HSBC - January 2022

Charities Portfolio update and Outlook – Q1 2022

Video

Good day All, and thank you for taking the time to watch this update on the previous year's market recap as well as our 2022 market outlook and portfolio implications for Charity clients.

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As 2021 came to a close it's easy to forget the multitude of market themes which dominated the investment outlook and I will briefly summarise these before touching on the respective asset class performances.

The first quarter of 2021 was largely dominated by the new US administration's agenda for fiscal stimulus and talk of the broad reflation trade on the back of the global vaccine rollout.

In the second quarter of 2021 the focus shifted to what have been called crypto assets and India, the latter of which was likely to be trending in news feeds due to a severe wave of COVID-19 from the outbreak of the delta variant

As the delta variant spread to Europe and the US over the summer, the third quarter of 2021 saw a strong focus on the delta variant and its possible implications on the global economy. Additionally, the focus turned to China and the various regulatory changes that impacted the likes of property developers such as Evergrande.

The final quarter of 2021 was dominated by interest rate increases across various Emerging Market and some Developed Market central banks. The degree of the various supply chain issues, bottlenecks and shortages came to the forefront in conjunction with the natural gas shortage enveloping Europe. Towards the end of the quarter attention on the omicron variant became so acute that it emerged as one of the most frequently used words for the whole quarter.

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This now leads me to the market review for 2021:
Equities 2021 review
Equity markets continued their rally in 2021, posting double digit gains in pound sterling terms in most Developed Markets. This is highlighted in the bar chart by the black bars on the left that reflect the equity market returns. The only exception being Japan which posted a low single digit return. Emerging market equities on the other hand underperformed through 2021 and produced a negative return in Sterling terms. This negativity was particularly prevalent in the third quarter due to the growth and regulatory concerns in China.

On the fixed income side of things;
Fixed Income (government bonds) – 2021 review
The government bond market over 2021 was dominated by market expectations for central bank policy to normalise and subsequently for central banks to start raising interest rates from historically low levels. US Treasuries came under pressure in late-February and early-March as markets started to look ahead to a possible tapering of the US Federal Reserve's QE programme. The summer briefly saw a bounce back and improving returns in government bond markets across the board, however this was short lived and was followed by further pressure as markets priced in expectations that developed market interest rate increases would occur sooner than expected. This was particularly acute in the UK government bond market as markets started to price in over 1% of Bank of England interest rate hikes for 2022 alone.

Moving on from government bond markets:

Fixed Income (credit) – 2021 review
Performance over the year in investment grade credit markets largely reflected the profile of their respective government bond markets. With credit spreads in investment grade markets relatively muted, total returns were dominated by duration. Yet in high yield markets the story was different. For the first half of the year credit spreads, which is the difference between government and corporate yields with similar maturities but different credit ratings, continued to tighten at a fairly decent pace, supported by the ongoing pandemic recovery and reopening of economies. The second half however saw spreads remain fairly range bound, amid renewed lockdowns and the spread of the Omicron variant.

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We will now move on from the market recap to the 2022 market outlook:
2022 Market outlook
After many years of benign inflation numbers, higher inflation is now starting to come to the forefront of many economic forecasts. The implications of higher inflation is very important for the 2022 market outlook.
OECD economists now expect 2022 inflation to stay high, potentially around 3.9% globally for the full year. Based on Asset Management's research, we would concur with that scenario as a base case. But the inflation journey looks set to be complex, with the big inflation prints front-loaded in the year. Many of the temporary factors that are boosting inflation now such as automobiles, energy & housing, should shortly peak, and should be softening by the second quarter. Instead, the principal driver of inflation will likely be wage growth, which is beginning to pick-up in the main economies.

This economic back drop creates both opportunities and risks in markets:
Opportunities & risks for equities in 2022
We see a solid investment case for global equities. Stocks typically beat bonds while labour markets are improving, and we think a mid-cycle wobble requires a more decisive softening of company profits - which hasn't happened yet. With regards to potential risks, we need to be attuned to the risks around a profits margins squeeze which could be driven for eg. by rising unit labour costs. Secondly, in early 2023, financial conditions could tighten on the back of the interest rate policy tightening we are expecting this year, and this increases the risk of a market correction in equity markets.

For fixed income markets
Opportunities & risks for fixed income in 2022
2022 will be all about the pace of central bank policy normalisation, which as I alluded to earlier is Central Banks increasing interest rates. The US Federal Reserve is increasingly concerned about higher inflation expectations and a tight labour market. The question is therefore not whether interest rates will move higher but by how much. On the risk side of the coin, increased inflationary pressure could lead to an aggressive US Federal Reserve normalisation policy, higher yields and negative returns.

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This all leads to some assumptions around our base case scenario for 2022 & this will have associated portfolio implications

- Post-covid recovery continues globally
- Inflation shock transitory and subsequently not permanent
- Policy normalisation will be gradual
- Stocks > bonds amid falling unemployment
- I would however caveat the aforementioned that geo-political escalations could be a risk to these market scenarios.

What this translates to for portfolio positioning going into 2022 is that we continue to maintain a cautiously pro-risk allocation. And what this means for portfolios is that at a top line level we are overweight equities, favouring positions in global financials and US quality. We are also overweight in broad commodities on the back of the robust energy prices we have seen recently. In order to fund these overweight preferences, we are marginally underweight government bonds and we remain underweight in most credit markets.
So, to summarise, despite the fact that we believe 2022 will be a far bumpier ride in markets when compared to 2021, we are actively reviewing positions as and when markets dictate this requirement. Finally, we believe that active portfolio management and being broadly diversified across asset classes offers the best potential for positive portfolio outcomes.

I thank you all for your time.

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