# Manager's Report

**QUARTER TO 31 DECEMBER 2021**

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**An eventful year has closed on a positive note as far as risk markets are concerned, after a momentous and volatile final quarter.**

Some of the most significant events, which reverberate into the new year, have been the acceleration of inflationary pressures, especially in the US, the hawkish pivot of major Central Banks, the COP 26 international climate summit, the passing of the bipartisan Infrastructure and Jobs Act in US Congress, and a new wave of COVID infections through the Omicron variant.

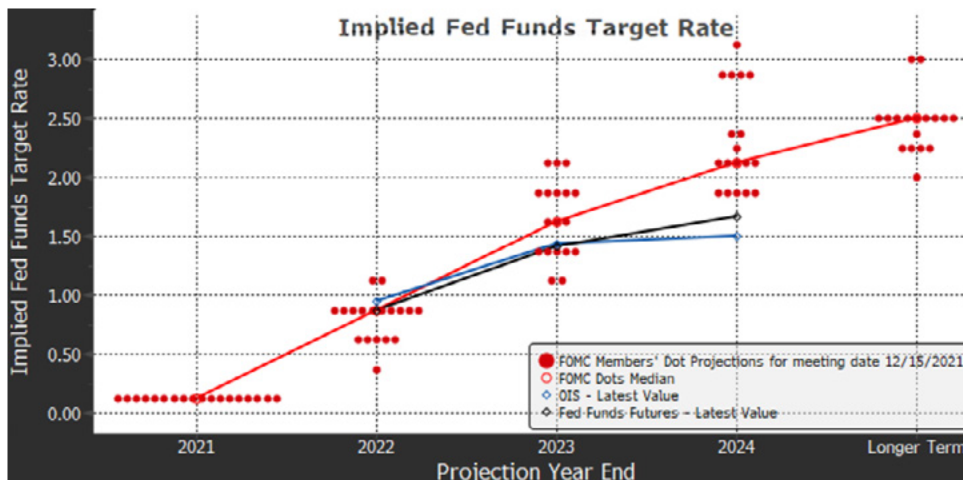
**The minutes of the US Federal Open Market Committee meeting of 15 December, just released, show Fed officials becoming notably more hawkish,** which is not a surprise given the decisions at that meeting to accelerate the QE taper, drop the characterization of inflation as "transitory" in the statement, plus the new median projections of FOMC members (or Fed "dot plot") showing expectations of three rate hikes in 2022.

Market estimates of the Fed's coming rate hike path (as expressed by the Overnight Indexed Swap (OIS) rate and Fed Funds Futures), have adjusted to the Fed's median estimates up until the end of 2022, but remain below the projected trajectory for 2023 and 2024, perhaps fearing that renewed waves of COVID will depress economic activity and cause the Fed to backtrack on its path to normalization.

Our previous manager's report highlighted the different inflationary pressures building in the global economy, especially in the US and to some extent in the UK, where the Bank of England delivered a surprise rate hike in December, lifting the base rate to 0.25% from 0.1%.

Part of these pressures are due to the rapid restarting of activity after COVID lock downs and resulting imbalances in supply and demand, and thus transitory in nature. But there has been increasing evidence of more durable inflation emerging in the US economy, led by wage pressures and cost of shelter.

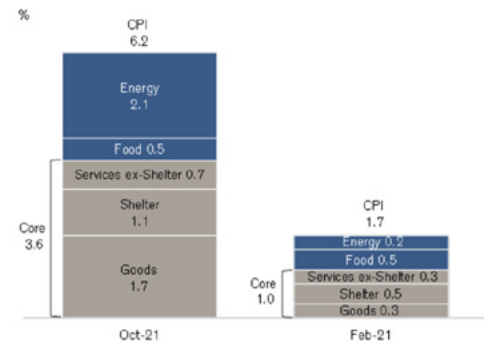
**Chart 1)** FOMC "Dot Plot" 15 December, compared to market estimates




Source: Bloomberg Finance LLP

The graph below shows the CPI inflation breakdown in the US for February and October 2021, and the increase in "core" components is notable.

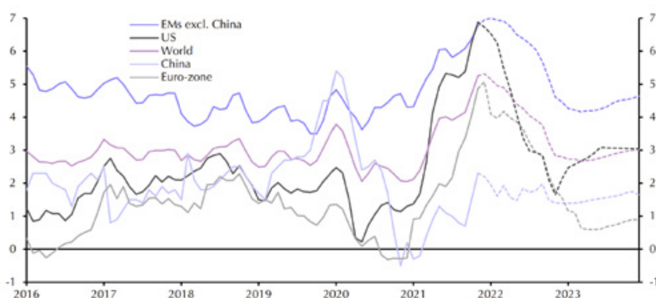
### **Chart 2)** US inflation components




**Source: Credit Suisse**

Before the new, virulent "Omicron" variant of the COVID virus spread, some of the worst supply/demand imbalances in the global economy had started to ease and growth momentum was again picking up; current estimates for real GDP growth in 2021 are 7% for the UK, 5.5% for the US, 5% for the Eurozone. But high infection rates are once again starting to wreak havoc with labour supply, even though the US and UK are unlikely to resort to the tough containment measures many European countries are adopting. Until the Omicron wave crests it will have the effect of temporarily dampening growth and further increasing inflation.

### **Chart 3)** Estimates of the Path of Headline CPI Inflation, by Capital Economics




**Sources: Capital Economics, Refinitiv**

It is notable that inflation in the eurozone is expected to fall back below the ECB's 2% target level by the end of this year, while inflation in the US is expected to settle at 3%: not too high for comfort but above the Fed's recent 2% target, and above the recent (post Great Financial Crisis) levels.

What is also notable is that, despite its newly found hawkish tone, the Federal Reserve's own "dot plot" indicates they see the longer-term peak in the Federal Funds rate at 2.5%; considerably below previous peaks and below current estimates of where CPI inflation will settle. Meaning that "real" (after inflation) interest rates, though increasing, are expected to remain negative. As stock market valuations are influenced by the level of real interest rates, this bodes well for the continued attractiveness of stocks as an asset class. Though the trajectory of the market is likely to become more volatile in a rising rate environment, the positive risk premium offered by stocks remains well supported.

### **Chart 4)** Level of Real US Interest Rates – using 5 year and 10-year inflation estimates

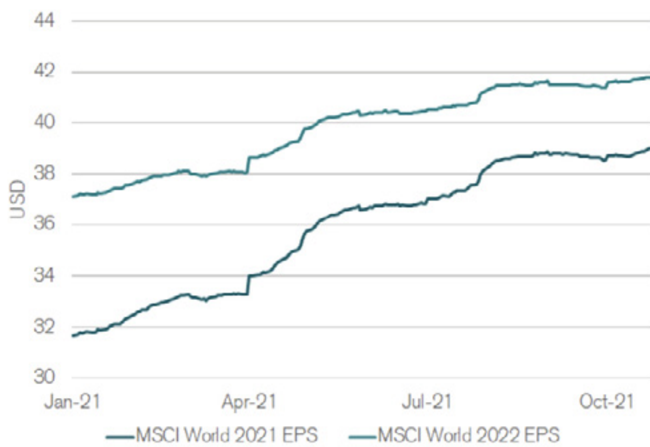
**Source: Bloomberg Finance LLP**

The chart above shows the nominal 10-year US Treasury yield (orange line) compared to the market-derived real (after inflation) yields on the 5-year (blue line) and 10-year (black line) Treasury bonds – these remain deeply negative, hence our negative view of Developed Market government bonds as an asset class.

Meanwhile, corporate earnings estimates have increased in line with stock prices. Also, despite paying higher wages and input cost inflation, most companies have been able to pass increased costs on to their clients and profit margins remain at an all-time high.

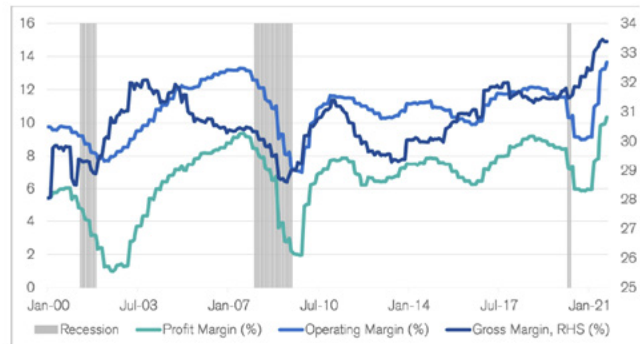
When it comes to stock selection though, identifying companies with pricing power is imperative.

**Chart 5)** Global Earnings estimates continue to be revised higher




**Source: Bloomberg, Credit Suisse**

**Chart 6)** MSCI World Margins remain above pre-pandemic levels despite price pressures




**Source: Refinitiv, Federal Reserve Economic Data, Credit Suisse**

**World leaders, negotiators and captains of industry and finance gathered for COP 26 in Glasgow in November, a key global climate summit meant to set the world on a path to contain global warming to 1.5 Cº or less. There is now broad agreement, supported by science, that the 2.7 Cº warming path previous global pledges implied would have disastrous consequences for life on our planet.**

Negotiations were intense for 14 days and many long nights, and the result contained some successes, some disappointments, and much further work to be done.

Some of the summit's successes include:

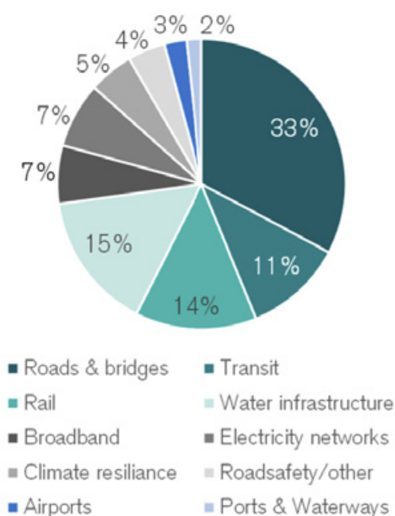
- There is now a globally agreed framework for Carbon Trading Rules. Previously primarily used in the EU, a global system for pricing and trading Carbon across borders is key to levelling the playing field, bringing clarity to companies, and encouraging the transition to clean energy. The global Carbon market is eventually estimated to be worth USD 100 billion.
- For the first time, Coal is specifically targeted to being phased down. In a last minute (and disappointing) concession to China and India, two large coal users, the final text got watered down to "phasing down" rather than "phasing out", but the inclusion is still significant.
- The US and China surprised by reaching an agreement to work together on climate, helped by the significant rapport between John Kerry (the US climate envoy) and China's "Mr. Climate", a senior official called Xie Zhenhua.
- The final COP accord, signed by 200 countries, calls for an end to (inefficient) fossil fuel subsidies, on which G-20 nations still spent USD 600 billion last year.
- For the first time ever there is reference made to Methane in the pact, and 110 countries agreed to slash methane use.
- There is broad agreement that countries that get struck by adverse climate events will get financial help, though the details will need to be hashed out in next year's (COP 27) event in Egypt.
- Banks, investors, and insurers representing USD 130 trillion in assets pledged to decarbonize their businesses by mid-century – an initiative led by former Bank of England governor Mark Carney.
- It was agreed that countries will go back to the drawing board and come back next year with tighter commitments. Before COP 26, countries' NDCs (Nationally Determined Contributions) were on track for 2.7 Cº of warming. If – and that remains a big "if" – all the current pledges come to pass, the world will be on track for 1.8 Cº, still above the 1.5 Cº target, but clearly better than before.

The now well-established global transition to cleaner and more sustainable energy use will have profound effects on the global economy, companies, and consumers. The more gradual the change, the less disruptive and inflationary it will be, but some disruption is inevitable, as illustrated by the recent energy crisis in Europe. By the same token, not acting would eventually lead to disastrous economic circumstances.

The World Economic Forum estimates that solutions that address the twin crises of climate change and biodiversity loss could lead to unprecedented investment opportunity. From climate-smart agriculture to alternative proteins and reduced waste, nature-positive solutions could create USD 10 trillion in new business opportunities, plus new high-quality jobs.

**Also in November, US Congress passed the bi-partisan USD 1.2 trillion Infrastructure Investment and Jobs Act (IIJA), consisting of about USD 650 bn in re-authorized spending and USD 550 bn in new expenditures.**
Plans include significant funding for ground transportation, that would help improve economic productivity, as well as modernizing the power grid and making it more resilient and sustainable, including clean energy sources.

**Chart 7)** Estimated Allocation of USD 1.25 Trillion Infrastructure Investment (until 2029)




**Source: Whitehouse.gov, Credit Suisse**

Meanwhile it is looks increasingly unlikely that President Biden's broader economic agenda will garner enough votes to pass before the midterm elections. So further fiscal stimulus is unlikely to be forthcoming in the US. Having said that, consumers and businesses remain in decent shape, with a strong jobs market, high cash balances and low debt compared to before the pandemic, so we expect the US economy to retain positive momentum once the Omicron wave of infections passes.

**What does all of this mean for our 2022 Portfolio strategy?**

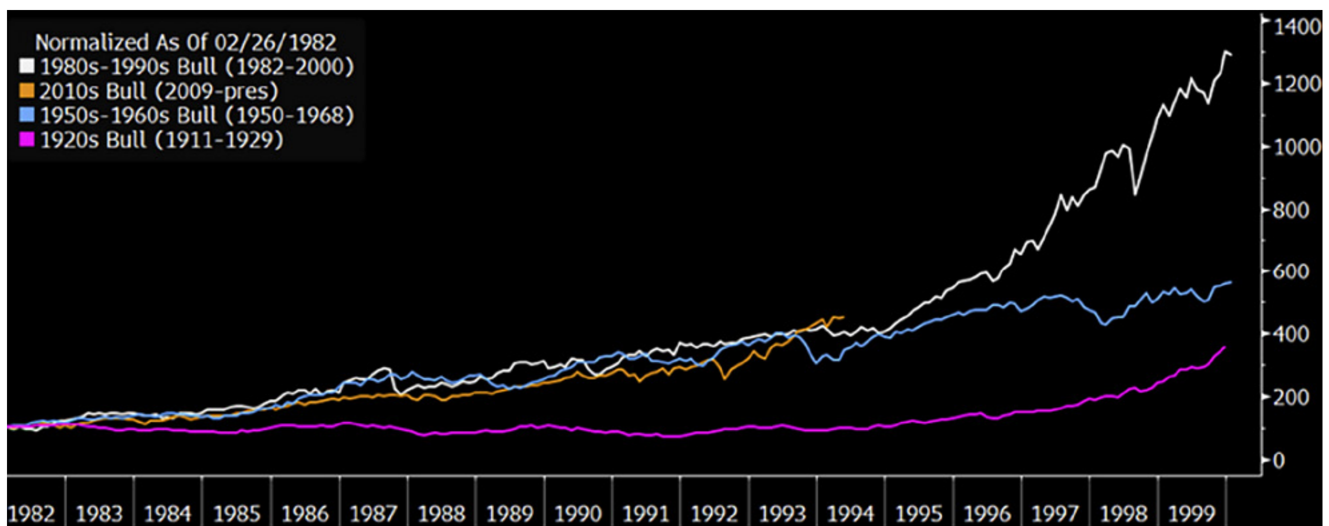
- The past year was a positive one for risk assets – stocks and private assets – but negative for bonds. It is likely that the current year will bring more of the same, as stock values remain supported by positive earnings momentum and growing real cash flows, while real yields on high quality bonds remain negative, and bond capital values will suffer in a rising rate environment.
- Rising interest rates in the US (the Fed is expected to deliver three 0.25% rate hikes this year, starting in June but perhaps even earlier) will not derail the stock market but could make returns more volatile. Because of this, we reduced our significant overweight to stocks twice last year, in September and again in November. Portfolios are currently some 2.5% above their "neutral" equity allocation. Depending on how the first quarter of this year shapes up, we might reduce this further to a neutral weight. Bond allocations are underweight; profits from equities have been allocated to the "Alternatives" section of Portfolios.
- Within Bond portfolios, we retain our overweight to High Yield and Emerging Market bonds, due to positive yield differentials and relatively low default risk. We are underweight core government bonds as real yields are unattractive and expected to rise. We have opened positions in global Inflation Linked bond funds, floating rate bonds in USD portfolios (as rising reference rates will benefit floating rate bonds), and a Senior Loan ETF (only available as a US security, for Schwab portfolios; Senior Loans are also floating rate bonds).
- Within the Alternatives section of portfolios, we have initiated a position in a new Volatility Trading fund, managed by experienced specialist

managers ABR. This way the increased market volatility we expect can be a source of attractive additional return generation.

- On a final note: there is always some "market chatter" about this bull market being long in the tooth, and perhaps due to end. As a rule, bull markets never die from old age, but from some shock to the system, usually a recession, often brought about by a Central Bank that tightens policy too far, too fast. Given the current uncertainty around inflation – which aspects are transitory and which are lasting – especially in the US, there is clearly potential for a policy mistake, and we cannot rule this out.

However, assuming the Fed embarks on the normalization path indicated in its most recent notes, the stock market could remain well supported. It is also worth noting that by historic standards, the current bull market, which started in 2009 and has been punctuated by frequent corrections, is not all that long, nor carried that high. This can be illustrated by the graph below, compiled by Bloomberg Intelligence, which compares the duration and extent of the current bull market to those of the 1980-1990s, the 1950-60s, and the 1920s.

**Chart 8) The Current Bull market (orange line) in historic perspective – not that long, not that high....**




**Source: Bloomberg Intelligence**

As always, please do not hesitate to contact us if you have any questions or comments, about the contents of this report or your portfolio in general. We hope you are safe, and well, and keeping in good spirits in these unusual times.

**Portfolio Management Team, ISGAM AG**

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