2021 in review
A year of exceptional gains for risk investors

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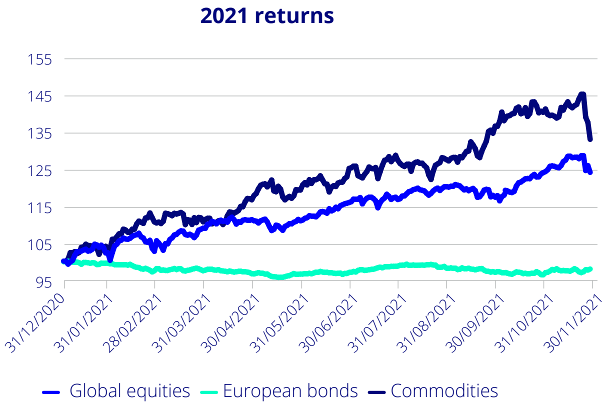
Figure 1: Asset class returns 2021 (2021 rebased to 100)



Source: Bloomberg/BOI Investment Markets 06.01.2022

1. Economic growth continues

The economic recovery continued in 2021 - Q4 2021 looks like it delivered mixed fortunes across the world. According to Bloomberg's survey of economists, expectations are that the US economy's growth is accelerating and may reach 6% annualised growth in Q4. The US Federal Reserve (the Fed) in its December meeting indicated this also, suggesting that growth and inflation in the US are both stronger than anticipated. By contrast European growth rates in Q4 were impacted by the resurgence in Covid-19 and Q4 quarter on quarter growth estimates stand at 0.6%, compared to expectations of twice that level back in July[1]. Significantly, growth in China appears to be decelerating with consensus estimates of 8% growth for 2021 and estimates for the year ahead considerably lower at 5.1%[2].

2. High levels of inflation persist

Euro area inflation increased significantly over recent months, In December EU inflation hit 5.0%, with energy prices the biggest contributor up 26% year on year[3]. US inflation according to Bloomberg's monthly survey[4] is expected to show 5.4% per annum (p.a.) in Q4. If so, this will further prove the elevated and more persistent nature of the inflation being experienced.

3. Equities – 2021 a bumper year, but one of stark contrasts

2021 saw global equities deliver a strong set of returns with global stock markets up 27.5% for the year[5]. Strongest amongst the main markets was the US, with the S&P500 making gains of 38.2% in euro terms[6]. A narrow number of the tech giants contributed a large part of this outperformance. European markets, with a greater proportion of cyclical, financial and energy stocks, saw gains of 25.8% and reached new highs towards the end of December[7]. In contrast to western markets, Japan made gains of just 6.6% for the year[8] and Asia ex Japan delivered a meagre 2.3%[9]. Emerging Markets also struggled comparatively with gains of just 4.71%[10], as China in particular saw losses due to the ongoing property crisis in that country.

4. Bonds – a challenging year

In the face of higher inflation and a shift in Central Bank policy settings, bond markets had a difficult 2021. Global bond indices registered losses of 2.6% for the year[11]. European government bonds saw losses of 3.5% while US government bonds recorded losses of 3.2%[12]. European corporate bonds experienced losses of 0.9%[13]. In riskier high yield bond markets, European high yield bonds made gains for the year of 3.5%[14] and Emerging Market debt also made gains of 4.8%[15].

5. Commodities – 2021 a record year

It was a bumper year for commodities with the Bloomberg Commodity Total return index rising 36.5% in euro terms, having reached as high as +45% in November[16]. Global economic recovery, supply chain disruptions, government policy and adverse weather all played their part in driving prices higher in 2021. Most headline grabbing amongst the commodities have been the major energy indices - oil gained 99.2%, gas increased by 71.4% and coal saw increases of 180% for the year (gains which are also down from the heights they reached in October/November!)[17].

Market Outlook for 2022 on page 2

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Sources: [1]Factset January 2021 [2]Bloomberg 06.01.2022 [3]Eurostat 7 January 2022 [4]Bloomberg 17.12.2021 [5]MSCI ACWI index in euros to 31.12.2021 [6]S&P500 Total return in euros to 31.12.2021 [7]MSCI Europe in euros to 31.12.2021 [8]Nikkei 225 in euros to 31.12.2021 [9]MSCI Asia ex Japan in euros to 31.12.2021 [10]MSCI Emerging markets in euros to 31.12.2021 [11]FTSE WorldBig in euros to 31.12.2021 [12]FTSE Eurobig Sovereign in euros to 31.12.2021 [13]FTSE Eurobig Corporate in euros to 31.12.2021 [14]Bloomberg pan European High yield in euros to 31.12.2021 [15]FTSE Emerging markets in dollars to 31.12.2021 [16]Bloomberg Commodity total return index to 31.12.2021 [17]Bloomberg 06.01.2022

Outlook for 2022
Less of the same

1. Above trend economic growth to persist, but slower than 2021

Due to the rapid spread of Omicron, we expect growth may slow in the global economy in Q1 2022. There is already some evidence of this in the slowdown seen in purchasing managers data in December 2021. The evidence from South Africa, where Omicron began, seems to be that it peaked in mid-December and has been on a decline since[18]. That prospect has been extrapolated by markets for developed economies and markets are taking the view that growth will re-strengthen once this wave subsides.

As a consequence, there remains a lot of catch up growth to happen in the world economy. Supply chain blockages have left inventories of goods and energy at record lows. Service providers ranging from hotels, to public transport to sporting venues have all yet to stage a full recovery. Savings levels in developed economies remain at very elevated levels and a record rise in the net worth of households in many economies provide a further support to demand in the years ahead. Even if the pace of growth is slower in 2022, it remains likely to be a year of above trend growth and reasonable corporate earnings which will continue to support risk assets such as equities.

2. Inflation to remain as the headline risk as Central Banks 'take the punch bowl away'

Inflation is likely to remain as the prominent challenge for 2022 and Central Banks have turned their attention to it.

It's plausible we'll see a slowdown in inflation as the base effect from energy price rises moves out of the figures. However there remains at least two further effects that may cause inflation to persist, most particularly in the US. Firstly, labour markets in the US are increasingly tight and there is a risk that a wage price spiral may emerge later in the year. Secondly, as house prices have risen, there is likely to be a delayed knock on impact on rental prices. Markets are very aware that inflation is likely to persist throughout the year, what remains a risk is if Central Banks decide to become more aggressive with interest rate increases or the pace of balance sheet reduction.

3. China slowdown

China has grown into the second largest economy globally and is likely, by some measures, to surpass the US in the coming decade. Yet it has been hugely dependent on its property market as both a source of economic activity and indeed wealth. The government is clearly intent on deflating what many see as a property bubble and in so doing has begun to clamp down on some of the excesses in the property development market. This shift in policy will likely result in lower but more sustainable growth levels as the Chinese leadership seeks to transition its economy from one based on investment to one that is more consumption led.

4. Bond market prospects remain challenging

If 2022 delivers a second year of equity gains and bond losses, as we expect, it will the first time since 1977 that this has occurred[19]. In the US, the Fed has been very clear that it is going to withdraw the pandemic bond purchase support programmes by March, and will raise rates possibly three times during 2022. Furthermore in the minutes from the Fed's December meeting, they have signalled to the market that they will be reducing the size of their balance sheet. In Europe, the inflation pressures are slightly less pronounced and the European Central Bank (ECB) is indicating to the (somewhat sceptical) market that it will be 2023 before rates are increased. In the UK, the Bank of England began to raise rates in December 2021.

Sources: [18]Ourworldindata.org 06.01.2022 [19]Blackrock asset management January 2021

Warning: Past performance is not a reliable guide to future performance.

Outlook for 2022

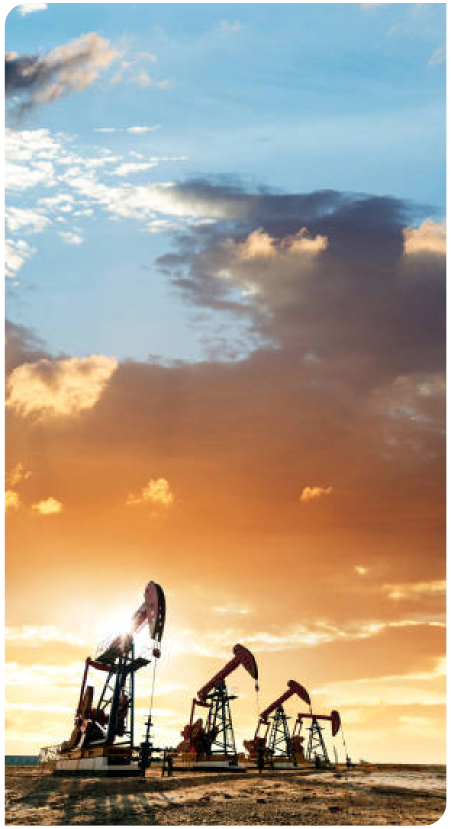
Outlook for 2022
Less of the same (continued)

5. Equities – 'There is no alternative" scenario intact

A 'melt-up' in earnings proved a significant support to equity markets with three quarters of strong earnings growth in 2021. It also saw valuation levels drop from the heights reached at the start of last year. While we don't anticipate that this will continue, earnings expectations remain solid and this is a cause for some confidence that the equity market is well supported for 2022. With bonds and cash offering so little, the "TINA effect" ("There is no alternative") remains in place for equities and our expectation is for equities to grind higher in 2022. That said, with Central Bank policy shifting, inflation remaining persistent and the unpredictable risks from Covid-19, there will be plenty of sources of volatility in the year ahead.

6. Commodity markets expected to cool

After the significant gains of 2021, it seems unlikely that commodities will repeat the performance in 2022. While energy prices remain elevated, oil is expected to see strong supply growth from both Non-OPEC (Organization of the Petroleum Exporting Countries) and OPEC nations. Gas prices remain elevated in Europe as tensions with Russia persist. Most metals are well supported by economic growth and low inventory levels. Much of the agricultural commodity space was impacted in 2021 by adverse weather conditions as well as supply chain challenges, and providing these don't repeat, this area too should no longer present price pressures. Prices across the commodity market may remain elevated but are less likely to push higher in the fashion of 2021.



For more information:

Click here to view a short video where Kevin provides insight into what investors might expect in 2022.

To see how this market environment is impacting fund performance, click on Fund Centre

Summary outlook for 2022 click here

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Summary outlook for 2022

For investors, the transition to the post-pandemic economy will begin to be more of a reality in 2022. We can expect to see economic growth continue to be strong, but less so, especially given the slowdown that is likely within China and the remaining challenge from Covid-19.

- We can expect inflation to remain a difficulty for most of the year but ultimately to dissipate. However, there remains a risk that a wage spiral or rental increases could create a further wave of pressure.
- We can expect corporate earnings growth to normalise in the year ahead, but to remain strong as companies transmit prices to consumers in an effort to limit any margin squeeze.
- Central Bank policy is expected to remain accommodative in 2022 but we are likely to see the first interest rate moves in the US and possibly the Euro area in 2022. The risk this presents is that Central Banks act too aggressively but so far it appears that they are intent to very clearly signpost the path they are set upon.
- As for Covid-19, we have seen Omicron spread rapidly but the policy response has been less impactful on economies, much as has been the case with Delta. Covid-19 seems likely to become endemic during 2022, and we will learn to live with periodic restrictions until improved vaccine treatments and perhaps even cures begin to build greater immunity.

This is an environment in which we believe risk assets can continue to perform, but at a slower pace than we saw in 2021. By contrast for bond markets it appears that the impact of inflation and changes to Central Bank policy will make it yet another challenging year.

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Each of the transitions we've described may create uncertainty and pockets of market volatility but as we have seen throughout 2021, these are likely to be short lived. The reason for this confidence is that we continue to see a backdrop of strong global economic growth. Despite the shift that is underway in Central Bank policy, financial conditions remain accommodative and should be supportive of risk assets. This also means the environment may continue to present headwinds for bond markets, making it more challenging to eke out gains from lower risk portfolios.

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Performance Table

Appendix 1: Calendar 5 year performance of markets and stocks mentioned

	2017	2018	2019	2020	2021
Equities	7.5%	-4.9%	28.9%	6.6%	27.5%
European government bonds	0.1%	0.9%	6.8%	5.0%	-3.5%
Global bonds	1.2%	-1.1%	5.4%	4.9%	-2.6%
Commodities	-12.4%	-6.8%	9.8%	-11.0%	36.5%
US 10 year bonds	-4.1%	11.6%	-28.6%	-52.4%	65.4%
Oil	-19.0%	-11.3%	30.7%	-36.1%	68.6%

Source: Bloomberg 06.01.2022

Warning: Past performance is not a reliable guide to future performance.

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Warning: The value of your investment may go down as well as up.

Warning: If you invest in these funds you may lose some or all of your investment.

Warning: These funds may be affected by changes in currency exchange rates.

Warning: Forecasts are not a reliable indicator of future performance.

January 2022.

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