SALT GLOBAL OUTLOOK January 2022

By: Bevan Graham, Matthew Goodson and Greg Fleming.

Themes for 2022

Two years on from the first Covid-19 cases emerging from Wuhan in China, a new year brings fresh hope of a return to normal, though Covid continues to endanger that hope. Omicron is just the latest manifestation of Covid-related disruption.

Over the course of 2021 economies made significant progress towards reopening and solid recoveries in activity. This was, however, hampered by new virus outbreaks and congested supply chains. Hope for 2022 has its genesis in steadily improving vaccination rates, growing herd immunity and new pharmaceutical innovations to combat the worst symptoms of the virus.

A constructive view on 2022 is built on the assumption of fewer disruptions to activity, allowing the global economy to continue to expand, supply congestions to ease, and for a more balanced growth environment to evolve.

Supply-side pressures and unbalanced demand since the pandemic began have resulted in sharply higher inflation that central banks have only belatedly determined to be more than transitory. Jay Powell's recent "retirement" of the term transitory from the US Federal Reserve lexicon is possibly the closest one will likely get to an admission from the Fed that they got it wrong.

The continued withdrawal of monetary stimulus will be a key feature of 2022, with the debate focussing on speed and terminal rates. We now see the US Federal Reserve hiking the Fed funds rate for the first time this cycle in March and beginning the process of reducing its balance sheet (Quantitative Tightening) from mid-2022.

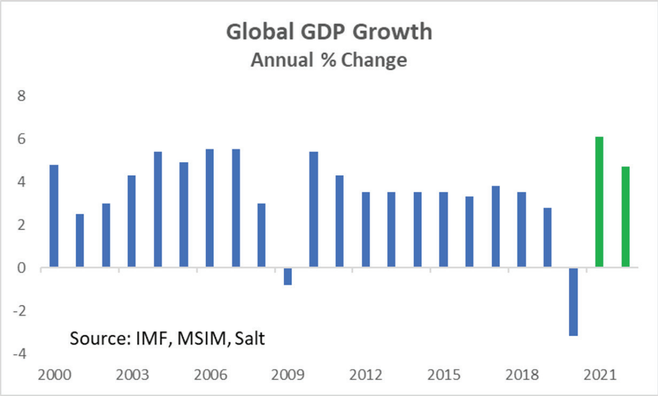
There is the usual catalogue or risks to navigate. The pathway of Omicron and likely further mutations of the coronavirus, especially those that challenge the efficacy of the current crop of vaccines, could undermine our base case optimism. If central banks continue to dither, markets may begin to fret they aren't getting on top of the inflation problem. And of course, there are myriad geopolitical risks which include Taiwan, Ukraine and the US mid-term elections, plus an undoubted host of current unknown unknowns.

Global growth slows but remains above trend

The initial recovery out of economic restrictions came quickly and is now largely behind us. Many economies, including importantly the United States, have regained their pre-Covid levels of output. Others, including the Eurozone and the United Kingdom (check) are not far behind. New Zealand reached that milestone three months after the contraction but has slipped back as the Delta variant arrived and we went back into lockdown.

While a return to pre-Covid levels of activity is to be celebrated, it belies the fact that activity would have been significantly higher had Covid not transpired in the first place. The recovery to the pre-Covid growth trajectory will take longer to achieve and will require a full recovery in supply chains. Only then will we be able to make a fulsome assessment of the overall costs (economic scaring) of Covid on global output.

Following the initial recovery in 2021, growth slows this year but remains above trend and does not stagnate. Our partner Morgan Stanley Investment Management is estimated global growth of 6.1% in 2021, slowing to an above-consensus forecast of 4.7% in 2022.



This slowdown reflects a shift to a more balanced and trend-like pace of growth. We assume that Covid case numbers continue to rise but a return to large-scale lockdowns is avoided, though worker absenteeism through illness will be disruptive in some areas. Therein lies the biggest risk to our constructive 2022 outlook.

Likely gone are the large swings in consumer spending and household savings rates that were a consequence of lockdowns, meaningful shifts in employment levels, at times forced retrenchment in consumer spending and significant fiscal outlays in the form of income support.

Household savings rates remain elevated across many countries that will see further release of pent-up demand through 2022, but with inflation currently running stronger than wage growth, real wages are in decline. This will put something of a dent in the otherwise strong household consumption story, even as inflation moderates over the course of 2022. This loss of real disposable income will boost wage claims further as households seek to restore real purchasing power.

Inventory rebuild will be a feature of economic normalisation in the period ahead. As supply chains recover to eventually meet the needs of final demand, firms will then be keen to restore inventory levels. This will be offset to the extent that some businesses have been hoarding supply of inputs and finished goods.

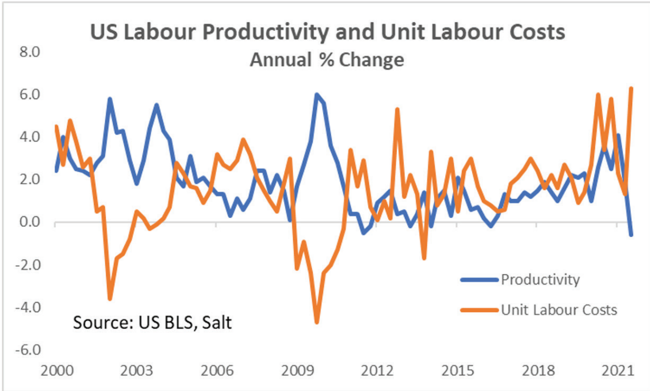
At the same time many businesses are rethinking their supply chains and are contemplating near or nearer sourcing key inputs into their production processes or customer sales to avoid a repeat of the challenges of the last two years. This will be an ongoing transition.

Strong capex spending critical for longevity of the cycle

It's notable that stronger business investment has ready played a key role in the economic recovery. At the global level, business investment has recovered faster than overall GDP and faster than in previous recoveries.

We expect this strength to persist into 2022. With labour markets generally tightening (at least as measured by the unemployment rate), business will turn to capital expenditure to resource the growth in demand for their goods and services.

Stronger capex growth will improve the longevity of the business cycle, improve growth in productivity and help keep inflation in check by dampening increases in unit labour costs. Annual growth in US unit labour costs is currently running at over 6% per annum – a clear sign of the strength of fundamental inflation pressure.



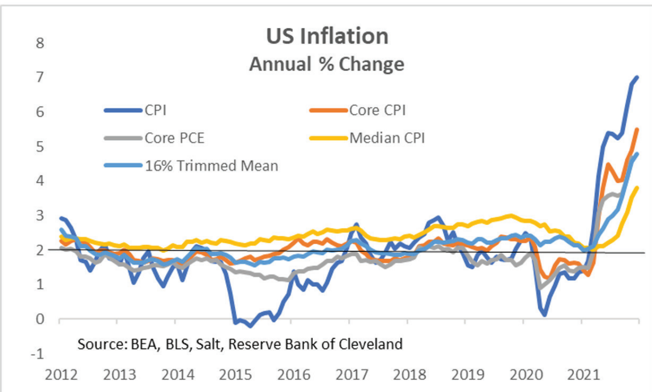
Inflation moderates

Inflation moved sharply higher as demand recovered, supply chains became congested and commodity prices surged. The great debate of 2021 was the extent to which this inflation would ultimately prove to be transitory or more enduring.

We haven't seen this as a debate with a binary outcome. For us the question was always the extent to which inflation would have both transitory AND durable components.

The inflation emanating from excess demand for goods at a time of significant supply constraints and logistical bottlenecks would ultimately prove transitory. The only real questions were how high and for how long?

As it has transpired, this inflation has been of a greater



magnitude and longer lasting than expected at the time of the emergence of the economic recovery. The US CPI hit 7.0% in the year December 2021. That does not however make that inflation more durable, at least in terms of the timeframes considered by central banks in their policy setting deliberations. That said, the longer the transitory inflation lasts, the greater impact it will have on inflation expectations and wage-setting behaviour.

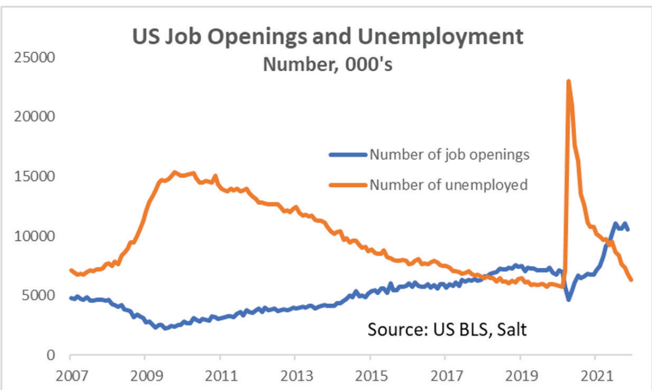
As supply chains gradually normalise through 2022, inflation can be expected to moderate. Whether we see outright falls in goods prices will be dependent on pricing power of individual firms. At the very least the inflationary consequences of supply chain disruption will not be repeated as pressures ease.

Not all inflation is transitory

However, not all inflation is transitory. Employment has improved along with the recovery in activity, supported in many countries by significant and targeted support for businesses to retain staff. That has combined with reduced labour mobility and ongoing and increasing demand for labour as fiscal stimulus has morphed from pandemic response to generalised fiscal largesse. Fiscal policy was always going to be more effective in generating greater employment growth than quantitative easing was ever going to.

In some cases, most notably the United States, reduced levels of labour market participation has also contributed to tightening labour markets and rising wage pressure. In the US the latest labour market report read of the unemployment rate at 3.9%, only 0.4 percentage points higher than pre-pandemic. The US participation rate is currently 61.9%, still lower than the pre-pandemic high of 63.4%. That means there are around 2.4 million people "missing" from the labour market.

At the same time, the Job Opening and Labour Turnover Survey tells us there are currently more job openings in the US than there are unemployed people to fill them. This dynamic and its implication for wages has led to a phenomenon with the sobriquet of the "Great Resignation", where Americans are quitting their jobs at the fastest rate in measured history for higher pay and better conditions.



We expect this labour market tightness to be an ongoing feature of the recovery, underpinning strong wage growth and durable underlying inflationary pressure. So, while inflation emanating from supply disruptions and overall headline inflation slows moderates this year, the more fundamental pressure emanating from the labour means that inflation remains above target in many countries, requiring the ongoing withdrawal of monetary stimulus.

Monetary policy – stimulus is withdrawn but tightening is constrained

Through 2021 many developed central banks finally recognised the likely more enduring nature of higher inflation. This saw them become increasingly hawkish during the year with some now realising how far behind the curve they are.

At the time of his address at the Monetary Policy Symposium at Jackson Hole in August 2021, Fed Chairman Jay Powell indicated a tapering of the Feds asset program was soon likely with the program likely to be wound up by mid-2022. He warned markets not to assume that interest rate increases would automatically follow the end of the asset purchase program.

Move forward four months to the December FOMC meeting, where the conclusion of the asset purchase program was brought forward to March 2022 and the use of the word "transitory" was retired. The minutes of the meeting, released in early January, surprised with its hawkishness and apparent fresh urgency to get on with the job.

This more hawkish tone, along with the clear and obvious ongoing tightening of the labour market has us expecting the first increase in the fed funds rate in March, with the Committee likely to commence the reduction in the Fed's balance sheet (Quantitative Tightening) by mid-2022.

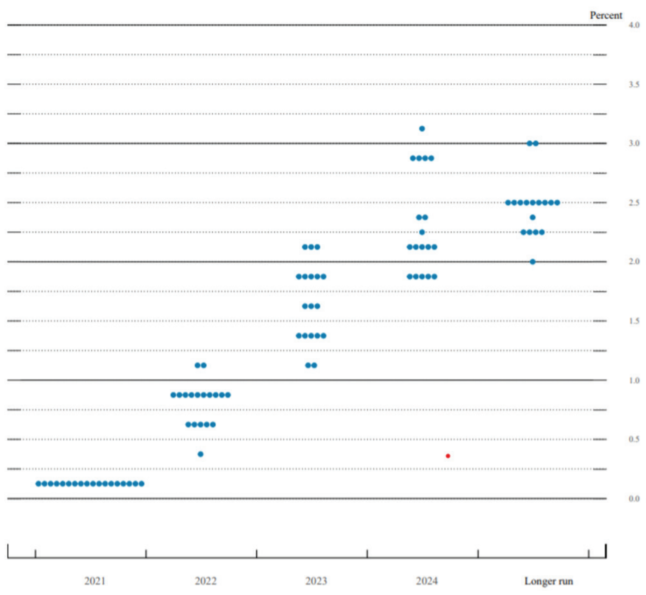
This has been a marked shift in tone and guidance from the Fed, now known more colloquially as the "Powell pivot", has been quite remarkable. We wonder if part of the problem was the FOMC's recent adoption of a more flexible framework targeting average inflation. This tweak was borne of many years of missing its inflation target on the downside. Unfortunately, the shift to greater flexibility came just at the time they needed to be at their most responsive.

Amongst other key developed central banks, the Bank of England raised interest rates for the first time this cycle just prior to Christmas and the Bank of Canada is expected to follow suit within the next few weeks. Even the European Central Bank has moved cautiously in the direction of reducing its asset purchase program.

The great monetary policy debate of 2022 will be how quickly central banks tighten conditions and how high interest rate need to go (the terminal rate). Initial focus will be getting key policy rates to neutral, though exactly where that is in 2022 remains open for discussion.

Unless individual banks get on top of the inflation problem, getting policy rate to neutral may will prove insufficient to rein in inflation. Already the FOMC dot plot shows some Committee participants expecting the Fed funds rate to exceed the long-term average. Here in New Zealand, the Reserve Bank of New Zealand is projecting a terminal rate higher than their assumed neutral level.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



However, the extent to which central banks can tighten this cycle is more constrained than in previous cycles given significantly higher debt levels, particularly amongst households. So, while central banks will need to be cautious, remaining behind the curve could see interest rates move eventually move to a level that becomes problematic for household balance sheets.

Stagflation or Growthflation?

Another debate through 2021 was the extent to which we would see a set of economic conditions that resembled 1970s style stagflation – the combination of low growth, high inflation and high unemployment.

So bleak was that combination of factors the economist Arthur Okun was motivated to establish his Economic Discomfort Index. This was later renamed the more commonly remembered "Misery Index" by former US President Ronald Reagan.

This year, we expect to see an unusual combination of factors: growth is expected to slow, inflation is expected to moderate, and monetary conditions are expected to tighten. However, growth is expected to remain higher than trend and central banks have sufficient tools to tame inflation – they just need to use them in a timely manner!

We don't see this as stagflation, but rather inflation driven by above trend growth and tight labour markets. In an effort to become famous and often quoted in decades to come, we will call this "Growthflation".

Jokes aside, we don't completely dismiss the concept of stagnation, however. The onset of Covid has seen politicians and policy makers setting aside their normal policy deliberations, the most important of which is what to do about moribund developed world productivity growth. Without improved productivity many developed economies face low-growth futures and declining living standards.

China sets its own course

Observations of the Chinese economy need to be seen through the lens of the ongoing structural shift from exports and investment to consumption and an ongoing deceleration on GDP growth as that transition occurs.

During 2021, that downward bias to growth was accelerated by the authorities' commitment to a Covid elimination strategy, which saw the regular imposition of lockdowns, and the "regulatory reset" targeted at achieving common prosperity. At the start of the year, the consensus view on calendar 2021 GDP growth was 9.5%. This was revised down at regular intervals during the year with consensus now at 7.8% for calendar 2021.

This downward revision was significant and poses ongoing risks to Chinese GDP growth through 2022. We don't expect Chinese authorities to change their Covid strategy, especially with Omicron on the doorstep.

We also expect the property slowdown to persist into 2022. Recent regulatory restrictions aimed at over-speculation and mitigation of the risk of potential asset bubbles, along with limits on the borrowing power of developers could lead to further defaults this year. Many property developers are already in distressed territory.

Despite these negatives, it's likely that further monetary and fiscal policy easing will see some stabilisation of the economy during the latter part of 2022. Further cuts to the Required Reserve Ratio are likely, and a reduction in the repurchase rate is also possible.

On the fiscal side, further expansionary spending is likely. The annual Central Economic Work Conference that took place at the end of last year was clearly pro-growth, in the context of ensuring economic stability. Infrastructure is the likely big winner out of any new supplementary budget measures.

Our partners Morgan Stanley Investment Management see China GDP growth of 5.5% in 2022. While that's a long way short of historical growth rates, it needs to be considered in the context of an overall structural decline that will see GDP growth slow to around 3.5-4.0% over the next few years. A slower China is a more stable China.

What are the risks?

Covid and its evolution remains the most significant global risk as the global supply chain and its functioning remain the dominant growth and inflation story.

We have not yet seen the full impact of the Omicron variant, though high vaccination rates provide some degree of insurance against its worst effects. The emergence of anti-viral medications will provide an extra layer of protection against the worst outcomes.

Further variants are possible, if not probable, and vaccine efficacy and hospitalisation rates are the key factors to continue to watch with any fresh outbreak.

Persistent inflation pressures are a downside risk to growth as it weighs on consumer spending. Central banks continuing to equivocate necessitating monetary conditions potentially becoming tighter than neutral could prove to be more destabilising for activity levels and risk assets than earlier, more decisive action by central banks.

Geo-politics will continue to provide a source of news and, at times, tension. Tensions between the United States and China are in one sense structural, in that both countries are vying for economic and political supremacy. This will manifest primarily around technology, but occasional flashpoints will emerge, such as current tensions over Taiwan. Russia's intentions over Ukraine are also an ongoing source of tension.

There are some interesting elections to watch this year. French President Emmanuel Macron seems to be facing an uphill battle ahead of elections in April. This is an important election from a Eurozone perspective also. With Angela Merkel no longer German Chancellor, an older steady hand is required as the defacto leader of Europe. Macron has been making good pro-Europe noises of late, however those positions are deeply unpopular at home which has seen the anti-establishment gain the ascendency.

President Bolsonaro of Brazil faces elections in October. A populist, the President seems likely to announce further fiscal spending measures, and with that a further deterioration in Brazil's already fragile fiscal sustainability.

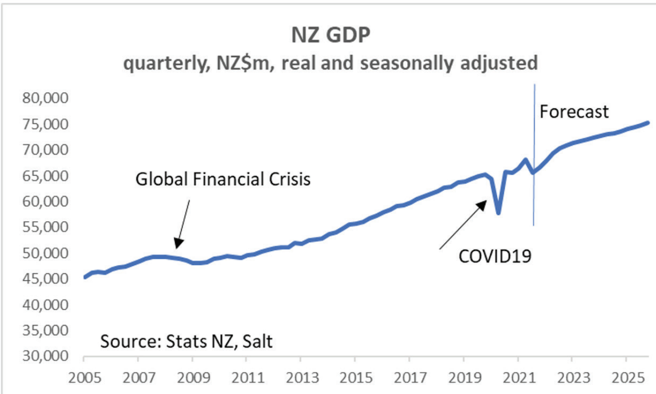
President Biden faces US mid-term elections in November. The Democrats will likely lose congressional control, ushering in yet another period of US political gridlock and policy stalemates.

New Zealand - changes in the growth driving seat

One word described the performance of the New Zealand economy in the latter part of 2021: Resilience.

After a strong recovery from the initial lockdown in 2020, the economy was plunged back into lockdown in August 2012 as the Delta variant arrived. For most of the country that was for a very short period, but for Auckland, that lockdown persisted in various forms through the whole of the fourth quarter of the calendar year. The city only dropped down from Red to Orange under the traffic light system in January.

September quarter GDP came in at a far better than expected -3.7%. That compares more than favourably with the -9.9% for the June quarter of 2020. Businesses clearly pivoted to on-line and contactless activity where they could, benefitting from the earlier practice. But for many, particularly smaller businesses, a further lockdown was too much, and they have closed.



While the decline in third-quarter activity was less than expected, as Auckland's lockdown lingered, we assume a full recovery will take longer to be achieved.

Omicron is yet to make its presence felt in New Zealand. Its arrival is inevitable, as is further disruption to activity. High vaccination rates including the faster roll-out of booster shots, will provide a degree of protection from the worst effects, its impact on economic activity will only become clear with time. Whether that means a return to lockdowns remains to be seen. At the very least further supply chain disruption seems likely given its greater transmissibility and the likelihood of high work absenteeism through illness.

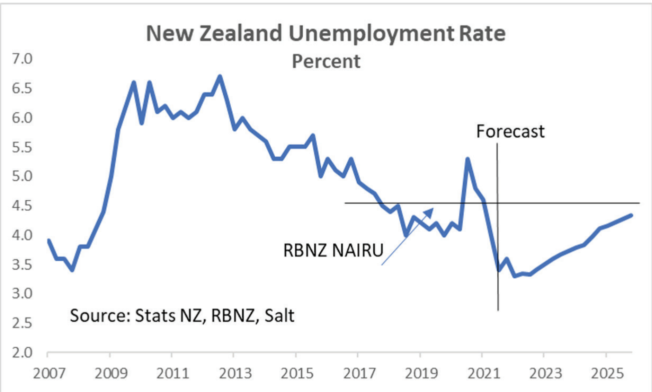
For now, our forecasts have us expecting an annual average 4.3% GDP growth in 2022, down from 5.3% in 2021. The key drivers of growth change through the year as activity shifts from a reliance on housing and fiscal support to business investment and hopefully the reopening of borders later this year.

Household consumption is expected to remain strong in 2022, though the recent and likely short-term phenomenon of declining real wages along with likely modest falls in house prices this year will be limiting factors. Covid remains the key downside risk, as is a sharper than expected fall in house prices as interest rates rise.

NZ labour market – beyond strong

If the resilience of activity has impressive, the performance of the labour market has been nothing short of spectacular. On the back of strong employment growth over the September quarter, the unemployment rate fell to 3.4%, equalling the record pre-Global Financial Crisis low of December 2007.

Given the extended lockdown in Auckland in late 2021 we wouldn't be surprised to see the strong September quarter gains in employment and drop in the unemployment rate reverse somewhat in the December quarter. However, we expect the unemployment rate to remain on a downward trajectory towards 3% in the first half of this year.



The strong labour market is a combination of strong demand for labour, but also severely constrained supply. New Zealand relies on strong migrant inflows to meet its labour market needs. With the mobility of labour severely constrained and net inward migration now negative, that source is labour is largely closed and expected to remain so until border re-open.

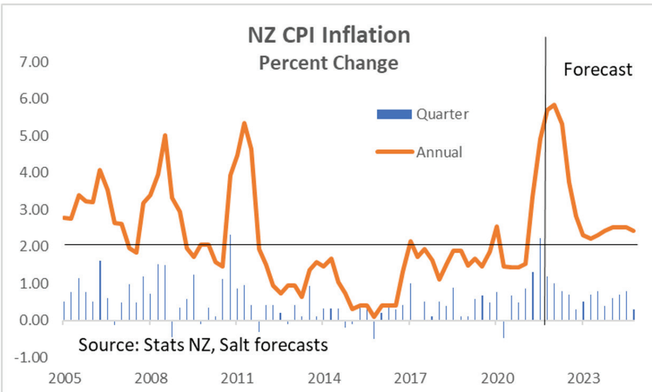
Even then the impact on net migration is uncertain given there is considerable pent-up demand for people currently in New Zealand to leave when they can.

At the same time the labour participation rate has recovered to a new record high, so there is little room left in the workforce to encourage new entrants to the labour market.

Wage pressures are strong and building momentum. The Labour Cost Index (a proxy for unit labour costs) posted an annual increase of 2.4% in the year to September and will head higher to over 3.0%. This is consistent with above target mid-point inflation. Wage increases can be expected to remain strong until the unemployment rate heads back towards more sustainable levels.

NZ inflation nearing its peak, but to remain above target

The NZ CPI surged to 4.9% in the year to September and is expected to accelerate further into the first quarter of 2022 and peak in the range 5.5-6.0%. Inflation also became broader based as 2021 has progressed, with the annual rates of most core measures of inflation now in excess of 4%.



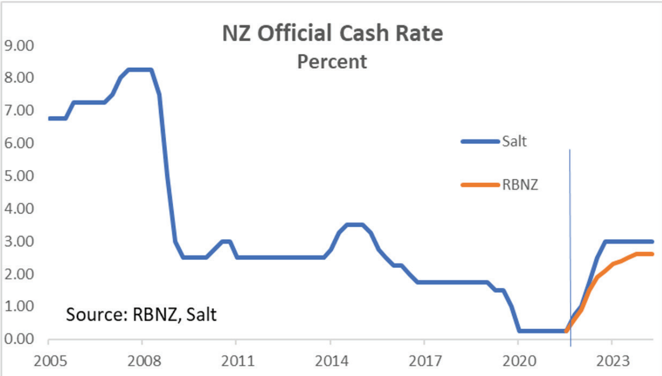
Inflation moderates over the course of this as supply disruptions ease and large increases over the past 12-months aren't repeated and drop out of the annual calculation. However, the annual rate of headline CPI is still expected to be higher than the top end of the RBNZ's 1-3% target range by the end of the year.

Into 2023 and beyond, inflation remains above the mid-point of the target range reflecting the tightness of the labour market and rising wages. It only starts to ease back towards 2% as the unemployment rate heads back up to more sustainable levels.

RBNZ – well behind the curve

The Reserve Bank of New Zealand is well behind the curve. Having missed the opportunity for their first intended hike as the country went into lockdown in August 2021, the RBNZ took both remaining opportunities in 2021 to raise the Official Cash Rate, increasing it by 25bps in each of October and November. The OCR finished the year at 0.75%.

This rate of increase is, in our view, too slow. Importantly, it means that just tightening to neutral will be insufficient to rein in current underlying inflation pressures. We have therefore raised our estimated terminal rate for the OCR to 3%. To their credit the RBNZ also now sees the OCR moving higher than neutral to 2.6%, above their assumed neutral rate of 2%.



Assuming the RBNZ takes every opportunity to hike rates next year (Monetary Policy Statements and Monetary Policy Reviews), but keeps to 25bp hikes, the OCR will reach 2.5% by the end of 2022 and 3% by early 2023. It could get there more quickly as the RBNZ steps up the occasional 50bp hike. That will, of course, be largely Covid dependent.

Bevan Graham.

Outlook for New Zealand Equities

The NZ equity market trailed its global peers in 2021, declining by -0.4% compared to the +17.2% advance by Australia, the +28.7% surge by the S&P500 Index in the USA and the +21.8% rise by the MSCI World Accumulation Index. Why did NZ lag and will this repeat in 2022? In what follows, we examine the drivers.

1. The low beta composition of the NZ market is the first key reason. While growth and high momentum stocks came off the boil towards the end of the year as interest rates rose, they still performed well overall in most markets. Large cap high quality growth did particularly well, while lower quality "vapourware" companies struggled. This can be seen in how the Nasdaq 100 Index rose by +26.6%, whereas the broader Nasdaq Composite was +21.4%, while the Ark Innovation Fund (the poster child for early-stage growth) fell by -24.0%.

2. A couple of the highest quality large cap growth names in NZ struggled for their own unique reasons. A2 Milk (ATM, -50.9%) was brutalised on the back of earnings warnings due to fierce headwinds from a collapse in the cross-border daigou trade and a sharp fall in the Chinese birth rate. ATM alone detracted -3.5% from the NZ market. After a stunning 50% advance in 2020, Fisher & Paykel Healthcare (FPH, +1.1%) had a high bar to beat, with the positive impact in Covid-19 hospitalisations already baked in. The stand-out quality growth names that did do well were Ebos Group (EBO, +47.9%) and Mainfreight (MFT, +37.3%).

3. The NZ market faced a headwind from Meridian Energy (MEL, -31.7%) and Contact Energy (CEN, -3.8%) having performed unnaturally well in the prior year due to price insensitive buying from an ETF which tracked the S&P Global Clean Energy Index. They were then down-weighted as the Index was realigned to account for the liquidity of its constituents in 2021. This detracted -2.3% from the NZ market.

4. Starting valuations for the NZ market were high with the forward PE for the "core" market (ex-property and airlines) being a near record 36.6x in Dec20 (using Jarden data). This multiple required exceptional earnings growth to be justified and this was not ultimately delivered. Year-ahead earnings forecasts rose by a respectable but not unusual 11%. The starting PE for 2022 is a still high 32.6x, with a growth outlook that is perhaps less promising.

5. NZ 10-year bond yields rose sharply over the year from an absurdly low 0.99% to a still moderate 2.37%. When discount rates are at such low levels, a small rise has an out-size impact on the net present value of long-duration assets such as equities. With inflation careering away well above the RBNZ's 1%-3% target range, it is perhaps reasonable to expect further headwinds from this source in 2022.

6. Earnings growth was affected by an uneven response to the economy moving in and out of lockdowns. While the NZ stock-market has a somewhat different composition to the NZ economy, there is still a reasonable linkage. Business confidence surveys suggest the activity outlook is tepid at best, while profit expectations are well below average, with cost pressures and labour shortages being particular problems.

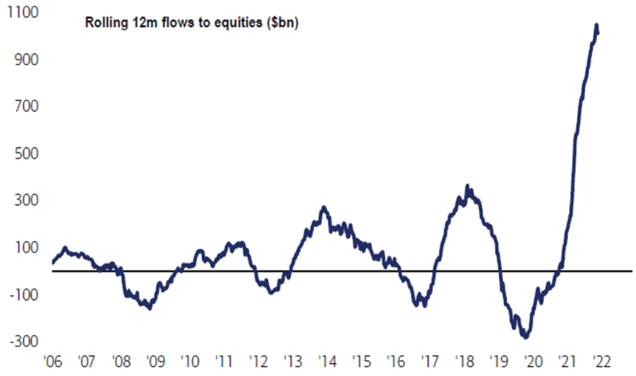
In our last NZ equity market outlook piece back in June, we argued that inflation pressures were rising, that central banks were behind the curve and they would have to tighten. This is just starting to play out and the evidence for this view remains compelling in NZ and overseas. This brings us to the hoariest but truest cliché in finance - "Do Not Fight The Fed".

The latest FOMC Minutes suggest 2022 will not only see several rate hikes but may also see the beginnings of Quantitative Tightening (QT). The last time the Fed tried QT was in 2018 and resulted in the mother of all equity market dummy-spits in 4Q18, with the S&P500 falling by -19.9%. It subsequently regained that ground as the Fed backed off in the face of this reaction and relatively subdued actual inflation outcomes.

This coming sea-change in central bank activity will really matter as ultra-loose monetary policy has been a historically extreme driver of financial markets. Record negative real yields have "forced" investors into all sorts of positions. The chart below is concerning.

Chart 4: $1.0tn to stocks in '21

Rolling 12 month flows to equities

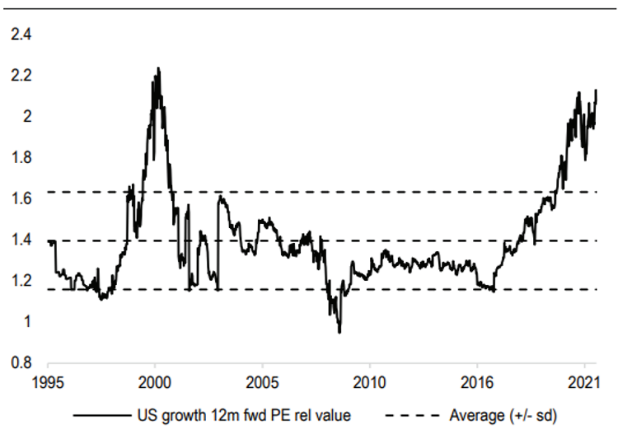


Source: BofA Global Investment Strategy, EPFR

When rates rise, it is highly likely that cyclicals and value stocks will outperform, which is how January has started. While the discount rate rises for all stocks, these styles tend to benefit from inflation enhancing their nominal revenue and earnings lines relative to other styles.

Growth has trounced value as a style for the last few years, with zero interest rates favouring long duration securities. Interestingly though, the price performance of growth stocks relative to value has far exceeded their relative earnings upgrades. This has left growth unusually expensive relative to value, meaning they are very vulnerable to a reversal in the discount rate declines that have driven them. This is shown below for the US market.

Figure 146: The P/E of growth to value is very high



Source: Refinitiv, Credit Suisse research

Quality stocks have had a wonderful few years but may experience a hiatus in 2022. Who doesn't like a stock with a high ROIC, strong and stable margins and good re-investment opportunities? However, if it was that easy, these stocks would always outperform and their valuation multiples would tend to infinity. This doesn't happen.

Such stocks are very attractive in a mixed environment because they tend to hit their earnings numbers whereas other companies struggle. However, this dependability isn't as valuable in a cyclical upswing when the financial and operating leverage of lesser quality names comes through. At the same time, falling bond yields and a dearth of other solid investment opportunities in recent years mean it has made sense to pay ever higher multiples for the earnings that quality names generate. The problem is that a 40x PE is now the old 20x and if we enter a period of higher bond yields, the multiple attached to these companies may contract.

While a relatively small part of the overall market, the NZ retirement sector may face headwinds in 2022 as the NZ housing market unwinds some of its excesses. NZ is building more than 40k housing units per year when we need 20-25k (remember people squeeze up when house prices and rents rocket); immigration has ceased thanks to Covid and may be matched by emigration when NZ opens again; mortgage rates are rising rapidly and have further to go, with the benchmark 3-year swap rate having risen from 0% in Nov20 to 2.5% today; 40% of all NZ households will have to refinance their mortgage in the next 6 months and 70% in the next year.

While hardly a unique insight, we expect stocks that rate well on ESG grounds to again outperform. There is significant data documenting the general outperformance of ESG strategies over the last several years. We suspect part of this is the sheer weight of money crowding into the same names but we also believe that a portion of the ESG stock outperformance is rational as the operating horizon for environmentally and socially questionable business models is rapidly shortening.

To conclude, the NZ equity market begins 2022 in the midst of a paradigm shift as central banks begin to tighten monetary policy. This will affect equities as the wall of "no alternative" cash subsides and as discount rates rise. Equities have historically been a good hedge against inflation up to around the 3-3.5% region. After that, rising discount rates more than offset higher nominal sales and earnings. Under the hood, this is an environment where cyclicals, special situations and value stocks have tended to outperform relative to the growth and pure yield names that have done so well in recent years. The jury is out on quality as a style but it could also be a surprising laggard given its elevated starting multiples.

Matthew Goodson.

Implications for Investors

The Age of Expensive Assets

As investors enter the third year of the decade, and of the CoVid-19 pandemic era, two main phenomena stand out. The first is, that wild-card risks to populations, economies and assets are at heightened levels compared to most prior decades. The second is that, notwithstanding these risks, many investment assets have retained or extended the degree to which they are "expensive" on many established valuation metrics. Put together, this implies that investors do not anticipate a major shock that renders the acquisition of key assets meaningfully cheaper. Holding Cash, and waiting for such a shock-driven repricing opportunity, has been shown to incur substantial opportunity losses, and until recently has provided considerable performance anxiety for value-driven and contrarian investors alike.

Does the persistence of over-valuation represent a tension, that needs to be resolved sooner or later? Or, does it signify an enduring re-rating in the financial "worth" to investors of asset pools, income streams, and even remote or implausible profitability prospects? This is the conundrum at the heart of current investment strategy. This dilemma has parallels with the much-cited "gamification" of investment (which is largely a gamification and democratization of trading, given the holding timeframe of most positions.) Mass enthusiasms for assets of questionable fundamental merit is already a defining feature of the 2020s.

There is no doubt that investors have, for some time, been willing to pay far larger sums in present currency-terms to access presumed future gains in many asset types. This willingness was pithily summarized by hedge-fund titan Ray Dalio and financial planning author Robert Kiyosaki as the "Cash is Trash" hypothesis. The popular consensus is that almost any asset is preferable to cash, particularly since inflation is continuing to erode the real value of liquid funds. Since the main objection to simply buying any available asset, using either cash or debt to do so, remains the risk of enduring capital loss, investors are adapting to a new test:

"Is this investment likely to experience merely transitory, or permanent, declines in real value during my planned holding period? If merely transitory, can I reasonably rely on other market agents to allow me to realize a positive return at any future time of my choosing?"

The key implication is, that there will be a strong underlying investor bias to deploy cash swiftly into any asset which passes the value-retention test to their satisfaction, and which presents a sufficiently tempting entry price. Behavioral psychology has shown that that "tempting price" is often not set with regard to fundamentals, relativities to other assets, or forecasts, but largely with regard to the recent price history of the very same asset (or closely-comparable ones.) Hence, the popular financial media penning lines like "Stocks are on Sale," or a stark example from last November 26, "Black Friday Deals: These 3 Stocks Are Already Trading More Than 50% Off. Motley Fool issues rare all-in BUY alert." Many non-professional investors consume this material, and easy trading platform access enables purchasing.

While this crude formula is not inevitably flawed, the danger is clearly that is can support a quality-blind "buy-the-dip" reflex because investors are adept at rationalizing and justifying historically-extreme valuation levels. As has been apparent over the last 12 months in the New Zealand equity market, an asset class which had performed far more strongly than fundamentals should reasonably support, for several successive years, can easily be susceptible to a subsequent multi-quarter period of flat- or negative returns, regardless of other macroeconomic variables (which may remain supportive and / or superior to those in competing capital markets.) A comparable period of anaemic returns for recently-expensive segments of the international equity markets may potentially lie ahead, and active sector and security selection will become even more crucial in achieving superior after-inflation returns.

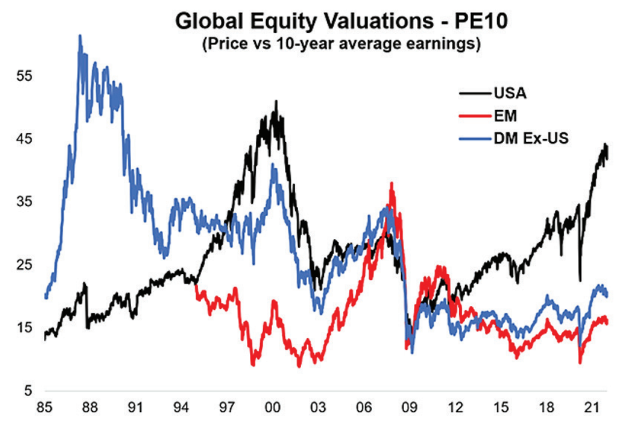
America, the Invincibly Optimistic?

As the chart below shows, the ten years since 2012 (that is, the decade since the turning-point in the European

Sovereign Debt Crisis) has seen a mounting expansion in the prices investors have been willing to pay, to gain exposure to the earnings of US listed companies compared to those in either Emerging Markets (EM) or in Developed Markets other than the United States (DM Ex-US.) This is partly because of the specific nature of the recoveries of the post-Global Financial Crisis, debt laden developed world economies. With sovereign debt burdens expanding, and sovereign interest rates kept consistently suppressed in the low-inflation decade up to 2020, the industries where prospective revenue and profit growth is highest have been strongly preferred - and these industries are over-represented in the US.

Simultaneously, rounds of tax reductions and special stimulus payments have boosted US investable cash levels while private debt servicing costs have been kept exceptionally low. Coupled with a perceived "innovation lead" in IT and associated entertainment by US firms and growing global enthusiasm for US-originated internet platforms fusing marketing and leisure, this has produced sustained boom conditions.

US Equity Valuations are well above major peer markets' based on longer-term earnings



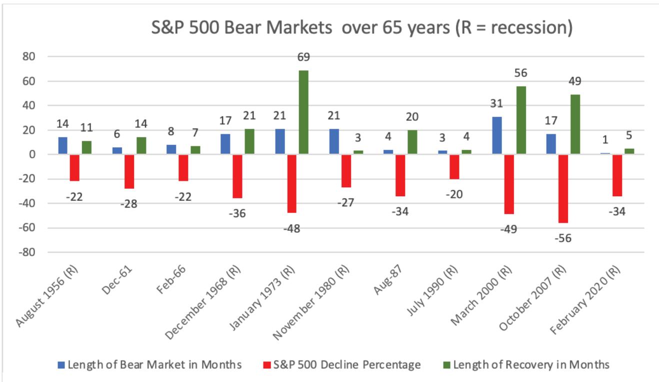
Source: TopDown Charts, Refinitiv

As a result, US equities have outperformed their Developed Market peers both by a returns quantum, and for a time-period that is historically rare (outside wartime.) Interestingly, because corporate earnings (while rebounding quickly from contraction periods) have not matched the gains in valuation optimism, US shares' expensiveness in aggregate has advanced toward the level last seen in 1997- 2000, into the peak phase of the dotcom bull market. Additionally, a wider set of market sectors has participated in these multiple expansions than occurred 25 years ago.

This suggests future gains in 2022 will be selective, while risks are also more pervasive. In 2000-2002, geopolitics following September 11 compounded the earlier deflation of the Technology and Communications sectors which had dominated the aggregate index, and made a generalized multi-year bear market from what had been an industry-specific deep reappraisal of value. Recall that in 2000, the equity market peaked three months before the conclusion of the Fed tightening cycle in July (with a Fed Funds Rate of 6.5% and a CPI-adjusted real policy rate of 3.0%.)

By contrast, a Fed tightening cycle beginning in 2022 would - on current median Fed projections - see a Fed Funds rate of 2.1% and a CPI-adjusted real policy interest rate of around zero in 2024. Suffice to say, the current situation is clearly not envisaging contractionary interest rate policy; in which case a non-recessionary correction in some growth sectors could potentially see a correction or bear phase in the headline Index with positive returns persisting nonetheless in sectors that are not considered grossly overvalued or vulnerable.

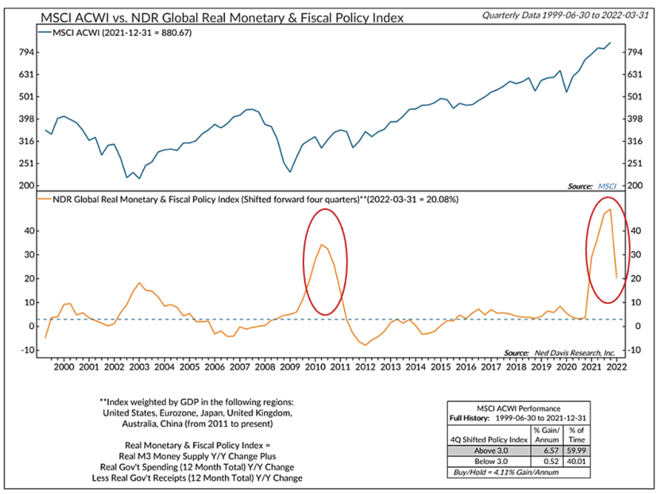
US Equity bear markets commonly require recessions to entrench



Source: CFRA, FactSet

However, the "excess liquidity" element of the recent, rapid rally may introduce equity conditions more akin to 2011-2012, when markets continued their "bull" uptrend, but at a significantly reduced rate-of-gain than had applied during their stimulus-enabled initial rebound.

Indicators reveal a high, but diminishing global stimulus level



Source: NDR / BCA Research

Valuations reflect marked regional and sectoral returns dispersion

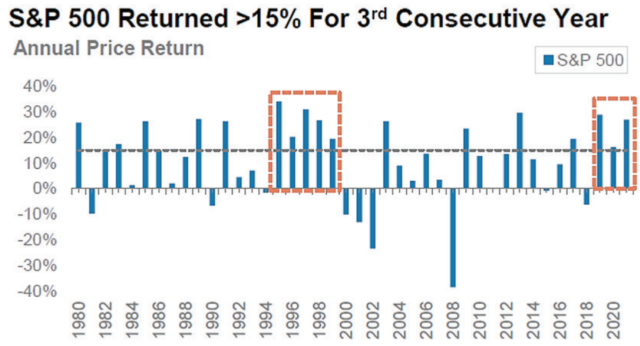
As at the end of 2021, the US equity market (proxied by the MSCI USA Index) has outperformed the MSCI Europe, Australasia and Far East (MSCI EAFE Index) for 14 years, and by a cumulative +275%, in US dollar terms. The forward Price Earnings (P/E) ratio for the S&P 500 Index stands at 21.5, and for US Growth stocks, at 35.2. This compares with a broad market P/E of 15 for the European EuroStoxx Index; 13.6 for Japan's Topix; 12.1 for the UK FTSE Index and 12.4 for MSCI Emerging Markets.

US Value stocks are currently valued more in line with prevailing international broad market ratios, at a P/E of 16.3. At the other end of the valuation spectrum are the European Value stocks, with a forward P/E of just 10.8. These comparatively well-valued companies are found in sectors like **Consumer Staples, Health Care, Financials, Industrials** and quality **IT.** Their profits more closely track the economic cycle, and many are seen as more defensive in character, while they may lack (from the momentum investor's viewpoint) the exciting and contagious narratives of disruptive, radical shifts in human consumption patterns.

Arguably, these global sectors where value still exists represent the "skeptic's selection," whereas the US Growth universe is the "utopian's charter." The former relies on consistent and recurring patterns of consumer and business spending and investment activity through a range of economic conditions, whereas the latter focuses more on e-commerce, entertainment, and internet engagement transforming utterly the types of items that are prioritized for purchase, either for consumption or savings purposes. The utopian growth mix has been a huge beneficiary of a decade of easy money, internet adoption and cultural factors favouring perceived "disruption," individualism and armchair anti-authoritarianism. However, its prospects are vulnerable to a higher cost of funds in future years, as well as to inevitable instances of technological disappointment, or of simple shocks arising from old-fashioned geopolitics.

Vulnerability historically rises when the overall level of monetary conditions "easiness" falls below a threshold level, and our best estimate is that this could occur in the latter part of 2022, suggesting the cyclical bull equity market may be already well-advanced and potentially, in its ultimate year. However, as stated above, while the bull trend may be disrupted for broad aggregate index investments, not all sectors will necessarily be forced into bearish returns patterns. Active selection will continue to prove its worth.

Multi-year periods with 15%+ US equity returns are rare

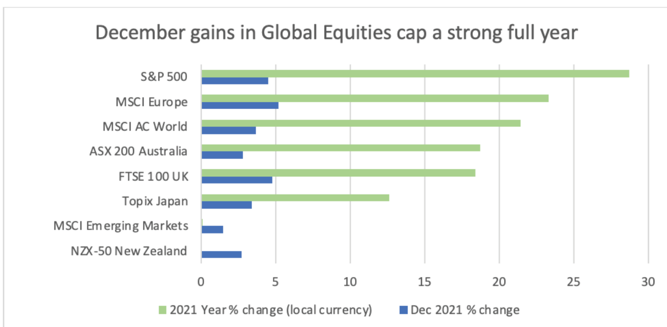


Source: Bloomberg, Morgan Stanley Research

2021: a year that rewarded investor composure

Following the loss of upward momentum in global equities during the third quarter, returns from growth-sensitive assets rebounded later in the fourth quarter of 2021, and full-year advance played out according to a historically common pattern. Developed market equities continued to rally in the December quarter, delivering equity investors a third consecutive calendar year of strong returns. Strong earnings growth outweighed fresh pandemic- and inflation-induced volatility as news broke of the new Omicron variant of Covid-19. Markets quickly recovered, as early indications suggested Omicron was less likely to lead to sustained serious illness. The MSCI World Index rose 7.6% (in USD) over the quarter to be +21.4% over the year. This return was enhanced for unhedged NZ investors by the 5% depreciation in the NZ dollar against the US dollar, lifting returns from the US asset component of international equity portfolios. Thus, while risks abounded -and some intensified- through the year, the cyclical bull market remained intact. It was an instance of the advisability of allowing for a longer investment timeframe to assess the impact of such risks, rather than pre-emptively attempting to avoid portfolio risk by exiting growth assets too early.

Seasonal "year-end" rally was slow to develop



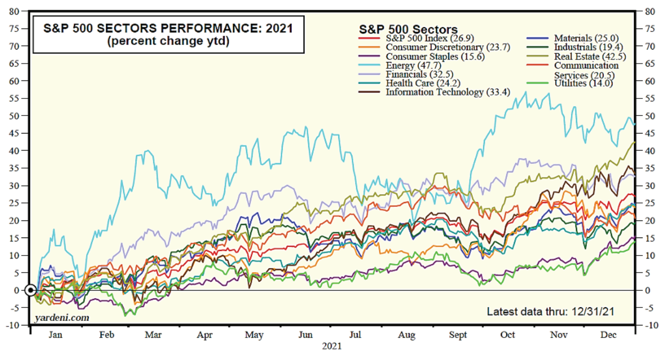
Source: Salt, Morgan Stanley investment Management

Choppy market continue into 2022 as inflation persists

Legitimate concerns about inflation and the prospect of tightening monetary conditions world-wide have triggered phases of "choppy market conditions" both in September and in early January, and these may continue for a little longer. Persistent weakness in bond markets, as interest rates across the yield curve increasingly reflect both enduring inflation and more active central banks, is eroding a support for the high valuations that US equities have achieved. However, a critical point is that **equity vulnerability does not equal bond desirability.** In less than the first fortnight of 2022, for instance, the important Bloomberg Barclays Global Aggregate Bond Index has declined by 1% (as at 12 January) reflecting higher yields over the last month of around 0.3% on 10-year maturities in many developed markets. In accord with global drivers, the S&P NZ Government Bond Index is also already almost 1% weaker in 2022 to date – a poor performance, coming on top of a more than 6% decline in calendar 2021.

As we noted in our last "Global Outlook," the conventional definition of a "correction" in equities is a fall in value of 10% from their prior peak. As of the date of writing, the US NASDAQ index, with its heavy weightings to interest rate-sensitive technology companies, has declined by 6% since its mid-November record level. While we believe further investor allocations at the expense of low- or no-profit tech firms will continue, this may not translate into excessive downside market risk for those equity sectors we favour, specifically: Consumer Staples, Health Care, and quality Information Technology, nor into drawdowns in the classically-defensive Infrastructure sector (which has lagged in recent years. US Utilities, within the Infrastructure universe, recorded a gain on "just" 14% for the full year of 2021, and was the weakest US sector overall. This contrasts with the best-performing S&P sector, the highly-cyclical Energy segment, which recorded a 48% rally as global demand and prices continued to surge, reflecting a post-pandemic normalization mindset. US Real Estate also benefited strongly, partly due to the value that the 2020 CoVid correction triggered in the sector for better-adjusted, more flexible and innovative property companies.

A late run by US Real Estate almost challenged Energy



Source: Salt, Yardeni Research, Standard & Poors

Indeed, the late-2021 surge in US Real Estate performance, which saw the industry group outperform IT, Communication Services and Financials, is quite surprising on the conventional view that long-duration property assets are automatically sensitive to a higher-interest rate track. This relationship is still theoretically-robust, but the inflation-hedging and stable-cashflow characteristics of property are now counterbalancing interest rate risk. This dynamic should continue, though as we have highlighted, a high degree of active management in the global (and domestic) property universe is crucial in avoiding the perennial risk of over-paying for mediocre or debt-swamped real estate vehicles.

Mini-corrections are tests that reinforce the bull trend

Overall, there remains scope for a corrective re-pricing, particularly in the more speculative parts of the international equity markets. There have been an atypically-small number of mini-corrections (down-moves of 5%) in the last 18 months, and these have been treated as "dips to buy" and swiftly resolved positively. We believe that while the entry-opportunity antennae of agile investors will remain alert this year, the periods of market softness may well last somewhat longer, potentially for blocs of 2-3 months. This is due to the altered backdrop of monetary authorities, led by the US Federal Reserve, progressively draining the extraordinary stimulus level that has prevailed for the last two years. However, as explained in the Economic outlook section of this report, the scope for tightening is constrained and a terminal US policy interest rate of 2.3% or so is not incompatible with the continuation of healthy returns for equities in the medium-term. Our global equity partner Morgan Stanley expects a slightly higher terminal rate of 2.5% and notes "Ultimately, the implication for investors of higher-than-expected terminal rates is lower stock valuations, with a somewhat steeper yield curve. This means equity-market leadership is likely to broaden from high-flying tech names toward value-style and cyclical stocks, which we believe are best accessed through active stock-picking."

Three key supports for global equity performance remain in place for now: overall monetary conditions remain loose, the equity risk premium remains elevated (note that 80% of bull markets end with below-average ERPs) and the stage of the global cycle remains expansionary. Current Revenue estimates for 2022 appear too low, though US profit margins are at all-time highs, so companies need to maintain their pricing power; in turn, if prices are lifted to compensate for rising costs, inflation expectations will increase further. Again, pricing power is most defensible in either high-quality IT and especially Software as a Service (SaaS) Health Care and in Real Asset classes that maintain inflation-linked pricing accelerators.

Positioning for a limited monetary tightening phase

History suggests that while interest rate hikes are undertaken to slow overheating economies and bring down incipient or current inflation, as long as they are not initiated too late in the cycle, certain industry segments can continue to accrue positive returns as their earnings increase. The graphic below indicates that as rate-hike cycles are undertaken during non-recessionary periods, but that an economic slow-down is implicit in the tightening process, US market returns in the order of 8% p.a. are still consistent.

We are comfortable with that scenario for 2022-23. Nevertheless, in the rarer instances where economic contraction becomes self-sustaining, such as the early 1990s or 2001-02, it has been prudent to build portfolio exposures in industries where demand is inelastic, such as Health Care and Staples. At present, a well-telegraphed programme of either three or four quarter-percent Federal Funds Rate increases in 2022, and a similar number the following year, is compatible with continued, moderating economic expansion.

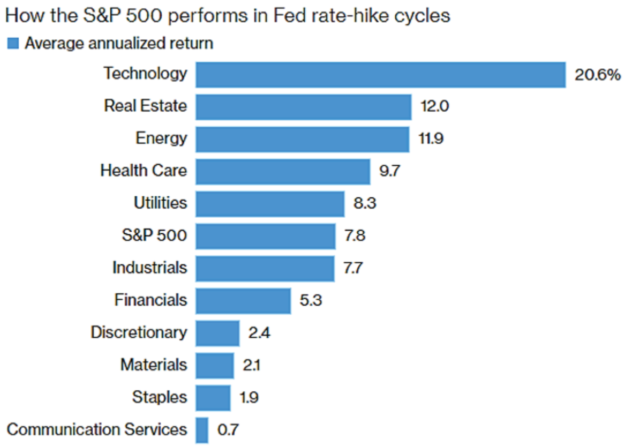
That would be a "slow and systematic" tightening cycle which in US market history (e.g. 1977, 2015) has been consistent with first-year market gains post-initiation of +10% and second-year gains of +2%.

By contrast, investors have historically been unnerved by "fast and furious" interest rate hiking cycles (e.g. 1987, 1994, 1999) wherein first-year returns have averaged -3% and second year returns, +4%. The net returns outcome of the two years' fast-tightening periods is thus, on average, a zero total market return.

Profit forecasts still sanguine on inflation impact

As per the latest FactSet data, analysts expect US corporate earnings growth of 9.4% for calendar 2022, and revenue growth of 7.6%. 2023 earnings growth is forecast at 10.3%. These forecasts are made on a bottom-up basis across the full S&P 500 company universe and are made with cognizance of rising inflation and interest rates operating as a constraint on future earnings. This suggests corporate profits can be protected and even selectively increased, under the cover of potential consumer price inflation in the region of 3%-4% p.a.

Rate-hiking phases reflect economic strength, but sector returns imply slowing growth



Source: Bloomberg, Strategas Securities

After a multi-year period in which double-digit equity market returns have been protected, due to unwavering support from both stimulus and central bank balance sheet "insurance," we believe that equity portfolios should now be constructed on value and inflation-resilience principles. We are retaining the preference for companies with reliability in cashflows and asset security, which includes **sustainability in both environmental operations, and in enterprise financing.**

Bonds still risk weak returns, we favour sustainability theme

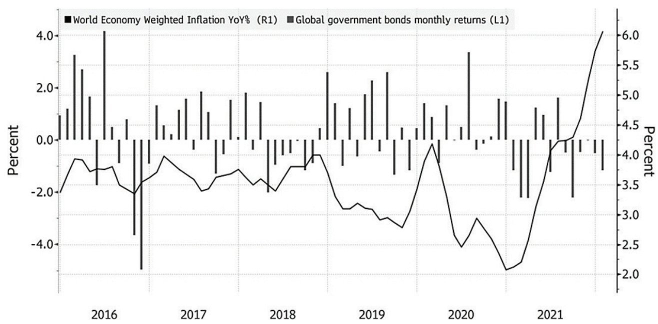
Total returns were negative from developed bond markets in 2021, with global Investment Grade corporate securities declining by -2.9% for the year and US 10 year bonds, by -3.1%. Longer maturity bonds have been hardest-hit on rising inflation concern, while corporate credit spreads in the US and Europe remained well-behaved and ended the year at less than 1% above equivalent-maturity sovereign yields (+0.92% in the US and +0.94% in Europe.) High Yield (non-investment grade) bonds continued to deliver positive returns in line with the optimistic tone in equity markets and supportive central banks. The US High Yield credit spread closed the year close to its historical lows, at +2.8%.

2021's reasonably sizable declines in the value of key Government debt securities are sobering, and make manifest the long-discussed asymmetric risks in buying bonds at very low (or negative) nominal yields. New diversifiers, less reliant on Fixed Income assets, are needed. For portfolios where bond exposure is still a requisite, active selection is absolutely critical to performance now – a fact exemplified by noting that the 2021 performance of Asian region Investment Grade dollar bonds was a solid +5.9%, whereas the Global Investment Grade bond index is down by -2.9% this year: an almost nine percent performance difference.

Note that these are all "Investment Grade" bonds being compared, so there is no element of additional riskiness being accessed on conventional credit rating metrics, to generate that superior return.

We believe than in years to come, investors will still wish (or need) to purchase both government and corporate bonds and debt securities. However, having learned in 2021 that rising yields hit undifferentiated or index-bound Fixed Interest portfolios rapidly, their appetite is likely to become much more selective. One area that we anticipate will see greater interest from both institutional and retail investors is the "sustainable fixed income" domain. For many years, bonds have been a blind spot in otherwise nominally ESG-focused portfolios, with little attention paid to the activities of debt issuers compared to the scrutiny directed at the equity market components. This is now changing, and we will be reflecting this positive and overdue development in our recommendations from this year onward.

Government bond markets return still biased to the downside

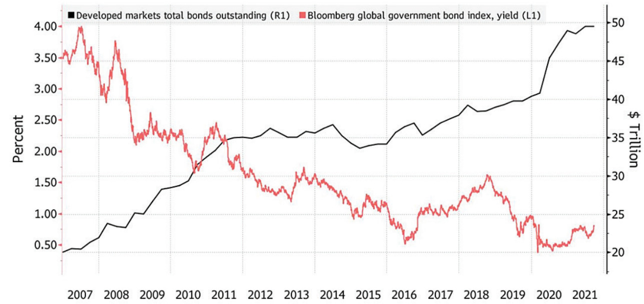


Source: Bloomberg

In terms of the outlook for global yields, we do not see a comparable upward surge in 2022 as was experienced last year. Nevertheless, there are unusual supply dynamics coming into play this year. Bloomberg has estimated that global government treasuries will issue less bonds by value, but that QE purchasing dynamics will still ensure a rising supply in the market for private investors to absorb. Other things being equal, that implies higher sovereign bond interest rates will be consistent this year and that the tendency will be reinforced by investors seeking yield compensation for inflation risk.

In the absence of sustained central bank bond buying on the scale established in 2020-21, there is little reason to expect global sovereign yields to remain on average below 1.0%. A return to the 2018 yield levels seen when major economies were being deliberately run "hot" is possible, implying another risky year ahead for the asset class. Overall interest rate dynamics will continue to be led by the US market, which retains its predominance at around 40% of total global debt.

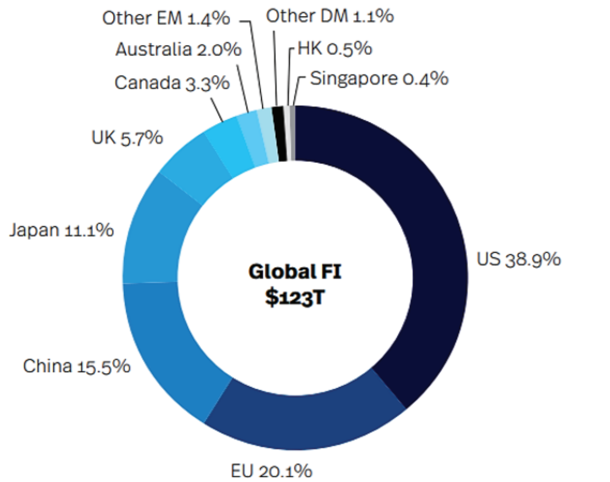
The dominance of US debt: $50 Trillion in outstanding US bonds, global total $123 Trillion



Source: Bloomberg

US fixed income markets comprise 39% of the $123 trillion securities outstanding across the globe, or $48 trillion; this is 1.9x the value of next largest market, the EU (excluding the UK.) With the US now more resolutely leading the "normalization" process, expect global yields to continue to move in concert.

Distribution of Fixed Interest securities outstanding



Source: BIS, SIFMA 2022 Capital Markets Outlook

Strategy conclusions

At the end of 2021, we set out our central market views for the current year, and these are reprised below:

- Even though Equities (as a whole) will potentially see returns close to their long-term average of 8%, with interim weaker periods; selected Equity sectors and markets still have scope for resilience and desirable investment features. There are all-weather stocks that have lagged in recent years
- For instance, listed real assets have superior, defensible yields and cyclical tailwinds, in a fraught political phase. In contrast to 2020, investors are now aware of CoVid revenue risks

- Within the broader market sectors, thematic and valuation support in Utilities and Consumer Staples, Healthcare, and Software as a Service (SaaS) Information Technology enjoy pricing power which assists them to ride out sentiment storms and hedge against economic slowdown

- De-rating in very overvalued equities (specific companies, rather than sectors) is likely as interest rates move up. A "hot stock" mentality will persist due to internet, but this is short-term only

Despite anticipating volatility as market leadership changes continue, we still prefer equity to fixed income or cash exposure. The negative real (after-inflation) yields dogging fixed income will persist for at least two years, and makes higher Fixed Income asset class holdings inopportune.

We prefer to wait for a better compensation for duration risk. Within fixed income, thematic support is ready to be a prime differentiator. We acknowledge sustainable or "green" bonds as a valuable emerging theme in this regard. Default risk and Credit Quality are likely to become a focus in late-2022 and set off portfolio re-allocations within and beyond bonds. This will set the stage for a potential global slowdown in 2023 as the tightening of policy around the world begins to impact the real economy, and asset markets adapt to protect existing capital gains by allocating funds toward "all-weather" securities. Such desirable investments, which we are actively seeking out across all our asset classes, are resilient to both inflation and to profit challenges in a less stimulus-based, endogenous phase of economic growth.

Greg Fleming.