SGMCAPITAL

OUTLOOK 2022

THE BIG PICTURE

The sun is shining bright here in Singapore as I sit down and rethink about everything that has happened in 2021. These few lines are too large a constraint to adequately express the tumultuous impact our lives have felt since the covid outbreak, how developed equity markets marched through all hesitations to close the year at historical highs, how Chinese markets on the other hand cratered on renewed political and economic sustainability fears, and how the rollercoaster in people's emotions throughout the year must have brushed on to the Fed Chair Jay Powell, making him change his mind on inflation depending on direction of the wind .

I will therefore focus on the future and on what we think 2022 will bring us. The upcoming year is likely to be a turning point: monetary policy normalization seems to finally be on the cards, not just in theory but also in practice. Markets will have to fight against restrictive monetary policy, something they are not used to, and the one time they had to do that in recent history (Q4 2018) it did not turn out so well.

Are we particularly worried? Not so much: global demand remains strong, supply chain disruptions will be eased over the coming quarters, and inflation will decline also thanks to higher base years. This being said, a potential Fed balance sheet reduction plan will be hard to digest and investors should be prepared for volatility and lower asset returns for the upcoming 2 to 3 years. Holding on to a solid portfolio core will be crucial, with the majority of alpha likely being created from tactically trading a market which is expected to fluctuate at a much larger magnitude.

Yes, the sun is shining, hopefully on a bright new year for all of us.

Massimiliano Bondurri
Founder & CEO

Background

Let's start with the fundamentals: **growth**, **employment** and **inflation mandates shape** the **key decisions** of most, if not all, **treasury departments** and **central banks**. The rude shock from the pandemic from early 2020 had all decision makers scramble to ensure the international monetary system did not collapse on itself. This needed some quick and innovative thinking and now, two years on, we have seen a semblance of stability return.

The bulk of this support has come through from expansionary fiscal policy in the shape of unemployment insurance, income replacement plans and tax relief among others, along with co-ordinated balance sheet expansion of the respective central banks. **Now**, unarguably, these **relief and support measures need to be scaled back and eventually unwound in order for policy to normalize**.

The big question we are left with is: **what are the mechanisms implemented and pathway followed that allows for an orderly unwind of said policies and with the least negative feedback loops?** This will be a tricky balancing act and will require coordination across many arms of government, as well as across political beliefs.

In general, countries that have a stronger inherent growth profile will be able to handle this process better. **Policies that create a positive economic growth path could lead to stronger economic outperformance**; and as importantly, looking for ways to have these policies pay for themselves or, at the very least, not create further drag on government finances, will be an important piece of the puzzle.

In the midst of all of this, it **will be crucial to pay very close attention to the following main macroeconomic themes which will shape future market movements**

2022 MACRO ECONOMIC THEMES

1.

INFLATION

"Anyone who is surprised that inflation turned out to be anything but transitory, kindly raise your hand. And, Mr Powell, you are not allowed to participate in this poll and likely never truly believed in this in the first place!".

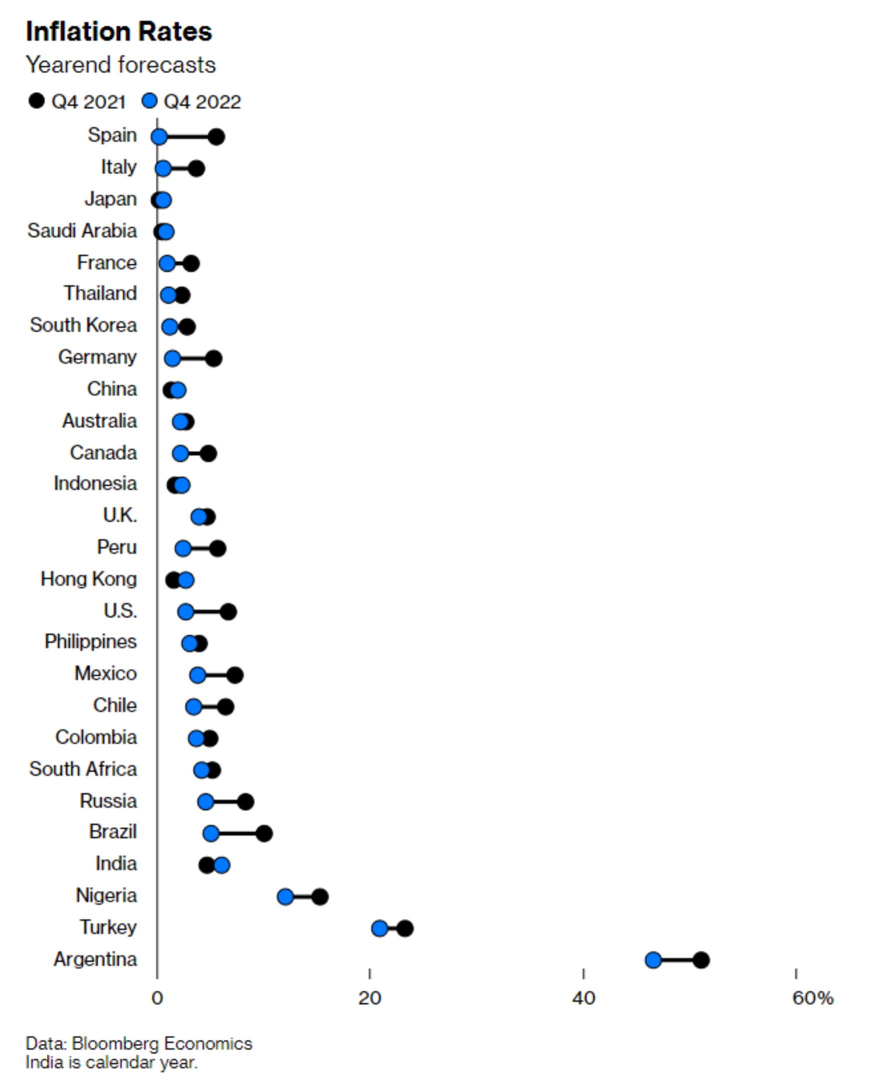
The real question now is: **What happens to inflation going forward?**

The inflation now on display **is the result of solid economic growth, strong pent up post-covid demand, supply chain disruptions** and also, year-on-year comparisons with weak covid related numbers. Going forward, **we expect demand and economies to continue healing and holding strong with supply chain disruptions likely easing**. Furthermore, year-on-year comparisons with a significantly higher base effect should, over a period of time, see **inflation tick down from the current 6 % to closer to the 3 – 4 % range**.

These levels, while lower than current readings, are still higher than the comfort zones of most developed market central banks.

This leads us to the second important theme for the year …

INFLATION RATES



2.

CENTRAL BANK ACTIONS

Central Bank balance sheets across the world have grown ever since the financial crisis of 2008. Providing support to the smooth functioning of global economies and markets has proven to be an easier task than withdrawing said support. The pandemic induced dislocation warranted remedial action. Now that we have effective vaccines and will soon have distribution of an oral antiviral, continuing support is detrimental to long-term resource and asset allocation decisions.

A case in point is the **balance sheet** of the **US Federal Reserve**:

- From below **USD 1 trillion in 2008** the Fed's balance sheet grew to around **USD 4.5 trillion in 2014**; the result of continuing rounds of quantitative easing (QE)
- The attempt, **starting 2017**, to allow the balance sheet holdings to run-off as they matured was laudable, albeit, **somewhat delayed and allowed a reduction of around some 15 percent from peak levels**
- **September 2019** saw a brief but severe bout of money market imbalances causing the **overnight borrowing rate to, intra-day, reach double digits**. The Fed slowly cranked up the printing press again and …
- When in **early 2020** the full force of the pandemic hit all stops were pulled out. **The Fed's balance sheet as at December 2021 stands at USD 8.75 trillion**

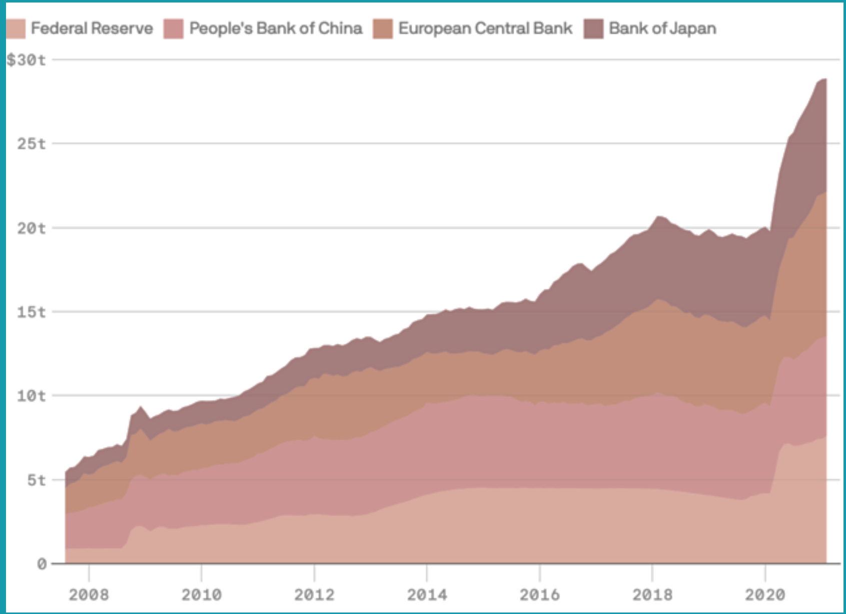
As an important aside, **Jerome Powell's Federal Reserve** has taken a different **approach to communicating policy**. In contrast with past experience, the current Fed approach **appears to be one that keeps market participants constantly guessing** and slightly off-balance **rather than providing a clear forward path**. We believe there are pros and cons to both approaches and raise this point only to acknowledge the change in reality. (More on this later in the note)

Towards the **end of 2021** the Fed tweaked its **messaging with a more hawkish tone and, in early 2022, this is more pronounced**; some analysts are **penciling** in rate hikes starting in March. **The yield curve has responded accordingly and has pushed outward**, acknowledging the more hawkish stance and at the same time a likely quicker end to rate hikes.

Watching the yield curve over the **last 24 months** has not been a particularly interesting experience given the **strong continuing bid from the Fed**. As these purchases wind down **the yield curve will begin to reflect the read on growth and inflation from the market** and these signals will regain their significance to other parts of the economy and portfolio analysis. As always, the interpretation of the yield curve and its implications for asset allocation is as much an art as it is a science.

What does this men for interest rate going forward?

CENTRAL BANK BALANCE SHEET



3.

INTEREST RATE EXPECTATIONS

The two key questions are the following:

1. **Will Central Bank normalization result in substantially higher long term interest rates?**
2. **Will we see a rapidly steepening American interest rate curve?**

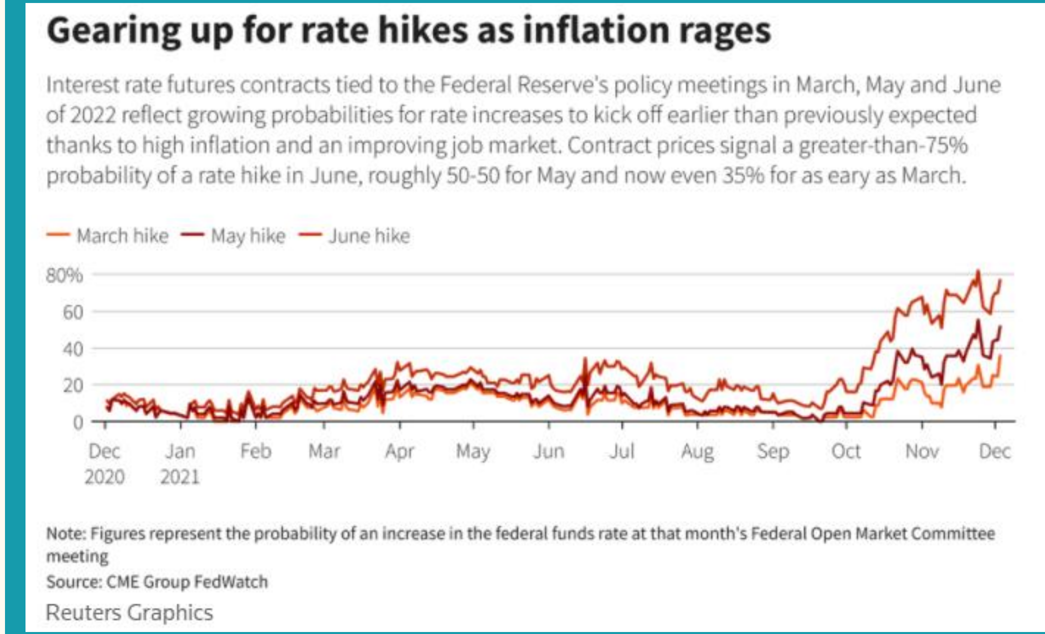
Here is our clear answer to both questions: **NO.**

Over the coming months we expect the American yield curve to undo part of the recent steepening and actually flatten, with short term rates raising more than their longer term counterparts, even though temporary fluctuations exhibiting the opposite trend will materialize. We wouldn't go as far as to say we expect the yield curve to invert, however, at the same time it would not surprise us if that did happen towards the end of the year. Some part of the evolving growth outlook will be a function of the potential passage of any additional fiscal stimulus (we discuss this below).

In Europe, the situation is different as the steepening of the European curve has more room to run. We believe also **in Europe the monetary support for the economy should reduce as the year progresses and we would expect talk of rate hikes to firm up toward the end of 2022**. This still is unlikely to lift shorter term rates to positive territory for some time to come.

We expect **Japan** to be the laggard and likely the last central bank **to look to turn off the taps**. This has implications for the Japanese Yen and we are starting to see a renewed interest to run short JPY positions.

INTEREST RATE FORECAST



US POLICY & POLITICS

4. US POLICY AND POLITICS

President Joe Biden's first year in office has been eventful and while the opinion polls suggest a poor report card, the reality suggests some strong positives as well.

The **Infrastructure Bill passed** and the perennial discussions around **the debt ceiling were handled well.** The passage of **the Build Back Better Bill will be closely followed and while we still haven't seen a positive result**, we are likely to see a strong focus on this initiative in 2022. The growth stimulus from these various measures cannot be understated and the impact will likely be felt across broad sections of the economy.

The **global supply chain has proven to be less resilient that what has been thought** of. Covid has stress-tested the system and the weak links have been exposed. There has been a **bi-partisan realisation in Congress as well as with businesses that much needs to be done to re-shore production facilities**. A case in point is the semiconductor manufacturing sector, where President Biden is working with large corporates on plans to increase investment in domestic production facilities. The impact of re-shoring, as wider policy, will further strengthen the growth outlook.

Mid-term elections will be held in November and the run-up and immediate aftermath will be closely scrutinised from a policy perspective. **What will the outcome be for the Democrats with respect to their majority in the House and their technical majority in the Senate?** The result of these elections will have an important impact on President Biden's effectiveness for the balance of his term.

5.

GLOBAL POLITICS

China hosts the Winter Olympics this February and the event has already taken on geopolitical implications with a number of countries conducting a limited diplomatic boycott. Later in the year the country holds the 20th National Congress and that event will provide indications of future policy initiatives.

The **situation between Russia and Ukraine has seen tensions being raised with a large build-up of Russian troops near the Ukrainian border**. We feel the probability of a real conflict is minimal, and this situation will be used mostly as a negotiation and bargaining tool rather than anything else, but expect the occasional headline to create a dip in risk sentiment.

Social unrest, on the other hand, remains the single most important political risk in our view, as the continuing widening income gap between the ones who have and those who have not, together with the social and psychological strain inflicted on populations by the covid emergency, could have a devastating effect. Recent developments in Kazakhstan are a clear example of this, and we expect other countries could face similar consequences, with Turkey being the highest risk for the global economy at this stage.

While the **South China Sea and Taiwan have been relatively quiet,** we should expect to see continuing rhetoric from both sides around this issue.

Germany has seen the leadership baton being passed on from Angela Merkel and we will need to **evaluate how this change impacts its role in Europe and the world**. Elsewhere in Europe, populism remain rampant and further surprises within the political landscape, especially in France, cannot be ruled out.

GLOBAL POLITICS

IMPLICATIONS ON PORTFOLIOS

Having analyzed the main macroeconomic themes that will likely direct valuations over the coming year, let us now look at what that implies for portfolios and how to best position them to capture the trends highlighted before.

1.

FIXED INCOME

Be Patient, the time for bonds will come..but not in 2022

In the fixed income space, **we continue to prefer staying with lighter allocations as well as skewing these to the short end**. Normalizing yield curves will throw up some opportunities and we will tactically take advantage of the same. However, **we believe a larger shift into long duration bonds is not warranted at this time**.

Opportunities remain within the high yield space in the short end of the curve, with **some energy companies and emerging market corporates still paying substantial premiums over Treasuries**. As we do not see defaults considerably increasing over the year, we are happy to take credit risk with a very limited duration risk.

Finally, it must be remembered **that period of raising rates tend to not only lead to an increase in the risk free rate** which negatively impacts bond prices, but also to a **widening of credit spreads again reinforcing the negative bias for corporate bonds**. The time will come when fixed income will once again be a viable asset class for a portion of globally diversified portfolios, but more patience is needed for this to come true.

NEGATIVE YIELDING DEBT PILE IS SHRINKING

Bloomberg Global Aggregate Negative Yielding Debt index
Source: Bloomberg
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2.

EQUITY

Developed vs Emerging, Growth vs. Value, Investing vs Trading

While 2020 was the year to be invested in small and mid-cap growth companies, **2021 was the year of value and large capitalization names**. We do not expect this outperformance to continue and, while we should have some allocations here, **we expect small and mid-cap growth companies that deliver to expectations**, both of sales growth and margins, to perform better. This will likely become true only during the second half of the year, once the first hikes from the Fed have been finalized and the initial negative risk reaction, impacting higher beta names especially, will have played out.

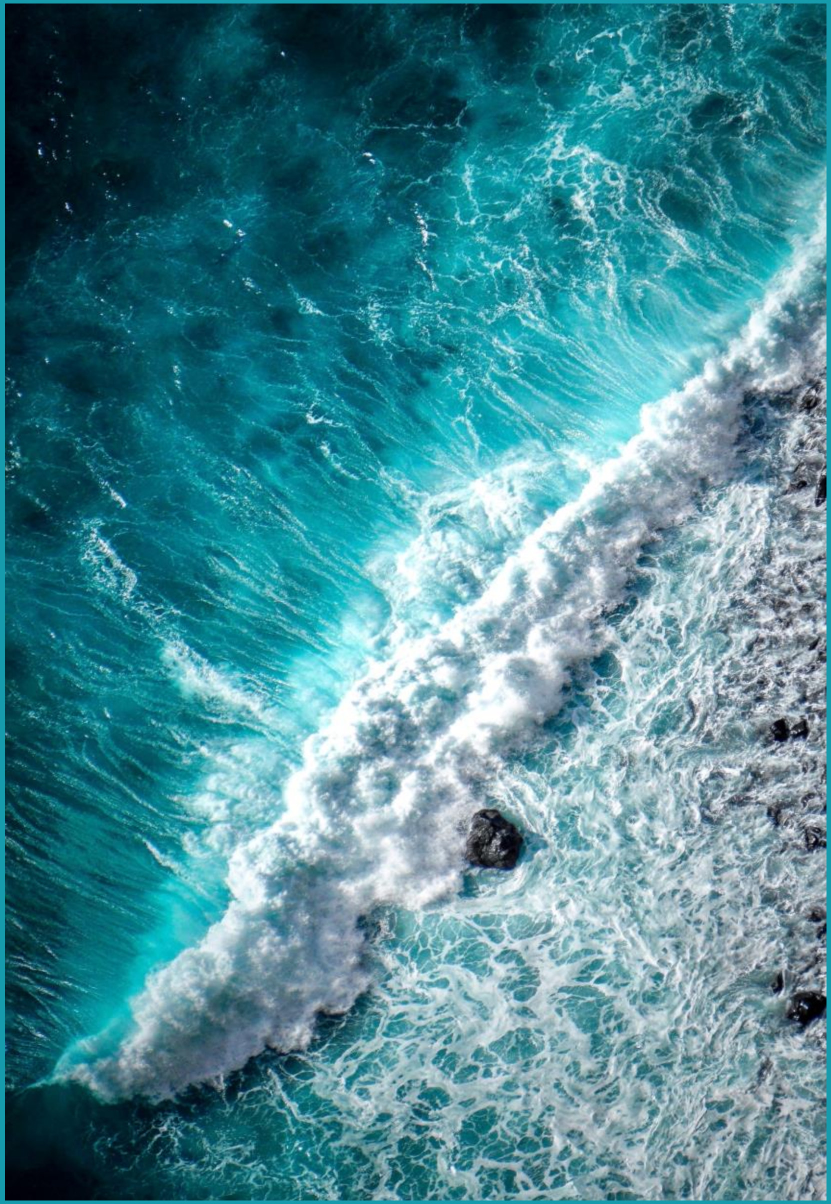
We would expect the out-performance of Developed Markets versus Emerging Markets to continue in 2022. Emerging Market companies will now have to contend with tighter funding markets and this will likely pressure businesses for most of the year.

This being said, there are **particularly interesting pockets of value within the Emerging Markets Space**, with China especially standing out as attractive. **Valuations have been cheap for some time and a large part of the regulatory uncertainty has likely been priced in.** We **prefer stocks in the technology and consumer focused sectors** and would particularly avoid companies that carry large debt loads, while advocating a diversified approach which encompasses both tech global darlings as well as the likely domestic Chinese winners of the future. **This is exactly how our Asia Equity Opportunity fund is positioning itself, with a strong overweight in Chinese beaten down names**.

2022 has started with a sense of unease as investors begin to grapple with the true intentions of the Federal Reserve and what that means for the path of interest rates for the year as well as implications of the same on businesses, economies and the markets.

As mentioned earlier, the Powell Fed has chosen to employ terms like “transitory inflation”, and then discard them from use, seemingly on a whim. “Forward guidance” from officials is now less instructive and, while the Fed’s balance sheet expansion pauses, **the signals from the market will take back the important role of guiding investment decisions**.

While **we do not expect interest rates to run rampant** (it is worth remembering that Uncle Sam is the largest borrower and that debt that is rolled over will be more costly) **the normalization of rates will lead to wider gyrations in market expectations and a higher degree of volatility**. Investors would do well to constantly return to the basic and fundamental rationale of their investment decisions. The alternative, of being swayed by the noise from the large-font headlines and blinking images on television screens, will likely produce sub-optimal long-term outcomes.



3.

ATTRACTIVE THEMES

Within the equity space, it **is important to have a firm view of what will likely be the industries and sectors that will continue thriving and have a bright future**. We have identified four main themes in which we are particularly bullish and in which we remain overweight:

1. **CYBERSECURITY**: Recent events show the importance of a reliable and sound cybersecurity, and as the **world becomes increasingly digital the demand and need for cybersecurity can only increase.** To gain exposure to this theme we would advise a buy and hold strategy involving top tier names (Palo Alto as an example) and smaller, high growth names (like Crowdstrike). As an alternative, the ETF route (CIBR) is also an efficient one

2. **DATA MANAGEMENT:** the amount of data companies will have access to will continue increasing exponentially, and **being able to decipher the data quickly and efficiently in an effective manner will continue being a key competitive advantage** going forward. Companies in the space tend to be more volatile (Snowflake and Palantir above all), hence a longer term view is fundamental, but rewards are likely to be hefty in the future.

3. **HEALTHCARE 3.0 : Tele-Medicine, healthcare robotics, genomics** are just some of the topics which will be part of our lives going forward. **It will be standard for a surgeon in Tokyo to operate on a patient in New York and vice versa thanks to the help of robotics and connectivity.** This trend will only become stronger as time passes, investors should dedicate a portion of their portfolios to this ensuring they look both East (Japan especially) and West (US).

4. **ESG :** While there has, and will continue to be a lot of talk and focus around issues such as the environment, societal impact and governance, captured in the acronym, ESG, the reality is likely more nuanced. **COP26 concluded with the chairman disappointed that not enough was being done**. In 2021, oil majors rallied strongly while the S&P Global Clean Energy Index lost around a quarter of its value. We would look to take **exposure to solid clean energy names as they help us position for the best possible sustainable future**. At the same time, we would prefer to not blindly follow the herd into what might tend to be over-crowded segments, which happen to also offer some promise from an ESG perspective.

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