalise in 2022?

The shortage of computer chips has zapped energy from the economy, punishing industries in a variety of sectors, from automakers to medical device manufacturers, and contributing to fears about high inflation. Problems in the global supply chain for semiconductors are not expected to ease any time soon and this is already having significant consequences for several industries. For example, component shortages and logistical issues led Apple (one of the largest buyers of chips) to revise down its iPhone 13 production targets for 2021 by 10 million units.

Companies like the Dutch producer ASML are at the core of the industry and are crucial for the planned expansion of chip manufacturing capacity. ASML, for example, is the sole producer of the EUV machines (extreme ultraviolet lithography – a technology that uses tiny waves to put the layers on the wafer) necessary to produce the most complex chips. One machine costs $150-200 million and it has to be shipped in 40(!) containers to the place of assembly. In addition to all the operational issues with adding extra capacity quickly, there are capital issues that put additional constraints on chip producers.

The US government has urged companies like Samsung, one of the world's largest makers of the high-tech components, to build new plants in the US, calling it an economic and national security imperative and the Senate passed a bill (CHIPS Act, the American Innovation and Competition Act) that includes an allocation of $52 billion in subsidies to promote semiconductor research, design and manufacturing. However, the bill has not yet passed the House of Representatives.

7) Markets love a buzzword and the latest that has begun to crop up is "stagflation". Is this a risk?

It seems that the recent energy price spike has lathered up recollections of the 1970s when double-digit inflation, rising unemployment and weak economic growth left scars on the collective memory of markets. However, we do not expect a repeat of this episode. Stagflation refers to *persistent inflation combined with stagnant consumer demand and relatively high unemployment*.

Neither the world nor the US appears to be at immediate risk of sliding into stagflation with manufacturing production going strong yet unable to satiate very strong demand. If the transitory inflation story does not hold, this is probably a discussion that will crop up again in 2022.

8) But what about unemployment, the labour market still seems to be struggling to recover from the pandemic?

Yes, it's true. While advanced economies are expected to regain pre-crisis output levels by the end of 2022, only two thirds are projected to regain their earlier employment levels.

In the US, for example, there are more jobs available now than ever recorded. With 10.4 million jobs open, employers are scrambling to find a workforce to meet demand. Similar trends are at play in Europe – in Germany, a third of companies are short of skilled workers with currently at least 400,000 skilled job vacancies.

There are various reasons for the labour market's sluggish recovery. On one hand, the health crisis is still influencing individual decisions about returning to work. However, the pandemic also seems to have catalysed something bigger – a shift in the collective attitude towards work, something that Anthony Klotz, an American psychologist, has dubbed "the Great Resignation".

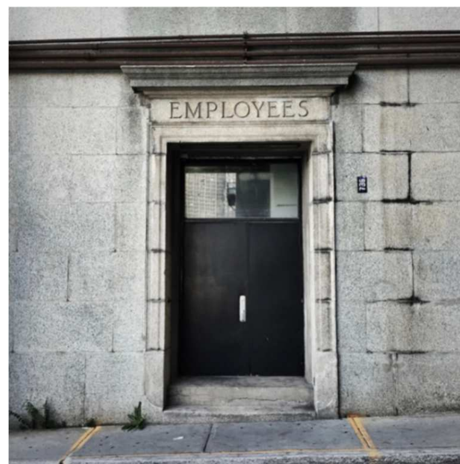
America, for example, has set a new record for the number of people quitting their jobs. 4.4 million people quit in September 2021 (3.0% of America's working population), the highest number on record in 20 years and well above pre-Covid levels of 2.3-2.4%. While quits are more concentrated in food & accommodation services, retail and wholesale trades, the departures are happening across the board. Again, this is not only a US phenomenon. According to the OECD, in 38 member countries, at least 20 million workers have not returned to work since the coronavirus struck. Of these, 14 million have exited the labour market and are classified as 'not working' and 'not looking for work.'

In an economy where jobs are plentiful and the people to fill them are scarce, the shoe is on the other foot for the first time in a very long time: the labour market is being driven by employees.

In turn, employers are beginning to raise wages and dangle more benefits to attract workers. Initially one might expect that this constitutes a red flag, indicating more ingrained inflation. However, for now, average, economy-wide wage inflation remains contained, albeit higher in certain sectors.

"A one-off shift in the level of wages as part of the adjustment to a transitory unexpected increase in the price level does not imply a trend shift in the path of underlying inflation"

– ECB Chief Economist Philip Lane, October 2021



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Even in countries such as the US where pressures are building, wages may not be rising at all after adjusting for inflation and considering that most pay gains are concentrated in low-wage sectors. Amazon's decision to pay warehouse staff an hourly $18 minimum, for example, prompted other big employers to raise starting pay at the lower end of the pay spectrum. In the eurozone, there are few signs of surging wages, even though unemployment has fallen back to pre-pandemic lows and the number of people on state job support schemes has dropped sharply. Wage trends ultimately depend on how embedded inflation expectations become: if central banks manage to avert this, an upward trend is unlikely to kick in.

But to get a true sense of the inflation risk emanating from the labour market, we also need to gauge how productivity growth will develop. The pandemic has had a large, abrupt and measurable impact on the global economy and business models but its effects on productivity growth, possibly highly significant, will take longer to judge. Currently, wage growth is outpacing productivity, and may do so for some time if workers don't re-enter the workforce in more meaningful numbers.

This slow recovery in labour markets is a key factor preventing central banks from tightening. At the November FOMC, Chairman Jerome Powell gave more weight to the Fed's mandate of reaching full employment than to inflation, and predicts that the former will only to be reached in the second half of next year, while the Bank of England took markets by surprise by abstaining from a much-anticipated rate hike. The BoE said that recent economic data reinforces a hike in coming months to keep inflation to target, but major uncertainties about the job market kept them on hold for now.

Fixed Income and Central Bank Policies

9) The million-dollar-question: will inflation prove transitory or sticky?

Inflation has been above 5% for five consecutive months in the US with the October reading coming in at 6.2%, the highest level since November 1990. In the eurozone, it sits at 4.1%, the highest level since July 2008. Investors accustomed to stubbornly low inflation are spooked. While inflation is likely to prove stickier than expected, it is unlikely that inflation will sustain today's elevated levels over an extended period of time. Ultimately, we expect it to settle within central banks' comfort zones – probably higher than in recent decades when it was notoriously low.

This is in line with the messaging from key central banks advocating for vigilance when extrapolating inflation readings.

"Despite the current inflation surge, the outlook for inflation over the medium term remains subdued"
Christine Lagarde, ECB Chair, November 2021

"These bottleneck effects have been larger and longer-lasting than anticipated," Powell said. "While these supply effects are prominent for now, they will abate. And as they do, inflation is expected to drop back toward our longer-run goal."
Jerome Powell, Fed Chair, October 2021 FOMC

"Our view is that the price pressures will be transient – demand will shift back from goods to services, global supply chains are likely to repair themselves and many commodity prices have demonstrated mean reversion tendencies over time."
The Hard Yards speech by Andrew Bailey, BoE Governor, September 2021

The market, on the other hand, is focused on uncomfortably high and longer-lasting inflation. Today, breakeven rates (an imperfect estimate of inflation expectations) imply that prices will remain high for years to come, but we feel that this overlooks the structural drivers that have had a dampening effect on inflation in recent decades, which are very much still at play (for instance digitalisation, demographics, increasing automation).

Beyond supply chain constraints and unprecedented pent-up consumer demand (discussed in the macro section), drivers of higher inflation today are stemming from volatile components of the inflation basket:

- A global thirst for raw materials as economies reopen has pushed up **commodity prices**
- A perfect storm of factors in the **energy market** that caused oil and gas prices to rally. Globally, we are facing an energy crunch ahead of winter and the reasons for this appear to be mostly temporary in nature: a lack of maintenance during Covid, one of the least windy summers in

Europe for years (affecting the production of clean energy), low stocks after a very cold winter 2020/21, competition from Asian countries for liquefied natural gas, fires at production plants and other pandemic-related factors). However, the crunch is also partly caused by long-term factors, such as divestment from fossil fuels and highlights the fact that the energy transition is something that will need to be managed very carefully. The International Energy Agency says that investment in clean energy needs to triple over the next decade to avoid extreme energy market volatility. See Appendix 3.0 for a breakdown of the inflation baskets.

As such, it seems that the market has got ahead of itself, baking in too much inflation even if we cannot ignore the fact that the lagged pass-through to broader inflation from higher food and oil prices for importers means that price pressures are anticipated to stay elevated into 2022: in other words, stickier than central banks initially expected.

"Inflation next year will slow without a doubt… But the intensity and speed of the decline may not be what we expected a few months ago." – ECB Vice President Luis de Guindos

The risk to this forecast is if inflation pressures continue to strengthen and broaden out. In such a scenario, inflation expectations could translate into higher actual inflation and what might have been a transitory inflation episode (in light of post-pandemic dislocations) could become more permanent.

This is what central bankers are fearful of, as it could have a direct impact on consumer behaviour and corporate spending. Already, rising rents and some wage pressure amid labour market bottlenecks are challenging the "transitory" narrative and pose the question as to how transitory "transitory" will be. However, we note the agnostic definition of transitory as one that doesn't state for how long the transition could last, merely that it will fade away on its own (without tighter monetary policy).

For now, central banks are sticking to their original script but, for more clues on hiking cycles, it is better to look at inflation expectations beyond three years. Central bank communication will be key in keeping these expectations at bay. It is also worth mentioning that Powell's reappointment as US Fed Chair, for another four-year term, with Brainard as Vice Chair, brings continuity in policy and leadership.

10) The tide has turned on monetary policy. Is that a risk?

Indeed the tide started turning in 2021, with Brazil, Mexico, Russia, Romania and many more emerging economies already embarking on a path of rate hikes. Developed economies are now acknowledging that inflation poses risks to the economy, and Norway and New Zealand have also hiked rates.

There's no doubt that globally we are shifting towards a synchronised tightening cycle. However, the continuation of this cycle in the short-term is very dependent on how Covid evolves over the winter.

Already infection rates are ticking up and compelling fresh restrictions. This could dent the willingness of central banks to begin hiking rates. If the health crisis plays out better than feared, it could clear a major hurdle to accelerate tightening.

In the US, the Fed is performing a difficult balancing act, trying to allow the economy as much time as possible to recover (particularly the labour market), while acting quickly enough to keep inflation contained. The market has been challenging the Fed's view that inflation will prove transitory, pricing in more than two hikes in 2022, with the first in July (coinciding with the end of tapering). These expectations are quite aggressive and we expect a hiking cycle beginning in 2023 (as is indicated in the Fed's dot plot). The asterisk is that this ultimately depends on the trajectory of inflation as well as supply- side constraints easing up.

What is clear is that the ongoing tapering of the Fed's QE (reducing Treasury purchases by $10 billion a month and mortgage-backed securities by $5 billion) is not tightening, even if it's a first step along the road. If a more permanent form of inflation takes root in 2022, the Fed may be forced to respond earlier than expected. The Fed's ambition will be to orchestrate a soft landing for the economy.

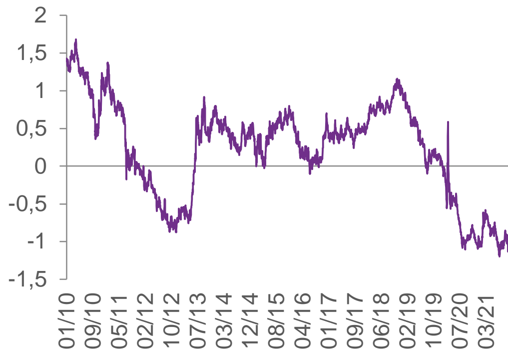
Central Bank Projections

				Central bank forecasts (%)		
	Indicator	Latest	As of	2021	2022	2023
Eurozone	CPI (YoY%)	4.10	October 2021	2.20	1.70	1.50
	GDP (YoY%)	3.70	Q3 2021	5.00	4.60	2.10
	Unemployment (%)	7.40	September 2021	7.90	7.70	7.30
US	Core PCE (YoY%)	3.60	September 2021	3.70	2.30	2.20
	GDP (YoY%)	2.00	Q3 2021	5.90	3.80	2.50
	Unemployment (%)	4.60	October 2021	4.80	3.80	3.50

Source: Bloomberg, *BIL*

The ECB, on the other hand, is the only major central bank not stepping into the rate hike game. Rather, it is discussing the end of the Pandemic Emergency Purchase Program (PEPP) (ix) and how to extend its Asset Purchase Program to avoid pulling the rug out from under weaker economies in the bloc. President Christine Lagarde has pushed back on market bets on an interest rate hike as soon as next October, saying it was "very unlikely" such a move would happen in 2022.

US 10y Real Yields* Since 2010



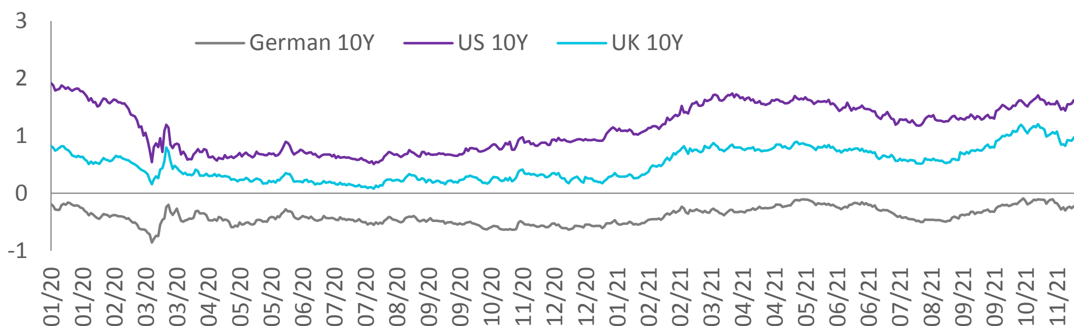
German 10y Real Yields* Since 2010

*nominal – inflation break-evens
Source: Bloomberg, *BIL*

Tightening is not a risk per se if central banks get the communication aspect right. Firstly, real rates are still deeply negative, even more so than at the start of year. Secondly, the economy is still enjoying fiscal support and strong demand, meaning it can likely withstand a gradual reduction in monetary support. However, tightening *will* have implications for asset prices. Equity volatility has been on a downward trajectory since central banks intervened in markets in the wake of Covid roughly 18 months ago and it could begin to pick up again. In the bond space, spreads for investment grade and high-yield spreads are expected to trade in a wider range while we could also see more volatility on rates moving forward. Furthermore, with less central bank intervention, the market could potentially rediscover the law of supply and demand and be more sensitive to large portfolio flows.

But volatility creates opportunities for seasoned investors.

10y Government Bond Yields Since January 2020



Source: Bloomberg, *BIL*

11) Do you see yields rising over the next year? What are your year-end targets?

Yes, it's very likely that yields will be higher 12 months from now. We see 10-year US Treasuries at around 2% by the end of 2022 and the German Bund at 0.20%; above their current forward prices in both cases. However, this doesn't necessarily mean that it will be a straight line from point A to point B; there could be some setbacks along the way with temporary technical corrections.

Given our expectations for a gradual rise in yields, we are broadly reluctant on fixed income, especially Sovereigns, while advocating caution when it comes to duration.

12) How can bond investors generate yield?

2021 hasn't been an easy year for bond investors – taking credit risk and no duration risk worked best. As we enter 2022, yields remain stubbornly low, despite the global economic recovery. The search for income is still a long-term challenge for investors around the world and requires consideration of all the different areas of the fixed income landscape. With real rates becoming further depressed in 2021 – and likely to stay negative for the foreseeable future – investors face wealth destruction in real terms by holding excess cash and high-quality bonds.

In 2022, we still advocate a tilt towards more credit risk, but without over-stretching on that front. Credit risk should be manageable in the first two quarters of 2022. Beyond then, it is more difficult to say, as a lot will depend on the impact that central bank tightening has on economic growth. Should central banks be forced to act aggressively, it could curtail growth and create an environment for higher spreads in the second half of the year.

We give preference to investment grade corporates and developed market high yield.

Within our current bond allocation, we give preference to **investment grade corporates**. On a micro level, corporate balance sheets are healthy, leverage is at pre-Covid levels and flows are strong with plenty of money chasing yield. However, credit is priced for perfection and spreads have little room to rally further, so excess returns must be generated through carry and selectivity: **short-dated corporate hybrids** and **financials** are of particular interest to us.

After a challenging 2021, we have also become more confident on the outlook for the Chinese investment grade bond market in 2022 with monetary policy expected to remain moderately loose with potential for a lower reserve requirement ratio (RRR) or even interest rate cut. Policy and credit risks will be limited for state-owned enterprises (SOE), which play an important role in China's economy. Valuations are reasonable at current spread levels, and we will see more technical support from the demand side with

the launch of southbound trading under Bond Connect between mainland China and Hong Kong. We give preference to firms with robust profitability and better stand-alone credit, particularly high-tech manufacturing companies and SOEs. Potential downside risks include a faster-than-expected rise in US Treasury yields and further deterioration in the property sector.

We are also positive on **developed market high yield bonds**. In this space, the number of zombie companies is low while leverage ratios are now at pre-pandemic levels and upgrades outnumber downgrades in both the US and Europe. While spreads on European high yield have opened recently, those in the US have remained rangebound, supported by higher oil prices (US high yield has a higher energy sector allocation). Within high yield, we give particular preference to **BB-rated corporates** given the strong upgrade cycle. There is a large pipeline of BB companies ready to join the investment grade universe and, if they make it, these so-called "rising stars" are usually rewarded with spread tightening.

In the emerging market debt space, we prefer **hard currency investment grade corporates**, which have a better volatility and duration profile. Corporates are more resilient against a rise in real yields. We are reluctant on emerging market high yield, with the entire universe affected by the uncertainties surrounding Chinese real estate developers. Chinese high yield alone has experienced its worst year on record, losing around 30% up until November (valuations have factored in the worst case scenario: the current yield-to-worst implies a default rate of over 30%). While the Fed has warned that China's troubled property sector could pose global risks, there are still no clear indications as to whether Beijing will step in with a broad, national plan to tackle the crisis and position itself as a kind of lender of last resort. Chinese regulators have, however, in recent weeks sought to reassure investors and homebuyers by saying that risks were controllable and that excessive credit tightening by banks was being corrected.

One of the segments within the bond market that delivered a stellar performance in 2021 was inflation linked (IL) bonds, with both TIPS in the US and Eurozone IL bonds surpassing the 6% mark. Those looking to invest in IL bonds to protect themselves from future inflation need to be aware that a lot of inflation risk is already priced in. The 5-year breakeven rates in Europe and the US are at record high levels (1.70% and 3.06%, respectively). Despite strong growth and tightening labour markets, easier year-on-year comparisons and an easing of supply chain pressures should lead to a moderation of inflation over the next 12 months, with inflation probably peaking in Q1 2022. This should lead to a repricing of inflation risk and hence an underperformance of IL bonds over nominal bonds.

13) So with developed market credit one of your key preferences, how is corporate debt in US versus Europe? Do we expect to see rising default rates?

Looking at the universe of outstanding bonds, debt levels are rising year after year. The silver lining is that so is GDP – the two are luckily moving hand in hand.

As of now, we don't foresee a rise in default rates, especially in the first half of 2022 and we are comfortable with dynamics on both sides of the Atlantic. Perhaps we could see an increase in default expectations in the second half of the year. Financial conditions are the key variable to monitor and, for now, they are still extremely accommodative. Rising rates are manageable for most corporates if they

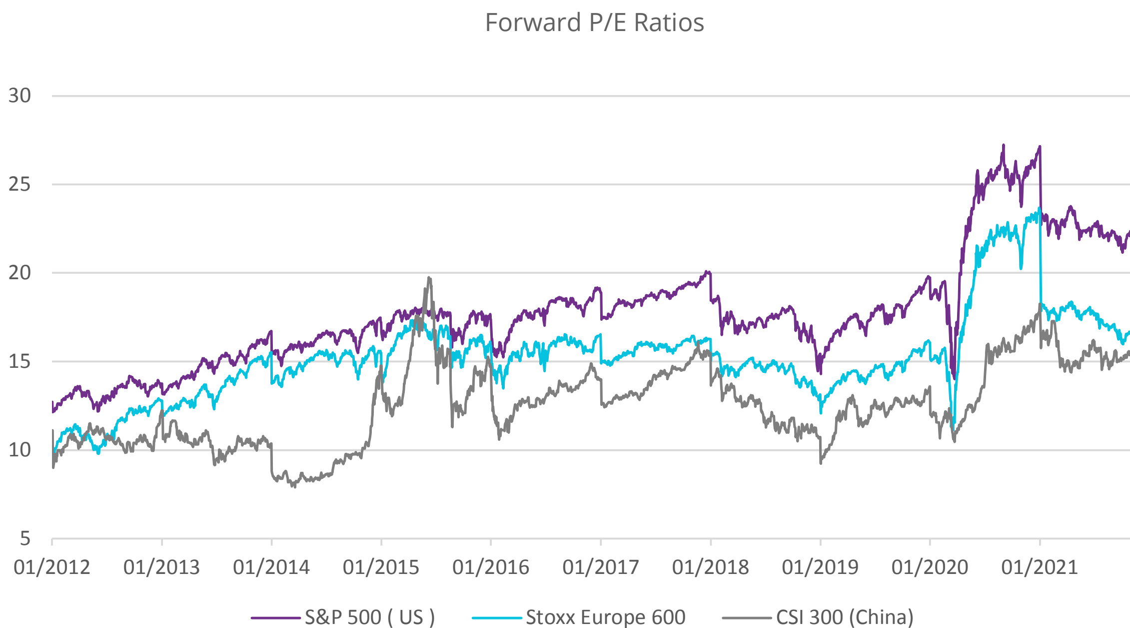
rise within our expectations. Nonetheless, certain sectors warrant closer monitoring; for example, real estate bonds, a segment in which some investors are already questioning valuations.

Equities

14) There is some talk of peak valuations – is this a risk? In 2022, what is needed for equities to continue their ascent?

Before Covid, equities were enjoying their longest bull market in history and the notion of "peak valuations" was already in full swing. Following the impressive post-crisis rally in which equity indices have effortlessly skipped from new high to new high, the peak valuation narrative is back and will probably continue to dominate the conversation in 2022. Stretched valuations aren't necessarily a barrier to higher equities – this just adds downside risk, as markets are essentially priced for perfection.

Forward P/E Ratios



Source: Bloomberg, *BIL*

Nonetheless, equity markets appear to be cruising optimistically into the winter holiday season, supported by very strong consumer demand, still-accommodative monetary policies, a just-passed infrastructure bill, and a 10-year Treasury yield around 1.5%. The market still has a lot of liquidity and

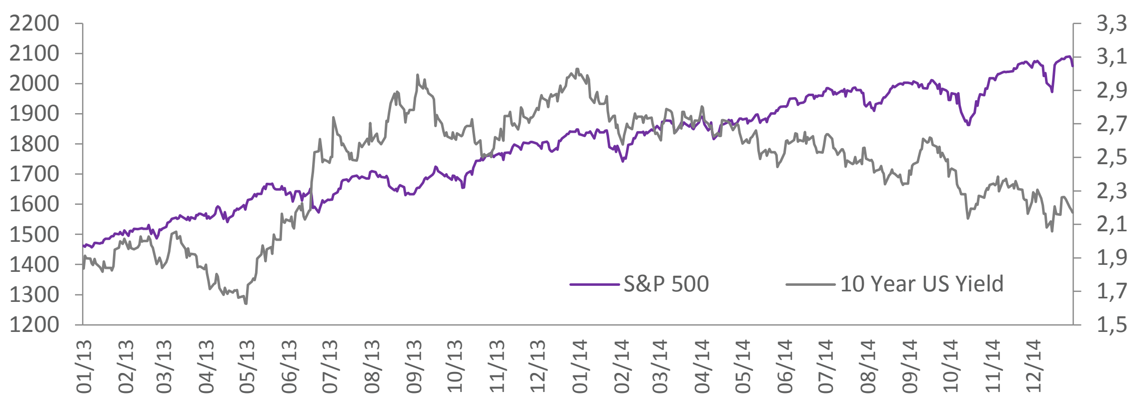
while equities are expensive, so is everything else (to illustrate, one just has to look at NFT auctions and the market cap of cryptocurrencies). From an asset allocation perspective, there are very few attractive alternatives to stocks (sometimes termed the TINA effect: There Is No Alternative) and unless you expect an imminent correction in equities, it is still the place to be because increasingly negative real rates render other asset classes (e.g. cash and fixed income) uninteresting. The resounding message that 2021 delivered to investors was that resilient markets make it costly to sit on the side lines.

Earnings will be the key driver for equities in 2022 and, while they may have peaked in 2021, the earnings cycle remains very strong and should remain so, given that strong economic growth is expected to endure well into 2022.

Increasing input costs have not yet had a meaningful impact on margins. However, the timeline for resolving bottlenecks and supply-side issues is becoming increasingly important: if they are resolved in the first half of the year (we are already seeing some flickers of light at the end of the tunnel), we expect to see revived growth, which will be supportive for equities.

With central banks now paring back crisis-era support, some are questioning whether rising yields are a threat to equities given that they could dent their relative attractiveness. In short, as an isolated theme, this won't pose a serious problem for equity markets because rates are still at very low levels. In 2013, when financial markets were expecting the Fed to taper its bond-buying program, yields rose from around 1.6% to over 3% and, in that period, equities rose too, as is shown in the graph below (the tapering was announced on May 22, 2013 and started in late December the same year). It would become concerning if higher yields converged with other risk factors (more persistent inflation, continued labour shortages, etc.); the culmination of risks could have a tipping effect.

10 year US Yield & S&P 500 during the last tapering episode



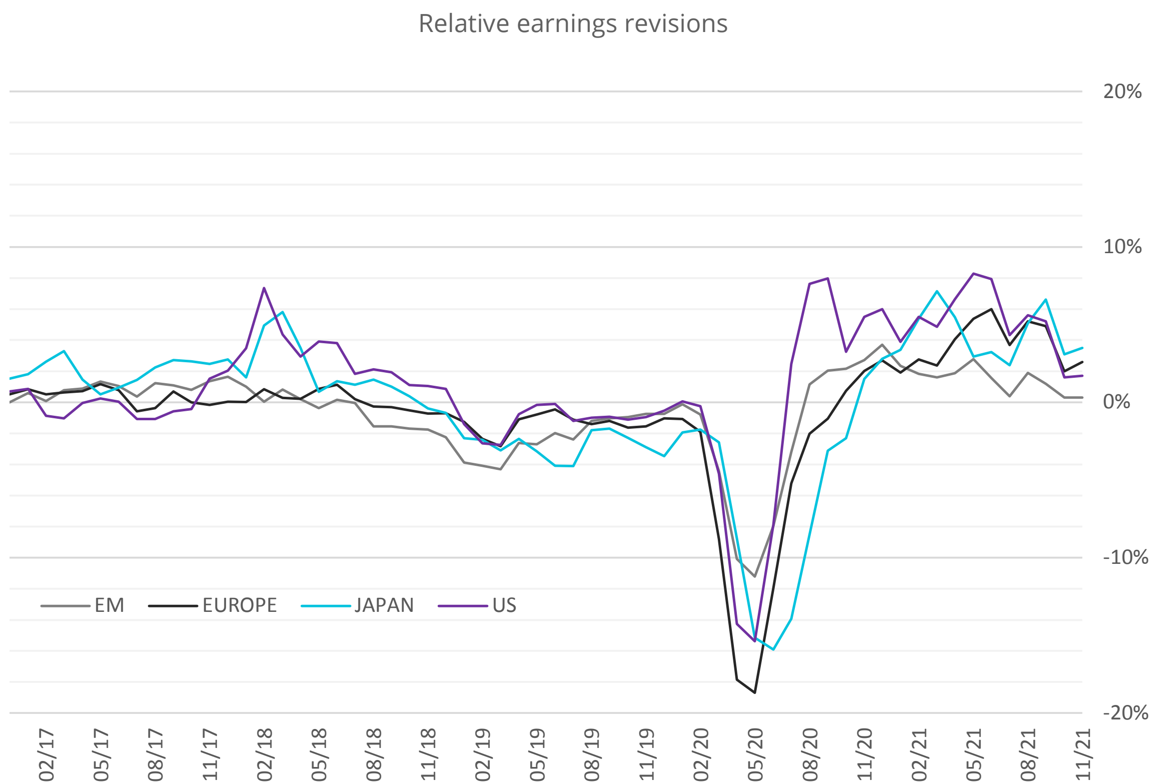
Source: Bloomberg, *BIL*

15) Are earnings expectations for 2022 lofty? Can companies beat them? Do we see negative revisions?

Expectations are not actually that lofty because we are in the process of normalisation. After EPS growth was wiped out in 2020, exceptional earnings growth has followed until now.

In the Q3 earnings season, 81% of S&P 500 companies delivered a positive surprise and earnings growth was 39% versus 27% expected. Halfway through the European reporting season, 68% of companies had delivered positive earnings surprises, with earnings growth of 57% versus expectations of 45%.

Prior to these strong results, earnings revisions had started to dip for 2022 at the index level, but the rollover has now paused.



Source: Bloomberg, *BIL*

While bottlenecks and labour shortages are yet to meaningfully impact margins, these topics were mentioned frequently in Q3 earnings calls, with opinions varied as to when companies believed they would be resolved. It is likely that in the Q4 2021 and Q1 2022 earnings results, these issues will start seeping into the actual numbers and it will be interesting to see if the market and analysts react in the same way to EPS misses driven by supply-side issues as they do to demand-based misses. We could see earnings revisions dip further south, but perhaps not, if analysts can look past these issues and perceive them as a deferral of revenue.

Later on in 2022, earnings revisions might pick up as more bottlenecks are resolved. The trend could also quickly move in the opposite direction if interest rates rise, inflation proves more persistent and input costs are not resolved in the first half of the year.

16) What are your equity preferences in terms of regions?

We are overweight the US and Europe, neutral on China and underweight emerging markets

In tune with our macro outlook, we prefer developed market equities over emerging.

The US is faring best, showing stability in its macro data. It is also attractive from a flight-to-safety perspective on any potential risk-off sentiment (there are more quality stocks in the US that tend to perform well in such periods). Towards the second half of the year, if growth and inflation moderate, GARP (growth at a reasonable price) and quality styles will come back in favour with investors and these kind of stocks are more concentrated in the US.

Europe, on the other hand, is experiencing a macro rollover at the moment and the region lags the US in terms of earnings. However, the current environment of higher interest rate and inflation benefits the more value-oriented nature of the European market while, on the monetary side, the ECB is decidedly more dovish than other major central banks.

China is attractive from a valuation standpoint; however, regulatory uncertainty is making international investors wary and the region is now very cheap relative to developed markets. For now, we are neutral on Chinese equities, albeit poised to increase exposure should we obtain more clarity on the regulatory front (which should ease volatility) and should China start to deploy its strong arsenal of fiscal firepower.

Both onshore and offshore China equities should offer comparative advantages for long-term investors and we are particularly optimistic about the following investment themes:

- **Innovation & the industrial upgrade cycle towards advanced manufacturing**
  These topics will prevail as a key pillar of China's long-term development and economic growth, with advanced manufacturing sectors at the core, in line with China's Innovation 2025 strategy. Hardware sectors such as electronic components, semiconductors and wearable devices continue to benefit from global innovation and technological breakthroughs by domestic producers. China's commitment to Carbon Neutrality by 2060 is driving long-term investment in the areas of solar/wind power, energy storage, smart grid construction, new energy vehicles and the lithium battery industry value chain. Leading companies in those industries are enjoying robust expansion, which makes them desirable underlying stocks for a long-term investment portfolio.

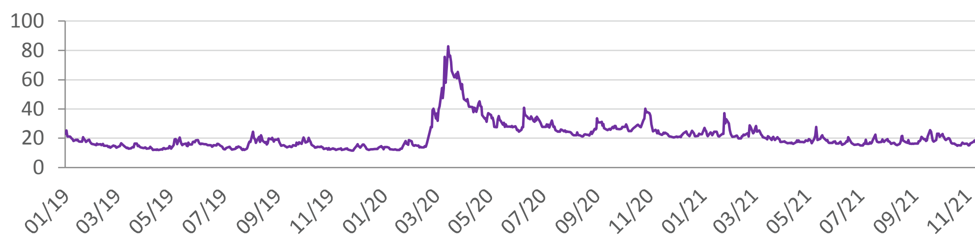
- **Reflation of consumer goods together with consumption upgrades as the middle class expands**
  As mentioned in the macro section, a trend towards higher CPI price pressures via rising retail prices began to take hold in Q3 2021. Leading consumer brands are beginning to pass on cost pressures to end-users as consumption gradually recovers. Premiumisation is also a long-term driver, reflecting consumers' upgrade needs and demand for diversified product offerings. We believe that price hike practices will be more prevalent in 2022 and leaders with a better product mix and strong brand images in consumer sectors will benefit from margin expansion. These names are projected to achieve above-average earnings growth in a reflationary context.

- **Normalised regulatory policies for tech sectors in 2022**
  After a one-year regulation cycle, we believe the market has factored in much of the policy headwinds, including anti-trust law, data security, minor protection and social responsibility. Chinese internet stocks have corrected by roughly 45%, on average, from their peak back in February 2021, due to regulatory overhang, a slowdown in earnings growth and long-term margin contraction. In the second half of 2021, we observed a trend of gradually improving policy transparency and regulation clarity from Chinese regulators. Some areas such as anti-trust and minor protection are close to a "phased" end. Companies like Alibaba and Meituan have received their respective penalties and specific directives for future operational adjustments. Looking ahead, more detailed regulatory measures might be rolled out, albeit in a more predictable and smooth manner. Sentiment surrounding the sector will be further boosted by 1) e-commerce bottoming out in Q3 2021, 2) large platforms enhancing their competitive advantages in online gaming due to better compliance with the regulator's minor protection policy, together with more innovative and diversified games portfolios; 3) attractive valuations.

17) What are your sector and style preferences?

We expect more volatility on equity markets in 2022, especially while supply-side issues remain unresolved.

Volatility is currently around pre-Covid levels (VIX)



Source: Bloomberg, *BIL*

Rather than reducing our equity exposure outright, we have applied a barbell strategy in our sectoral allocation in order to balance risk. This involves playing both cyclicals that typically thrive in an inflationary environment and defensives (healthcare).

Sector Preferences

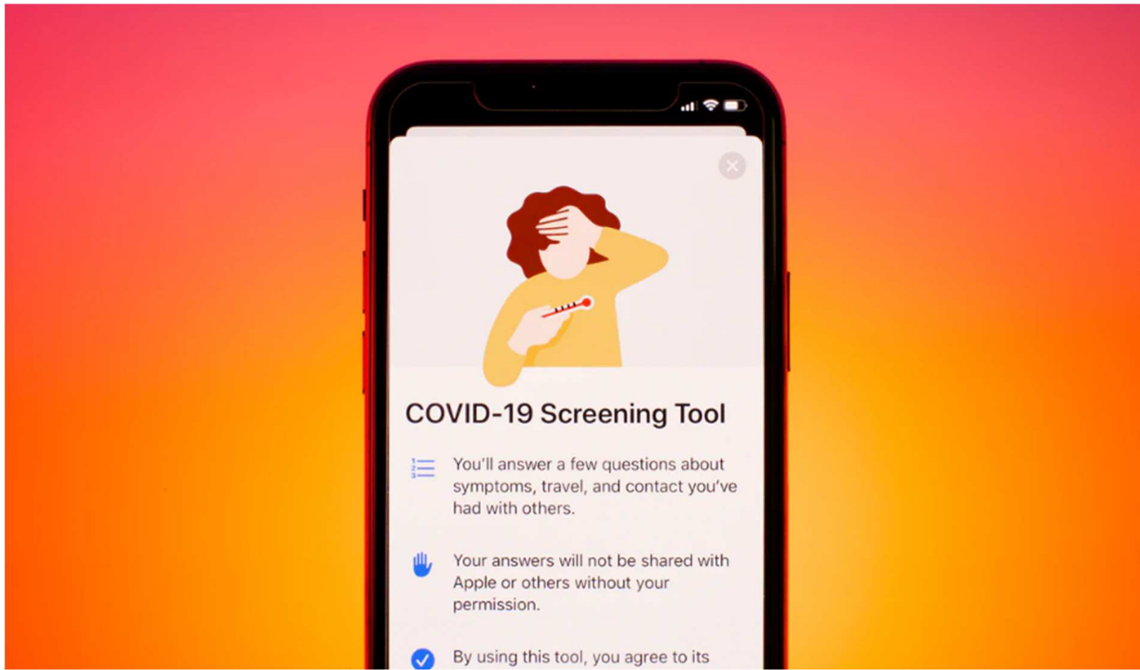
NEGATIVE	NEUTRAL	POSITIVE
Consumer Staples	Utilities	Financials
Industrials (Europe)	Industrials (US)	Materials
Consumer Discretionary (US)	Consumer Discretionary (Europe)	Energy
	IT	Healthcare
	Real Estate	
	Communication Services	

The **Energy** sector is poised to continue outperforming into 2022 given the global energy crunch and the tight situation in oil markets. The sector is a key beneficiary of the reopening theme (especially as travel resumes), earnings revisions are strong and the sector is supported by the continued upward trend in oil prices, which render more fields profitable.

Materials is another cyclical sector. It is set to continue benefitting from increased raw material costs across the board amid high demand and from strong flows of fiscal stimulus – whether it be from Biden's "Build Back Better" infrastructure drive in the US, or the EU's Next Gen program. We particularly like the mining subsector, a late cyclical play with high free cash flow yields. Demand for most mining commodities has created robust conditions for producers and explorers and supply constraints are setting the stage for historically above-average prices through to 2025 – driven mostly by increasing demand for materials used in the accelerating global energy transition. (x)

Financials are a key beneficiary of rising interest rates. Net interest margins are tethered to the long end of the curve, while deposit growth is strong thanks to stimulus. This is also a sector where we are seeing rising efficiencies and innovation through digitalisation.

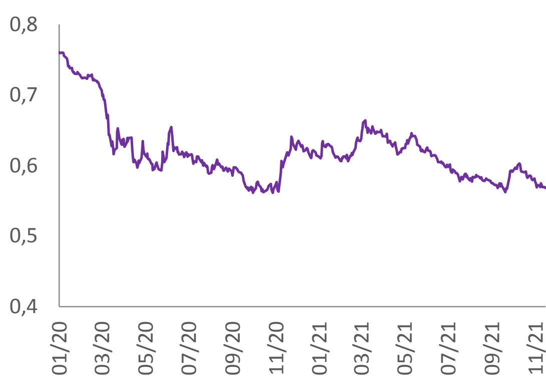
Healthcare is a defensive play that is less exposed to headwinds from inflation, elevated input costs, labour shortages and supply chain issues. After being thrust into the spotlight by the pandemic, the sector is undergoing a wave of innovation, especially in areas such as telehealth, patient care and treatments (MRNA vaccine technology could potentially be used to treat other severe illnesses (xi)). There is also a wide spectrum of opportunities for public/private sector collaboration.



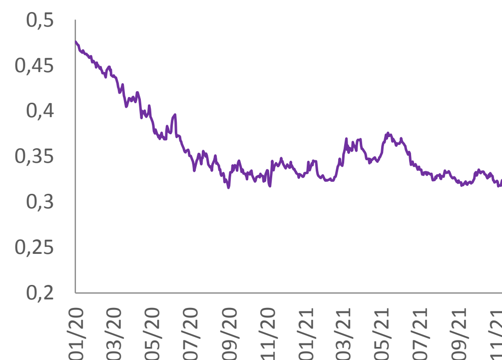
After being thrust into the spotlight by the pandemic, the healthcare sector is undergoing a wave of innovation

In terms of style, throughout 2021 we carried a preference for **Value** stocks, which typically benefit from higher rates and inflation. Given high inflation expectations and a more hawkish mood among central banks, it's still prudent to be there. Indeed, Value stocks still boast better net revisions than growth stocks – indicating there is still some juice left in the orange when it comes to this trade.

Europe Value versus Growth



US Value versus Growth



Source: Bloomberg, *BIL*

However, we believe the GARP trade (growth at a reasonable price) will take back the lead over the course of 2022 if supply chain issues ameliorate and if inflation moderates. This would benefit longer-duration stocks in sectors such as IT, whose profit streams are further in the future.

While big tech still faces regulatory scrutiny the world over (e.g. Google's $2.8 billion anti-trust fine, the Facebook whistle-blower's testimony before a Senate subcommittee claiming that the company puts profits before safety), it is unlikely that regulators will act so drastically as to break up or hinder the long-term growth of their homegrown, innovation powerhouses while the global race for technological supremacy is running. Tech has strong tailwinds from the structural shift towards a more digitalised society.

18) Are you focusing on inflation beneficiaries in your selection process?

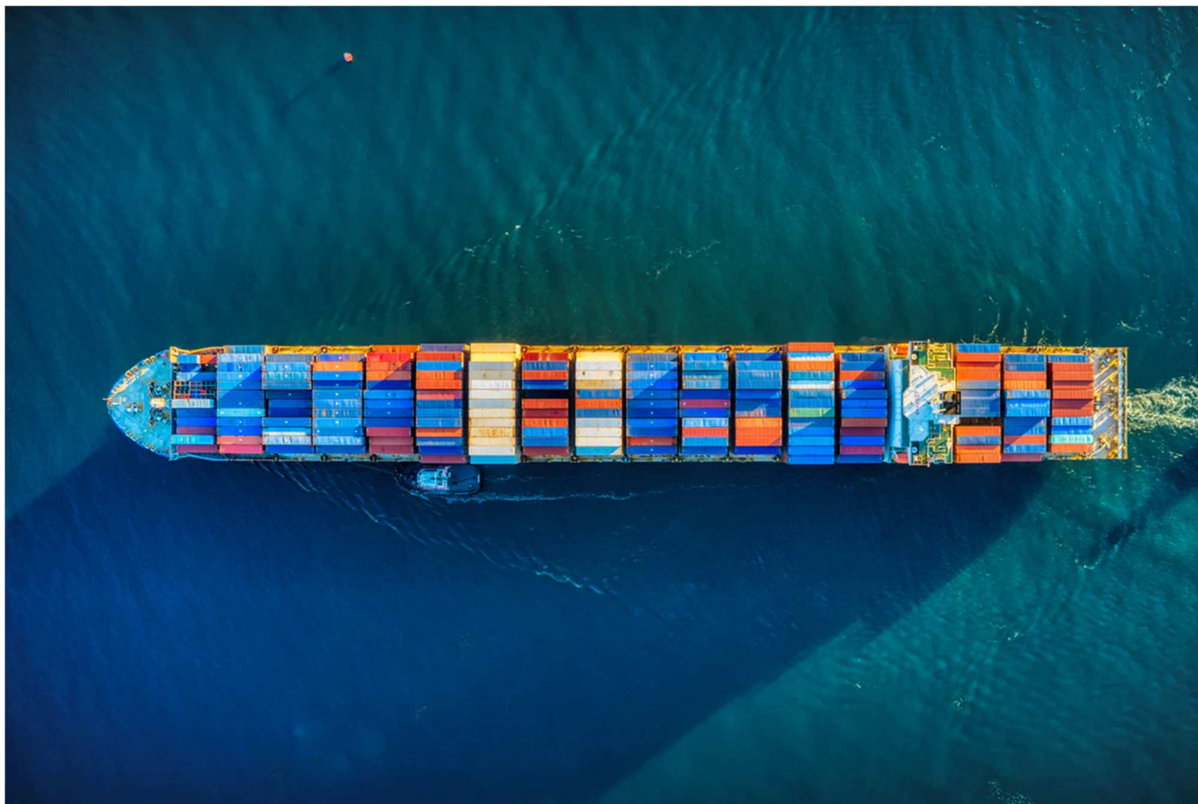
Indeed, one of the best ways to deal with shortages and supply-chain headwinds is for companies to raise prices. Already, a handful of companies have done so without ill effects on demand.

In summer, PepsiCo lifted prices for its fizzy drinks and snacks to offset higher commodity and transport costs and it plans further increases early next year. CEO Ramon Laguarta suggested in an earnings call in October that customers do not seem to mind, saying, "Across the world consumers seem to be looking at pricing a little bit differently than before."

In September Procter & Gamble, a multinational fast-moving consumer goods giant, increased prices for many of its products. Chief Financial Officer Andre Schulten told analysts, "We have not seen any material reaction from consumers."

And in October, fast food giant McDonald's announced a 6% increase relative to 2020 prices, due to rising costs (on top of higher ingredient costs, the burger chain said labour expenses had risen by 10% at its franchised restaurants and 15% at its company-owned locations). For now, it seems, customers can stomach it. The CEO, Chris Kempczinski said the increase "has been pretty well received". After digesting the news, investors sent shares in the firm up by 6%.

Pricing power should be an even more important theme in 2022 for relative returns, with high shipping costs, rising raw material prices, supply chain issues and some wage growth. But not all companies have this power. Recently, we have focused on identifying firms across different sectors that are able to pass on higher costs to consumers. This topic is quite well covered in earnings season guidance and gives us an idea of the companies that will be able to keep margins relatively stable through this episode of higher inflation. As we noted before, higher input costs have not yet showed up significantly in margins, which are still close to peak levels. At some point this will have to give, and it's better to be exposed to firms that have pricing power to defend their margins.



Pricing power should be an even more important theme in 2022 for relative returns, with high shipping costs, rising raw material prices, supply chain issues and some wage growth.

Commodities and Currencies

19) What are your views on commodities and currencies?

In response to rising demand, it was expected that OPEC+ would raise oil production by 800,000 barrels per day (bpd). However, its members decided to keep supply at 400,00 bpd, wary about renewed setbacks in the battle against Covid-19 and the macroeconomic slowdown. Higher prices are also allowing governments in those oil-producing countries that were hit hard in 2020 to improve the health of their ledgers.

The restraint of OPEC+ has supported a rally that pushed global benchmark Brent crude to a three-year high of $86.70 last month and we expect the upward trend in prices to persist into 2022 with supply failing to satiate the global demand surge. In an attempt to reduce prices for consumers, the US will

release 50 million barrels of crude oil from its strategic reserve from mid-to-late December. However, OPEC+ has already warned that it would slow its production rises in case of additional supply from stocks.

US shale companies whose breakeven rate is on average $46 per barrel (xii) are the world's marginal oil producers that often step in and balance out supply and demand dynamics when prices reach a certain threshold. However, while major oil firms, including BP, Chevron and Exxon Mobil, have publicly announced that they plan to ramp up output or shale spending next year, they are unlikely to fully address excess demand. We also have to keep in mind that US shale producers are somewhat limited by Biden's green agenda. This year, the Biden administration announced a moratorium on drilling permit issuances on federal lands and waters, and effectively cancelled the KEYSTONE XL pipeline from Canada to the US.

We are constructive on oil, less so on gold

Gold has often assumed the role of inflation hedge and portfolio stabiliser during financial market turbulence. As such, it is benefitting from a conjunction of factors in the short term:

- Recent red-hot inflation prints
- Reassurances from key central banks that interest rates would remain low for the time being
- Concerns around the Covid crisis as we head into winter in the northern hemisphere
- Industrial consumption of gold and silver

These factors have pushed gold above $1800 a troy ounce and should help gold continue its rally into year-end. However, longer term, as supply bottlenecks ease and as central banks begin to normalise policy, gold prices are expected to retreat (reduced stimulus and interest rate hikes tend to push up government bond yields and raise the opportunity cost of holding gold, which pays no interest).

What's also interesting to note is gold's competition from cryptocurrencies (or, more broadly, digital assets). Prior to the November rally in gold, more than $10bn had been pulled from the biggest gold exchange traded fund this year and funds' physical gold hoards have also been selling down, according to Bloomberg data. The price of gold had declined roughly 6% while Bitcoin had doubled in price to a record high of more than $67,000. It is emerging that some investors perceive Bitcoin and other cryptocurrencies as an inflation hedge. While we fail to see any strong correlation between Bitcoin and inflation, we note that the emergence of "digital alternatives" presents an additional headwind for gold.

In the currency space, we reckon with a change in tone from global governments. From around 2000, a primary policy focus has been to support expansion through a competitive currency while disinflationary pressures have tended to dominate, with the majority of developed countries largely preferring weaker currencies to support export growth. Now, intensifying price pressures are growing as a social, economic

and political issue and governments are cognisant that stronger currencies will help dampen inflation pressures.

We enter the new year more constructive on the US dollar, relative to the euro. The trajectory of monetary policy is likely to be the dominant driver of the USD going into next year, and tighter Fed policies (while the ECB remains relatively dovish), coupled with elevated inflation levels, should offer support. We are neutral on the Chinese yuan, believing that it could face some headwinds with more dovish policies from the PBoC potentially forthcoming. Nonetheless, it is still supported on the downside by the trade surplus (the trade surplus is still likely to contribute around 3% to GDP next year [the same as in 2019]). We are positive on the Swiss franc. Switzerland has shown strong supply-side resiliency during the Covid-19 recovery, and its currency has historically appreciated in an inflationary environment.

Long-term Investment Themes

20) Beyond short-term investing, what long-term structural themes are you following that transverse the traditional investment cycle?

Greek philosopher Heraclitus once said, "The only constant is change." Disruptive ideas, innovation, economic forces, and natural events keep reshaping the world we live in. Thematic investing is all about identifying these shifts and investing in companies strategically aligned to benefit most from such changes. We believe that thematic investing, with its resolute focus on long-term structural trends, offers an ideal platform to focus the mind on the long-term perspective that equity investing requires, regardless of the short-term vagaries in economic cycles.

For investors it is also interesting that thematic investment alleviates benchmark limitations. You don't invest in a company because it's headquartered or listed in a specific country but because the company is exposed to the identified long-term trend wherever they might be in the world.

In today's world, many people are worried or pessimistic about the future. This is clearly linked to the current context of Covid as well as a growing awareness of climate change.

The backdrop is obvious. Financial capital has mostly been detrimental to natural and human capital. To be fit for the future, the new paradigm must be aligned with the triple bottom line (people, profit, planet). A fourth P should also be added: purpose. This involves rethinking what we want and this is already happening to some extent.

Decarbonising our world, reforming our economic logic (circular vs. linear) and using technology to empower exponential changes all offer massive investment opportunities. Let there be no confusion: those are not superficial or empty words anymore but a massive transformation that is already playing

out across all industries and in every region. The sustainability revolution is in full swing, and green is becoming the new digital.

In our experience, the most attractive investment opportunities are found when multiple themes converge and reinforce one another. In that respect, the accelerating transition towards a more sustainable economy is the most obvious, empowered by the largest technological transformation in human history.

Climate change, the circular economy, water scarcity, and health care (oncology & biotech) are our current preferred investment themes, as well as some following more specific technological disruptions (agricultural technology, 5G and Fintech), especially when combined with (cyber) security solutions.

To conclude with another Greek philosopher, Aristotle teaches us that everything has a purpose or a raison d'être. If we want to understand what something is, it must be understood in terms of its end goal or purpose (Greek 'Telos' or τέλος). If wisdom is our guide, choices become obvious.

Sustainability

21) What's BIL's position on integrating sustainable considerations into investment decision-making?

In the last decade, ESG has gone from being niche to mainstream. Magnified by current environmental, social and health crises, massive societal shifts are now at play. Discussions about ESG are occurring at all levels, whether it be amongst policymakers, boardroom executives, employees or investors. In a nutshell, it's not a 'nice-to-have' anymore, it's simply a 'must-have'. The way that a company manages its ESG issues can be viewed as how futureproof the company is in today's ever-changing world.

With all stakeholders attributing strategic focus to sustainability issues, the asset and wealth management industry is undergoing a massive transformation.

But it's also broader than just the investment side with sustainable funding booming and expanding beyond green bonds. New issues for Green, Social and Sustainability (GSS) bonds, Sustainability-linked bonds (SLB) and Transition bonds with labels reached nearly half a trillion ($496.1bn) in the first half of 2021, or $2.1tn on a cumulative basis. This amount represents 59% year-on-year growth in the GSS market over the equivalent period in 2020. This illustrates amazing momentum that is further supported by the EU's entrance into the market with issuance to support the bloc's pandemic recovery fund. This robust growth provides extra liquidity and diversification opportunities for investors who can now make green bonds a realistic replacement for part or all their fixed income allocation.

While the Covid-19 pandemic shifted our collective attention towards the health crisis and related social issues, recent events – such as the heat dome over parts of North America, fires, and the devastating floods in Europe – reinforce the level of urgency required to halt global warming.

In that sense, 2021 brought a fruitful dynamic around intergenerational climate justice. More and more courts across the globe have been stepping in to close climate change action gaps, by calling on states and private sector companies to intensify efforts towards the collective pursuit of a more sustainable tomorrow. In April 2021, the German Constitutional Court ruled that Germany's Climate Protection Act of December 2019 was not sufficient to meet Germany's obligations. In May 2021, a court ruling demonstrated that a similar rationale also extends to private companies. In Milieudefensie v Royal Dutch Shell, the District Court of the Hague held that Royal Dutch Shell has an individual obligation to reduce CO2 emissions based on an established standard of care.

While climate justice advocates are becoming more vocal, ESG active ownership also celebrated a massive success. On May 26, 2021, climate-focused activist fund Engine No. 1, owning just 0.02% of Exxon Mobil shares, elected three directors to the board of Exxon Mobil and sponsored two shareholder proposals that won majority support, all against the board's recommendation. This was the first time that a board election truly centred on environmental, social and governance issues.

But 2021 also offered some backlashes and controversies on sustainable development. In March, the ousting of Danone CIO E. Faber highlighted the challenge of pursuing profits and ESG goals, while in August, DWS, the asset management arm of Deutsche Bank, faced a probe into allegations of exaggerating the environmental or social credentials of some ESG-labelled investment products.

It was also the year that Sachin Vankalas, general manager of the fund labelling agency Luxflag, passed away, a tremendous human being that will be greatly missed in the Luxembourgish sustainable finance community.

22) So, what will sustainable finance look like in 2022?

The fact is that the scale of investment needed to transition to a sustainable and green economy is beyond the capacity of the public sector. Investors have a role to play in driving positive change for the better by rechannelling capital towards sustainable businesses and innovations, contributing to the

creation of a low-carbon, climate-resilient and circular economy, while strengthening efforts to eradicate social injustices across the globe.

More savers want a better idea of what their money gets up to. What if their cash could be used to simultaneously generate a pension and improve the state of the world? Money can make returns, but it can also make the world a better place. If you care about climate change, gender inequality and social justice, what you do with your money has a crucial role to play.

Taking the European regulatory momentum into consideration, it's obvious that ESG is now embedded as a central tenet in the investment landscape.

With institutional investors prioritising non-financial impacts alongside financial returns, we are expecting this trend to be mirrored by retail investors and even more so that 2022 will be the year that investors' ESG preferences will have to be integrated in their suitability assessments, alongside financial objectives, risk profiles (incl. capacity and willingness to bear loss) and knowledge and experience in investment and finance.

For us, ESG investing is not a golden ticket to outperformance but an indispensable tool to scope out sound investments, identify opportunities, generate returns and manage risks. Next year, we will continue to focus on both governance and environmental factors (especially as climate risk grows as an important investment theme, with the recent COP26 reiterating the urgency), and have also begun to see increased value in leveraging the "S" in ESG factors.

This is the time for investors to sit down with their asset manager or financial adviser and future-proof their portfolio.

While the Covid-19 crisis supported significant outperformance of ESG-aligned assets, we also believe that the performance gap will continue to widen with a further shift in investor sentiment in favour of ESG investments and a societal acknowledgment of sustainability risks and identification of sustainability opportunities. Our conviction is that this is not just another product on the investor shelf, and it will be more and more difficult for fund managers to be both ESG and non-ESG.

The full impact of the European regulatory overhaul won't be felt for several years, but we believe this is the time for investors to sit down with their asset manager or financial adviser and future-proof their portfolio.

Conclusion

In last year's outlook, we focused on the light at the end of the tunnel. In 2021, the light turned out to be much brighter than expected. Economic surprises are now fading and investors are trying to second-guess when the current cycle might end. In this sense, the path ahead will be more difficult. Investment risks and opportunities will shift rapidly, but we remain committed to offering our clients efficient ways to navigate financial markets.

From a macroeconomic standpoint, indeed, the hey days of 2021 of turbo-charged growth that helped equities effortlessly record new highs appear to be behind us, but we are still basking in the afterglow of this rapid expansion and above-trend growth is expected to endure into 2022.

Of all the questions we have asked in this outlook, the trillion dollar one is whether inflation will prove transitory or sticky. As of now, companies faced with a bitter cocktail of issues from supply chain dislocations to labour shortages are beginning to pass higher costs onto consumers in order to protect their margins. The risk that inflation pressures continue to strengthen and broaden out is real, and this could eventually threaten consumer behaviour and corporate spending. Central banks are eager to prevent this but they are in a catch-22 situation: if they act too aggressively, they risk choking off growth and destabilising financial markets.

As such, the accommodative monetary policy punchbowl is still on the table, providing generous ladles of support, but every surprise inflation reading challenges the "transitory" narrative and suggests that the end of the party could come quicker than expected.

This tug-of-war between the transitory and sticky inflation narrative will dominate the investment conversation next year and the investment landscape will be heavily influenced by US monetary policy. Markets are already betting that the Fed will be forced to tighten earlier than current communication suggests in order to bring inflation under control. It is our belief that the resolution of supply chain issues through 2022 and a retracement in energy costs after winter will help ease price pressures, but the Fed's decision will ultimately hinge on labour market developments. With labour participation languishing well below pre-Covid levels, the question is whether more workers will stream into the job market or if a large number of potential new hires will remain on the side lines.

The reality is also that if central banks remain behind the curve for too long, it will be supportive of more short-term gains for equities, but the hangover could be all the greater once they do start to tighten.

While acknowledging the likelihood of higher volatility in 2022, we enter the year overweight on equities, which are still supported by robust growth and strong earnings: just because the pace of earnings growth has likely topped out, this doesn't mean that earnings themselves have peaked. 2022 should be another solid – though perhaps not spectacular – year for equity investors.

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To protect our portfolios from volatility and cyclical rotations, we have adopted a more prudent approach when it comes to our sectoral allocation, playing both cyclicals that typically thrive in an inflationary environment, as well as defensives. Regionally speaking, we give preference to the US, where macro momentum is undoubtedly strongest and which is also attractive from a flight-to-safety perspective, while retaining exposure to Europe given its Value characteristics which mean it tends to benefit from an environment of rising inflationary pressures and interest rates. However, further into 2022, if price pressures do begin to soften, we can expect growth and quality styles to take the lead once more.

For investors who rely on their portfolios to provide income, the environment will be more challenging than ever, with long-term yields headed on a slow northbound journey. We give preference to investment grade corporates, even if the market is priced for perfection, meaning excess returns must be generated through carry and selectivity in more niche areas of the market. High yield also offers some opportunities, but we advise our clients not to over-stretch when it comes to credit risk. Of particular interest is the BB space where a large pipeline of companies are set to join the investment grade universe – these "rising stars" are usually rewarded with spread tightening.

In a nutshell, 2022 will be a year of conservative growth, meaning that equities, while supported, won't skip from new high to new high as easily as they did in 2021. To take a longer-term perspective, a shift towards a more sustainable growth path isn't necessarily a bad thing, keeping in mind that the Roaring Twenties paved the way for the Great Depression.

Asset Allocation Matrix

(as at 22/11/21)

Global Allocation	-	N	+	Equities	-	N	+	Fixed Income	-	N	+
Equities			●	US			●	Government Bonds - Developed	●		
Bonds	●			Eurozone			●	Emerging Market Debt	●		
Gold	●			China		●		Corporate - Investment Grade			●
Oil			●	Japan		●		Corporate - High Yield			●
USD		●		Emerging Markets Ex-China	●						

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Appendix

1.1 Important Dates

Event	Date
Italian Presidential Election Incumbent president Sergio Mattarella, who is eligible for another term, has declined to do so	January 2022
US Fed Vice Chair Richard Clarida's term as a Fed Board Member expires	January 31, 2022
German Federal Convention to select Presidential Candidates	February 13, 2022
South Korea Presidential Election Incumbent president Moon Jae-in is ineligible to run for a second term	March 9, 2022
Hong Kong Chief Executive Election Carrie Lam will finish her current term on June 30, 2022 and will be eligible for a second term	March 27, 2022
French Presidential Election If no candidate wins an outright majority in the first round, a run-off will be held. Incumbent Macron is eligible for a second term	April 10, 2022
Colombia Presidential Election Incumbent Iván Duque Márquez is ineligible for a second term	May 29, 2022
United Nations Security Council election for 5 seats on the UN Security Council for 2-year mandates commencing on Jan 1, 2023	June 2022
Indian Presidential Election	July 2022
Brazil President, Chamber of Deputies and Senate	October 2, 2022
US House of Representatives all 435 seats	November 8, 2022
US Senate 34 of 100 seats	November 8, 2022
Austria Presidential Election	Autumn 2022
Hungary Presidential Election	2022

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1.2 Central Bank Meetings

Central Bank Meeting	Date
US FOMC	January 25-26
ECB Monetary Policy Meeting	February 3
ECB Monetary Policy Meeting	March 10
US FOMC	March 15-16*
ECB Monetary Policy Meeting	April 14
US FOMC	May 3-4
ECB Monetary Policy Meeting	June 9
US FOMC	June 14-15*
ECB Monetary Policy Meeting	July 21
US FOMC	July 26-27
ECB Monetary Policy Meeting	September 8
US FOMC	September 20-21*
ECB Monetary Policy Meeting	October 27
US FOMC	November 1-2
US FOMC	December 13-14*
ECB Monetary Policy Meeting	December 15

* Meeting associated with a Summary of Economic Projections

3.0 Inflation Basket Breakdown

Eurozone

	Oct. 2021	Sept. 2021	Aug. 2021	July 2021	June 2021	May 2021
Flash Estimate	4.1%	3.4%	3.0%	2.2%	1.9%	2.0%
Final HICP	n/a	3.4%	3.0%	2.2%	1.9%	2.0%
CPI ex energy	2.0%	1.9%	1.7%	0.9%	0.8%	0.9%
Core CPI (*)	2.1%	1.9%	1.6%	0.7%	0.9%	1.0%
Food, Alcohol, tobacco	2.0%	2.0%	2.0%	1.6%	0.5%	0.5%
Energy	23.5%	17.6%	15.4%	14.3%	12.6%	13.1%
Non-energy indust. goods	2.0%	2.1%	2.6%	0.7%	1.2%	0.7%
Services	2.1%	1.7%	1.1%	0.9%	0.7%	1.1%

(*) core rate excludes energy, food, alcohol and tobacco

US

	Weight	Oct. 2021	Sept. 2021	Aug. 2021	Oct. NSA YOY%
All items	100.0%	0.9%	0.4%	0.3%	6.2%
Food	14.0%	0.9%	0.9%	0.4%	5.3%
Food at home	7.7%	1.0%	1.2%	0.4%	5.4%
Cereals & bakery products	1.0%	1.0%	1.1%	0.0%	3.5%
Meats, poultry, eggs	1.8%	1.7%	2.2%	0.7%	11.9%
Dairy and related products	0.8%	0.2%	0.7%	-1.0%	1.8%
Fruits and vegetables	1.3%	0.1%	0.6%	0.2%	3.0%
Nonalcoholic beverages	0.9%	0.8%	1.2%	1.0%	4.5%
Other food at home	1.9%	1.2%	1.1%	0.6%	4.1%
Food away from home	6.3%	0.8%	0.5%	0.4%	5.3%
Energy	7.3%	4.8%	1.3%	2.0%	30.0%
Energy commodities	4.1%	6.2%	1.3%	2.7%	49.5%
Fuel oil	0.1%	12.3%	3.9%	-2.1%	59.1%
Motor fuel	3.9%	6.1%	1.2%	2.8%	49.6%
Gasoline (all types)	3.8%	6.1%	1.2%	2.8%	49.6%
Energy services	3.2%	3.0%	1.2%	1.1%	11.2%
Electricity	2.5%	1.8%	0.8%	1.0%	6.5%
Utility gas service	0.8%	6.6%	2.7%	1.6%	28.1%
All items less food & energy	78.7%	0.6%	0.2%	0.1%	4.6%
Commodities ex food & energy	20.7%	1.0%	0.2%	0.3%	8.4%
Apparel	2.7%	0.0%	-1.1%	0.4%	4.3%
New vehicles	3.8%	1.4%	1.3%	1.2%	9.8%
Used cars and trucks	3.3%	2.5%	-0.7%	-1.5%	26.4%
Medical care commodities	1.5%	0.6%	0.3%	-0.2%	-0.4%
Alcoholic beverages	1.0%	-0.2%	0.2%	0.3%	2.2%
Tobacco & smoking products	0.6%	1.9%	0.7%	0.1%	8.5%
Services ex energy	58.0%	0.4%	0.2%	0.0%	3.2%
Shelter	32.6%	0.5%	0.4%	0.2%	3.5%
Rent of primary residence	7.6%	0.4%	0.5%	0.3%	2.7%
OER Residences	23.6%	0.4%	0.4%	0.3%	3.1%
Medical care services	7.0%	0.5%	-0.1%	0.3%	1.7%
Physicians' services	1.8%	0.0%	-0.3%	0.0%	3.9%
Hospital services	2.2%	0.5%	0.1%	0.9%	4.0%
Transportation services	5.0%	0.4%	-0.5%	-2.3%	4.5%
Motor vehicle maintenance	1.1%	1.5%	0.0%	0.8%	5.4%
Motor vehicle insurance	1.6%	0.0%	2.1%	-2.8%	6.3%
Airline fare	0.6%	-0.7%	-6.4%	-9.1%	-4.6%

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