January 2022
Issue No. 22

GLOBAL INSIGHT

Overview

- In our Macro View, we look at the volatile path of US growth which reportedly will comfortably exceed 5.5% in 2021; the economy could be on track to record its best annual performance since the early 1980's.
- We also look at the twin objectives of the US Federal Reserve to maximise employment and to create a stable price environment through long-term interest rates.
- In our Investment Outlook, we assess activity in the fourth quarter and the position that financial markets find themselves.
- Developed equity markets continued to rally in the fourth quarter ensuring a third year of strong positive returns. Despite the growing headwinds, we feel equity markets maintained their underlying optimism due to corporate strength and potential earnings growth in 2022.
- Going into 2022 elevated levels of inflation will continue to favour value stocks with pricing power as rising bond yields undermine growth sectors.
- In our feature piece, Adam Jones looks at the outlook for the US economy and financial markets in 2022.
- We believe this year could be a very strong one for economic growth.
- Recent increases in interest rate expectations have supported the Dollar as the currency becomes more attractive to hold relative to its peers where expectations for cash returns may have risen less. We may have reached the point at which relative interest rate expectations have peaked.

5-Yr US Real Yield (Inverted) vs. NASDAQ Composite.

Inside this issue

Economic Highlights

- US Unemployment fell to 3.9% in December.
- EU Composite PMI's hit a 9 month low of 53.3 in December.
- EU Inflation rate reached 5.2% YoY in November.
- US Consumer Price Inflation hit 6.8% YoY in November.
- Turkish inflation rate accelerated to 21.5% YoY in November.

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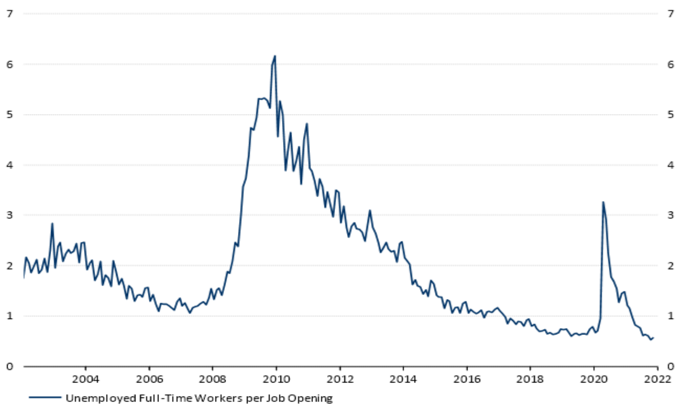
Based upon information available up to and including
14th January 2022

Key Issues in Charts

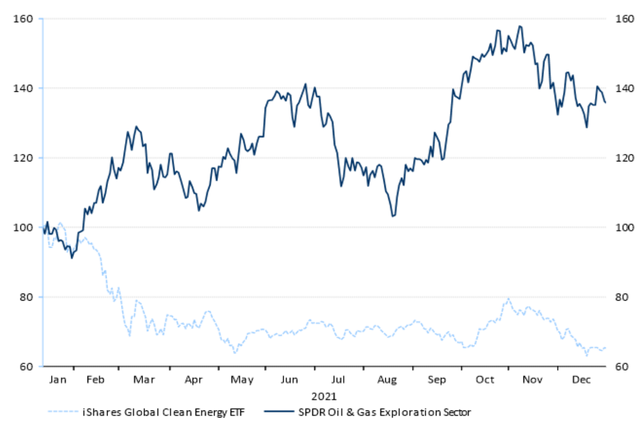
Number of Unemployed US Workers per Open Position



- This chart shows that there are now 2 open job positions available for every unemployed worker.
- Maximum employment is one goal of the US Federal Reserve, stable prices and moderate long-term interest rates are the other.
- Signs that wage inflation is increasing are unsurprising when unemployment is this tight.
- Will wage pressures feed through into higher prices for the consumer or be borne by companies via margin contraction?

iShares Clean Energy vs Oil & Gas Sector

- The wave of momentum in ESG investments has seen investor enthusiasm for clean energy investing.
- Before 2021 valuations in this sector had been pushed to extreme levels.
- Despite our belief in this theme this chart shows that valuation and potential are still central to any potential investment
- It also shows that global reliance on fossil fuels will play a major part in the transition to greener energy production.



2yr Yields vs US Dollar Index

- This chart shows the effect on the dollar and 2-yr yields of the more hawkish stance of central banks in the 4th quarter.
- The anchoring of short term rates was central to the Feds ability to prevent a taper tantrum in the summer of 2021.
- The markets now fear the potential for a Fed policy misstep as it prices in the tightening of policy rates in 2022.
- Dollar strength has reflected the growing strength in inflation and its expected effect on short-term rates.
- Any signs that the bond market will fail to react to the prospect of tighter conditions, or the need for the rate hikes that are priced in dissipates under a changing environment, could see this currency strength reverse.

Macro View

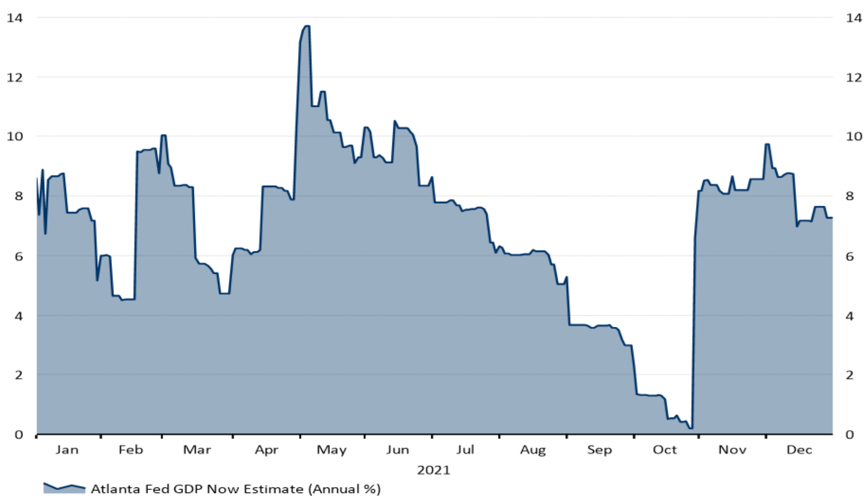
United States

2021 proved to be an especially resilient year for the United States from a macroeconomic perspective. Despite the ongoing challenges of disrupted supply chains, labour shortages, and the rise and fall of concern surrounding new variants of Covid, we anticipate reported economic growth to have comfortably exceeded 5.5% over the year (official Q4 data will be released later this month).

Despite ongoing challenges, we anticipate reported economic growth to have comfortably exceeded 5.5% over the year.

The path has not been a smooth one, however, as indicated by the real-time GDP tracker developed and published by the Atlanta Federal Reserve;

Estimated GDP Growth



Source: *Atlanta Federal Reserve / Refinitiv Datastream*

The path has not been a smooth one; growth slowed very sharply over the third quarter amid a flare-up in Covid-19 infections, but with activity having since recovered, the economy remains on track to record its best annual performance since the early 1980's.

Growth slowed very sharply over the third quarter amid a flare-up in Covid-19 infections, but with activity having since recovered the economy remains on track to record its best annual performance since the early 1980's.

This continuation of strong consumer demand led to both headline and core inflation far exceeding the average 2% level targeted by the Federal Reserve. As such we were grateful to have Jerome Powell officially retire the term 'transitory' at the Senate Committee meeting on November 30th. This admission also tacitly confirmed that the first of the Fed's dual objectives had been met (or indeed exceeded) with respect to prices. Headline inflation running at a level in excess of 6% per annum meant this came as no surprise to most market participants.

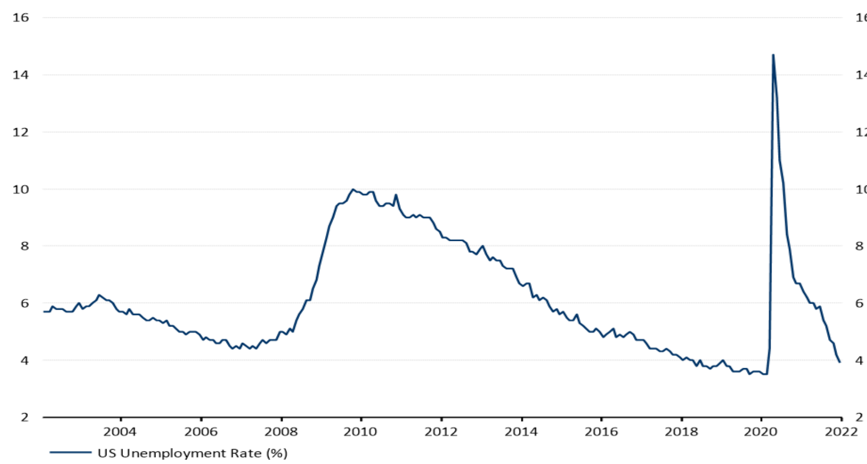
Continuation of strong consumer demand led to both headline and core inflation far exceeding the average 2% level targeted by the Federal Reserve.

In thinking about the Fed's second objective, employment, the year also gave us plenty of reasons to believe that this side of the equation is also on track to having been met (if they have not already been so). The level of domestic unemployment has now fallen to just 3.9% according to data released in December, the lowest since February 2020, and down from 4.6% in October. This comes alarmingly close to the level of 3.5% which the Fed had not anticipated the economy arriving at until the *end of 2023.* All of the indicators of labour market conditions we follow have since confirmed that we are unlikely to see any significant respite in early 2022.

The level of domestic unemployment has now fallen to just 3.9%, the lowest since February 2020, close to the level of 3.5% which the Fed had not anticipated the economy arriving at until the end of 2023.

US unemployment rate has now fallen to just 3.9%, down from 4.6% in October.

US Unemployment Rate (%)



Source: *US Bureau of Labor Statistics / Refinitiv Datastream*

With interest rates not having risen since the depths of the original Covid crisis in March 2020, policy today is far more accommodative than it was back then.

These two realities set the stage for the Federal reserve to finally begin discussions around hiking interest rates (as soon as March 2022) and, even more recently, floating the idea of an outright reduction in the size of their balance sheet via Quantitative Tightening. With interest rates not having risen since the depths of the original Covid crisis in March 2020 (despite such a strong and clear recovery since) policy today is far more accommodative than it was back then. This strikes us as being an issue which needs to be addressed quickly given the strength we are currently witnessing in macroeconomic data.

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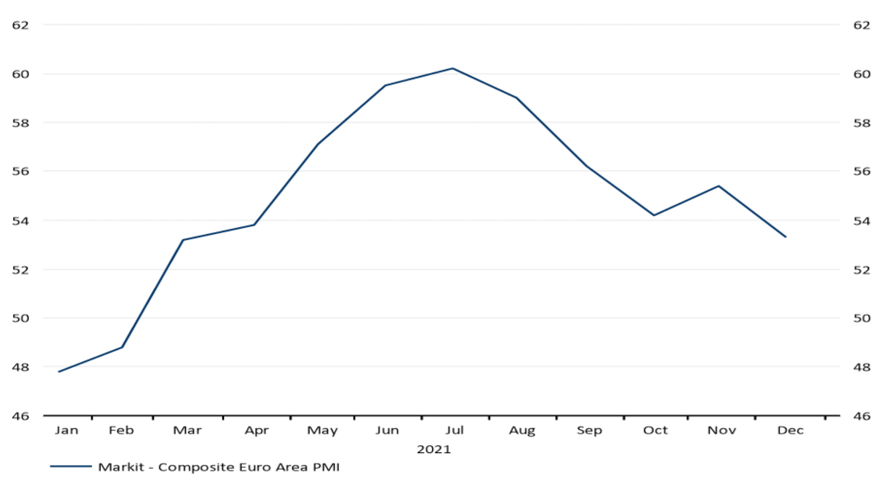
The resilience of the US economy and the market's focus on increasing the level of interest rates also proved supportive of the US Dollar, with the broad USD Index rising by over 6% during 2021.

Europe

As ever the complexities of Europe meant a more difficult macro environment in aggregate as economic challenges and responses to the pandemic varied greatly

The composite Purchasing Managers' Index hit a nine-month low of 53.3 for December as the service sector was especially badly affected by rising Covid cases.

Euro Area Composite PMI 2021



Source: *Markit Economics / Refinitiv Datastream* between countries. A number introduced restrictions on sectors such as travel and hospitality in attempts to limit the spread of the new variant. The composite Purchasing Managers' Index (a broad measure of economic activity) hit a nine-month low of 53.3 for December as the service sector was especially badly affected by rising Covid cases.

Despite this economic deceleration equity markets drew support from early data indicating a lower risk of severe illness than prior variants.

The fourth quarter was also marked by incredibly volatile gas prices which added to fears around the persistence of higher inflation. The annual inflation rate reached 5.2% in November compared to -0.3% a year earlier. The European Central Bank has since said it will likely reduce the extent to which it is purchasing bonds but continues to rule out interest rate rises in 2022. Either way the broad direction of travel is clear for monetary policy across many of the world's major developed markets.

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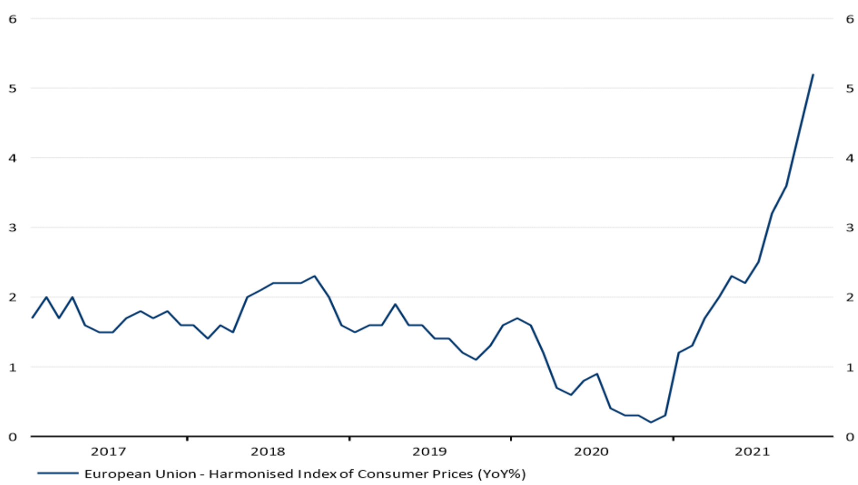
EU Harmonised Consumer Price Index (YoY%)



Source: *Eurostat / Refinitiv / Datastream*

The broad direction of travel is clear for monetary policy across many of the world's major developed markets.

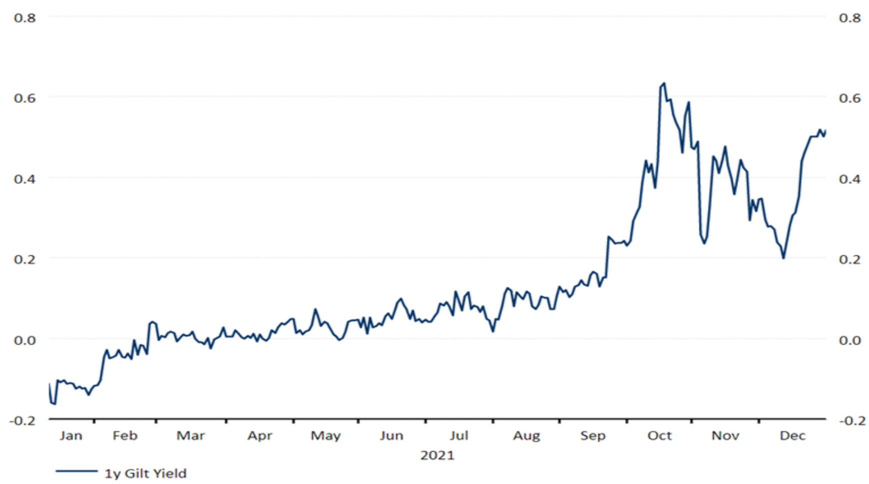
UK

In line with its developed market peers the UK performed strongly through 2021 with expected economic growth of over 7%. Labour markets have continued to improve and led to the Bank of England raising the benchmark interest rate by 0.15% at their December meeting. This surprised many market participants given the monetary policy committee had u-turned on their original plan to hike base rates just one month before in November;

The UK performed strongly through 2021 with expected economic growth of over 7%. Labour markets have continued to improve and led to the Bank of England raising the benchmark interest rate by 0.15% at their December meeting.

Short-term rates react to the beginning of policy tightening by the Bank of England.

UK 1-Yr Gilt Yield



Source: *Refinitiv Datastream*

The ruling Liberal Democratic Party's (LDP) election performance under Mr Kishida, saw it lose only 15 seats and hence retain a solid majority in its own right.

Japan

Heading into Japan's general election in October expectations for the ruling Liberal Democratic Party's (LDP) election performance under Mr Kishida's were modest at best. However the LDP went on to lose only 15 seats and hence retain a solid majority in its own right. With the election out of the way focus shifted toward a substantial fiscal stimulus package which includes direct cash handouts to households in an effort to drive a recovery in consumption as we enter 2022.

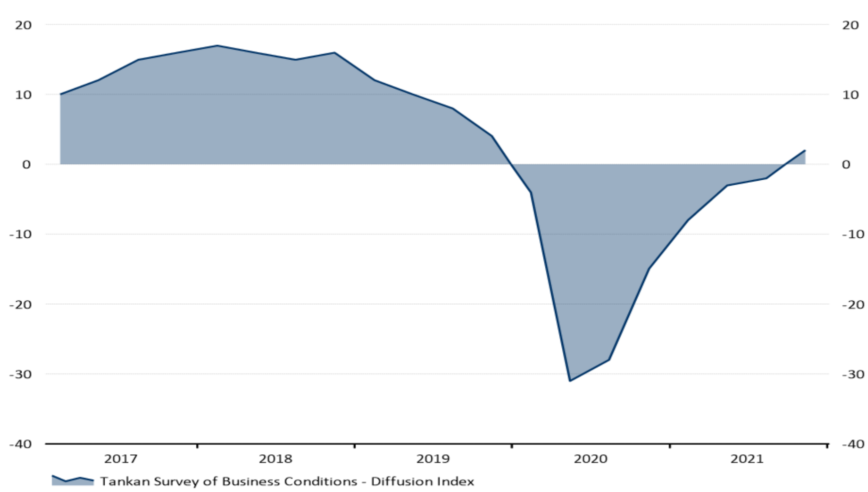
The Tankan survey showed evidence of a slight pick-up in corporate inflation expectations over the next two years which was taken positively.

The US Federal Reserve's discussion of accelerated tapering led to some short-term weakness in December despite the fact that such a move is very unlikely to be followed by the Bank of Japan. The Tankan survey showed evidence of a slight pick-up in corporate inflation expectations over the next two years which was taken positively.

There still seems little chance of Japan experiencing a short-term inflation spike as seen elsewhere around the world.

Meanwhile, current inflation crept back into positive territory as several one-off factors begin to drop out of the year-over-year calculations but there still seems

Japan Tankan Survey of Business Conditions



Source: *Bank of Japan / Refinitiv Datastream* little chance of Japan experiencing a short-term inflation spike as seen elsewhere around the world. Among other economic data released in December there was positive news in the strength of the rebound in industrial production as autos began to recover from the temporary weakness caused by the global semiconductor shortage.

Asia

Asia ex Japan equities recorded a modest decline in the fourth quarter. There was a broad market sell-off following the emergence of the Omicron variant of Covid-19 which investors feared could derail the global economic recovery.

China was the worst-performing stock market in Asia over the quarter, driven by investor fears that new lockdown restrictions would be instigated following the rapid spread of the new Covid-19 variant.

China was the worst-performing market in the index over the quarter as share prices fell sharply lower, driven by investor fears that new lockdown restrictions would be instigated following the rapid spread of the new Covid-19 variant. Share prices in Singapore also ended the fourth quarter in negative territory as investors continued to track developments surrounding the new Omicron variant. There were also fears that the Government might have to scale back some of the recently relaxed restrictions in activity. India and South Korea also closed the quarter lower although declines here were generally more modest.

Omicron also negatively affected Singapore, India and S. Korea although Taiwan saw a rise in exports boost investor confidence.

In Taiwan, positive economic data and a rise in exports boosted investor confidence with chipmakers yet again performing well. Share prices in Thailand, the Philippines and Malaysia ended the quarter marginally positive.

Emerging Markets

Inflation proved to be a significant problem for many Emerging markets in the latter half of the year as policy makers moved quickly to hike interest rates in order to combat the threat of persistently higher food & goods prices;

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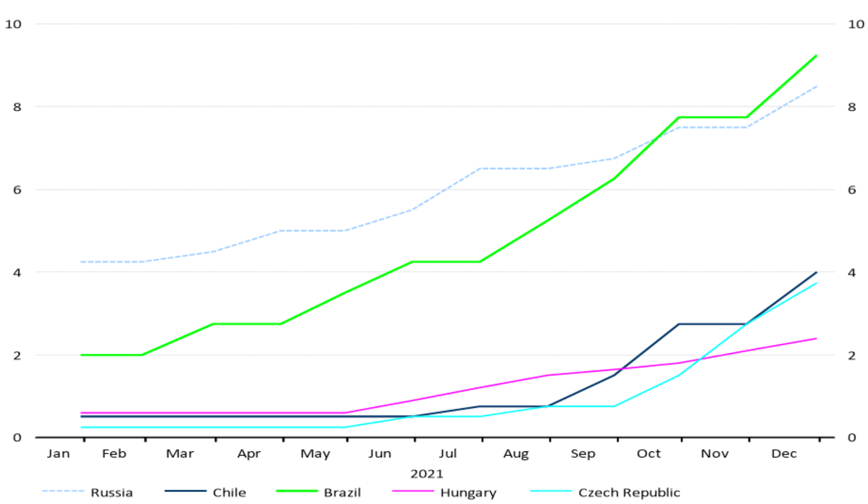
Select EM Policy Rates



Source: *Various Central Banks / Refinitiv Datastream*

USD strength proved a significant headwind to Emerging Market economies.

Despite these moves USD strength proved a significant headwind to Emerging Market economies. Turkey was the weakest equity market amid some fairly extreme volatility in the Turkish lira. The Turkish Central bank lowered its domestic policy rate by a total of 4% to 14% despite ongoing above-target inflation which accelerated to 21.3% year-on-year in November. With the Lira com-

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With the Lira coming under significant pressure President Erdogan announced an unusual scheme to compensate domestic savers for currency weakness in an effort to reduce the use of US dollars.

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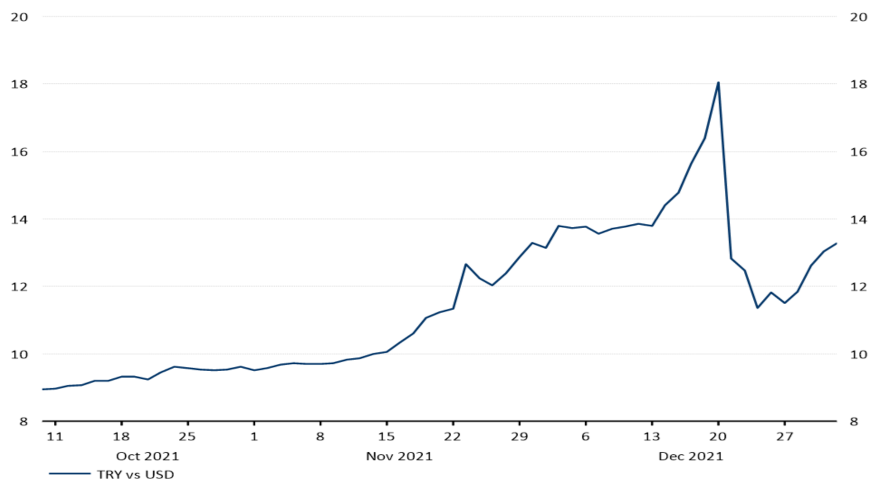
Turkish Lira vs. US Dollar Q421



Source: *Refinitiv Datastream*

2021 proved to be a year in which economic dispersion increased given differing policy responses to the pandemic and its impact.

2021 proved to be a year in which economic dispersion increased given differing policy responses to the pandemic and its impact. Early indications do suggest however that the emergence of Omicron could prove to be somewhat less disruptive than prior variants.

The most notable observation for us is the resilience with which many economies have dealt with the crisis and gone on to deliver positive economic growth coupled with significant recoveries in employment.

Investment Outlook

Developed equity markets continued to rally in the fourth quarter ensuring a third year of strong positive returns. Despite the COVID-19 disruptions and reactive rolling sector rotations, the MSCI World Price Index (USD) finished the year up 20% driven in the main by strong earnings growth[vii]. We started the year with optimism that the roll-out of vaccines would accelerate the return to a new normal and ended with the emergence of the Omicron variant threatening the recovery in global growth.

The MSCI World Price Index (USD) finished the year up 20% driven in the main by strong earnings growth.

The effects of the more highly infectious Omicron variant caused a spike in equity market volatility during November having been relatively sanguine for most of the year. The VIX market volatility index jumped to 31 having spent most of its time below 20 in the second part of the year before settling back down again as the initial news from South Africa and the UK suggested that although highly infectious the variant was less severe. Despite the growing headwinds of spiking inflation, supply chain disruptions, uneven economic recovery, and central bank policy tightening, we feel equity markets maintained their underlying optimism due to corporate strength, potential earnings growth in 2022, and a sense that there is still no real alternative to equity investment in relation to the other main asset classes.

Despite the growing headwinds, we feel equity markets maintained their underlying optimism due to corporate strength and potential earnings growth in 2022.

Due to the performance of a small number of mega-cap companies, the US equity market now makes up 70% of the market capitalisation of the MSCI World Index making it even more influential in investor thinking[i]. However, despite the S&P500 trading at a 52-week high towards the end of the year, 334 constituents traded at 52-week lows[ii] suggesting that there are many companies that may be trading on interesting valuations for the value seeking investor.

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Contrarian Investing

In fact, it could be argued that 2021 was a year for contrarian investing with many of the long-term themes in equity markets reversing under the pressures of the macroeconomic environment as well as valuation[iii]. As examples, two major themes seeing much investor interest coming into 2021 were technological innovation and sustainable energy investing. We believe technological innovation is very much a long duration growth investment that had seen valuations become very stretched, so when inflation began to pressure the economic outlook investors rotated more towards companies with strong cash flows and the ability to defend pricing and margins. To that end, the ARK Innovation ETF which we use as a proxy for the theme fell by more than 30% over the year compared to the S&P500 which gained 26.9%[vii]

It could be argued that 2021 was a year for contrarian investing with many of the long-term themes in equity markets reversing under the pressures of the macroeconomic environment as well as valuation.

The ARK Technology Innovation ETF fell by more than 30% over the year compared to the S&P500 which gained 26.9%.

ARK Innovation ETF vs S&P 500 (Rebased to 100 as at 1st January 2021)

Source: *Refinitiv Datastream*

Investor enthusiasm for clean energy was tempered by over exuberance in 2021, showing that it is important to understand valuation and potential when making investment decisions.

The wave of ESG (Environmental, Social & Governance) investing which has really gained momentum since 2020 has seen investor enthusiasm for clean energy, as well as increasing pressure on existing energy companies to split their businesses between clean and dirty production to provide more direct investment opportunities for ESG investors who had pushed existing investments to high valuations. The spike in European gas prices plus the supply restrictions in crude oil saw the oil price surge 54.5% over 2021 and many traditional energy stocks such as BP (+40%), Shell (+37%), TotalEnergies (30%) and Exxon Mobil (+62%) made above average returns over the year[vii]. By contrast the iShares Global Clean Energy ETF fell 30% over the course of the year showing again that although we still like the long-term story of this theme it is important to understand valuation and potential when making investment decisions.

The debate regarding the transitory nature of inflationary pressures saw US Treasuries end the year down 2.5% and Gilts down 5.2% following the tightening of interest rates by the Bank of England in December.

Inflationary Fears

The debate regarding the transitory nature of inflationary pressures has continued throughout the second half of the year leading to a more hawkish outlook from many central banks which kept fixed income performance quite flat over the fourth quarter. US Treasuries ended the year down 2.5%[iv] and Gilts down 5.2%[v] following the tightening of interest rates by the Bank of England in December.

US Consumer Price Inflation (CPI) hitting 6.8% year-on-year in November.

Despite US Consumer Price Inflation (CPI) hitting 6.8% year-on-year in November, Absolute Strategy Research (ASR) still sees US-CPI receding to 2.25% by the end of 2022[vi]. Despite surging inflation in 2021, the anchoring of policy rates by central banks saw real yields significantly negative forcing investors to chase duration which inevitably led them further into equities. The success of the US Federal Reserve (Fed) in separating balance sheet management policy from interest rate policy played a major part in averting another 2013 "taper tantrum" – The US 10-year yield has moved from 0.9% to 1.6% over the year - but we would argue that leaving the reduction in quantitative easing until December has narrowed the Fed's window of opportunity to roll out policy change and increased the chances of policy error. It is also our view that many of the inflationary pressures will abate over the first half of the year leaving a sustainably higher level going forward but not high enough to have a material effect on risk sentiment.

We would argue that leaving the reduction in quantitative easing until December has narrowed the Fed's window of opportunity to roll out policy change and increased the chances of policy error.

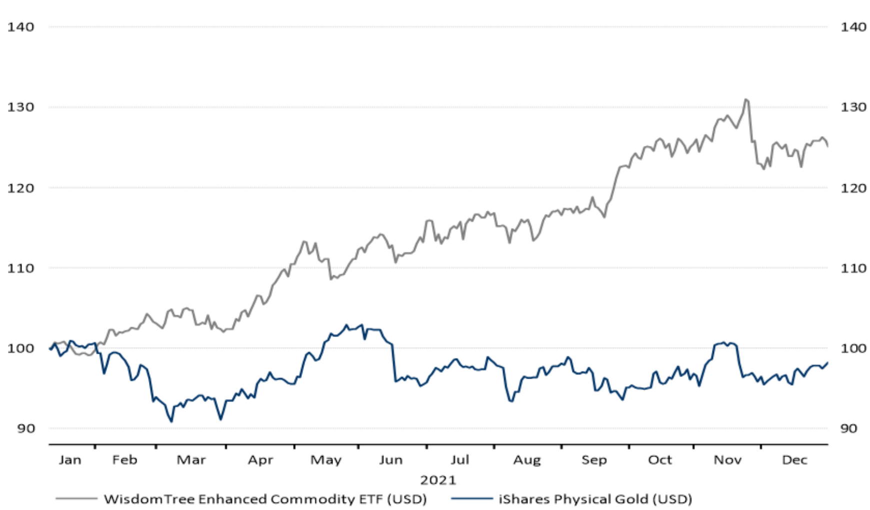
The spread of Omicron has led to general downward adjustments in both global growth and earnings estimates thereby reducing the possibility that the three 0.25% US rate hikes priced in to 2022 will be necessary. The recent release of December's meeting minutes also suggested that the Fed's plans to reduce its balance sheet were closer than the market had expected. The so called "Fed put" that has underpinned the stock market's "buy-on-dip" mentality over the past few years has largely been attributed to the liquidity injection of quantitative easing, therefore, the prospect of a withdrawal of liquidity may renew anxiety in financial markets. The confusing mix of inflation spikes, highly infectious Covid-19 variants, uneven re-opening of economies, and tight labour markets, makes the possibility of central bank policy error more likely in our view. We will be watching the labour market data as we believe this may signal the future path of intervention and the likely headwinds to global growth.

The confusing mix of inflation spikes, highly infectious Covid-19 variants, uneven re-opening of economies, and tight labour markets, makes the possibility of central bank policy error more likely in our view.

Cross Asset Round-up

Aside from crypto currencies, Oil was the best performing asset of 2021 with commodities overall as represented by the WisdomTree Enhanced Commodity USD ETF, up 1.7% in the fourth quarter, and 25% over the year as inflation hedges saw healthy demand. However, falling real yields could not save gold as the dollar strengthened 2% during the quarter, 6.9% over the year leaving the yellow metal down 2.1% in 2021 having been the best performing asset class of 2020.

WisdomTree Enhanced Commodity ETF vs iShares Gold (Rebased to 100 at 1st Jan 2021)



Source: *Refinitiv Datastream*

The WisdomTree Enhanced Commodity USD ETF was up 25% over the year, however, Gold was down 2.1% in 2021 having been the best performing asset class of 2020.

Emerging market equities as an asset class had a difficult year against a strong dollar, and a disparate global growth background, finishing the year down 4.6% after a drop of 2.8% in the fourth quarter[vii]. China saw poor performance as the transition to a consumer led economy and a zero-tolerance policy to Covid-19 undermined growth meaning the Shanghai Composite Index finished the year up only 4.8%[vii].

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Market Opportunities

Going into 2022 elevated levels of inflation will continue to favour value stocks with pricing power as rising bond yields undermine growth sectors. We expect global GDP growth to be strong enough to support estimated earnings combined with high levels of consumer savings underpinning equity markets. Assuming inflationary pressures start to abate mid-year as we expect, the path of central bank policy tightening is likely to be re-appraised meaning that alternative investments to equities will remain unattractive. We believe this environment is likely to favour banks in the medium term and the continued strength of oil due to supply constraints will support energy stocks. We also expect value to outperform growth and, assuming no further surprises from Covid-19 variants, sectors still struggling under social distancing guidance will be able to continue to open which will also ease some supply chain pressures. Labour markets in the developed world are extremely tight leading to clear signs wage inflation, however, the question remains whether this will manifest itself in higher prices or tighter margins. Changes to central bank policy will likely influence the path of the dollar which in turn will either support the developing world or provide a headwind for global growth.

Going into 2022 elevated levels of inflation will continue to favour value stocks with pricing power as rising bond yields undermine growth sectors.

We believe this environment is likely to favour banks in the medium term and the continued strength of oil due to supply constraints will support energy stocks.

[i] Societe Generale – Global Equity Market Arithmetic – Andrew Lapthorne – January 5, 2022

[ii] https://www.bloomberg.com/news/articles/2021-12-27/it-s-december-1999-based-on-the-nyse-shares-touching-new-lows-

[iii] Bloomberg Points of Return – Hindsight Capital Again Made The Year's Best Trades – John Authers – December 31, 2021

[iv] iBoxx USD Treasuries Total Return Index

[v] iBoxx USD Treasuries Total Return Index

[vi] Absolute Strategy Research – Investment Committee Briefing – January 4, 2022

[vii] All asset and index statistics taken from Refinitiv Workspace

Hottinger 2022 US Outlook - Walking The Line

By Adam Jones,** Portfolio Manager at **Hottinger & Co. Limited

In setting the scene for next year's outlook we felt it useful to start by highlighting some of the data that has contributed to our particularly bullish view on US economic growth for 2022.

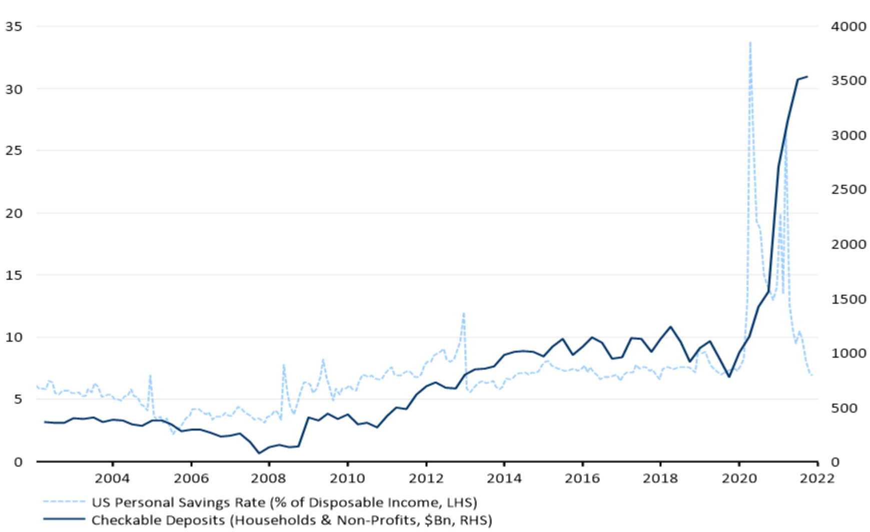
The sheer scale of the US fiscal response to the Covid crisis back in March 2020 amounted to some 27%[i] of GDP and its transmission enabled consumer demand to recover far more quickly than global supply chains were able to. This is particularly true given the shift in spending patterns as broad swathes of the economy (primarily in the service sector) remained closed and demand for durable goods exploded as people spent more time at home.

The sheer scale of the US fiscal response to the Covid crisis back in March 2020 amounted to some 27% of GDP .

During the initial stages of the pandemic households dramatically increased the level at which they were able to save, with the personal savings rate reaching more than 30% of disposable income during the initial phase of lockdown. Since then we have seen the savings rate all but normalise (*light blue* line in the chart below**).** In its wake, however, lies some $3.5 *trillion* dollars of accumulated liquidity which currently sits in checkable deposit accounts across the household & non-profit enterprise sectors (dark blue line).

$3.5 trillion dollars of accumulated liquidity currently sits in checkable deposit accounts across the household & non-profit enterprise sectors.

US Personal Savings Rate vs Checkable Deposits



Source: *Refinitiv Datastream*

In addition to this accumulation of cash there have been other notable tailwinds to household wealth during 2021. One of the major consequences of the redistribution in spending patterns has been a large-scale reallocation of workers, a process which comes with significant associated frictions. These frictions have resulted in persistent wage growth at the lower end of the income distribution, where the typical consumers marginal propensity to consume is far greater than those at the higher end.

One of the major consequences of the redistribution in spending patterns has been a large-scale reallocation of workers, resulting in persistent wage growth at the lower end of the income distribution.

Our proprietary indicator of labour market conditions suggests that we are likely to see a continuation in wage growth over the short term as the number of job openings and the availability of workers find a new equilibrium. This bodes well for ongoing consumption which accounts for c.68% of US domestic output[ii].

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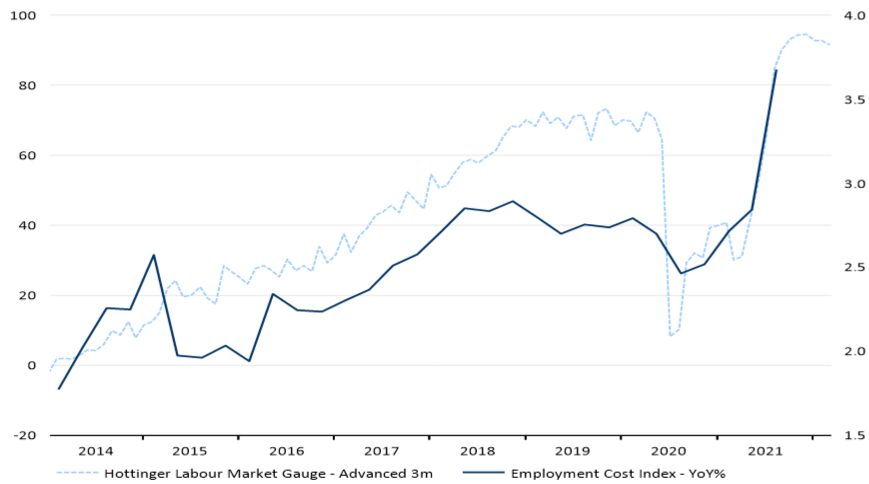
Hottinger Labour Market Gauge vs US Employment Cost Index



Source: *Refinitiv Datastream*

The other key aspect of household wealth is the overall value of assets, the vast majority of which is accounted for by property. US residential property prices experienced a marked increase in value over the past year as the persistence of low mortgage financing rates combined with strong demand and a renewed focus on homeownership in light of the pandemic. According to the most recent data US nationwide house prices rose by 17.4% between October 2020 and October 2021[iii].

According to the most recent data US nationwide house prices rose by 17.4% between October 2020 and October 2021.

The result has been a marked increase in household net worth relative to both household liabilities and GDP as well as homeowner equity approaching record levels of almost 70%.

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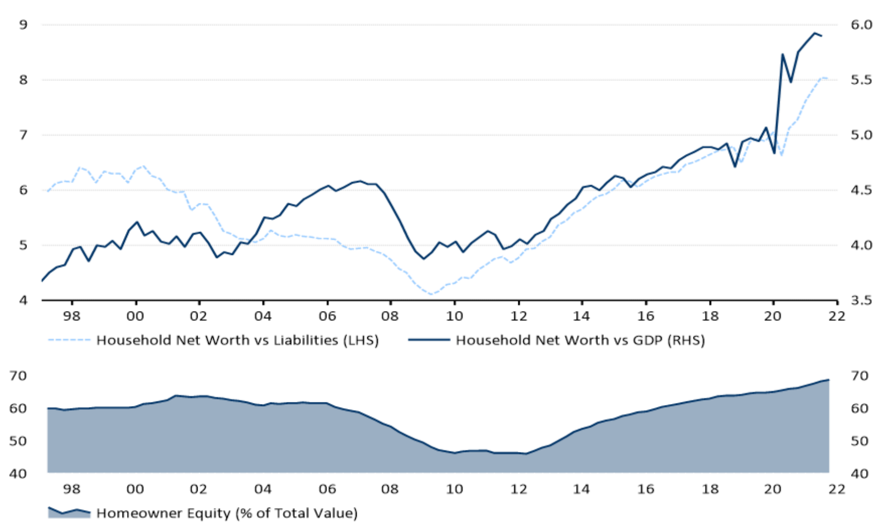
Household Balance Sheets

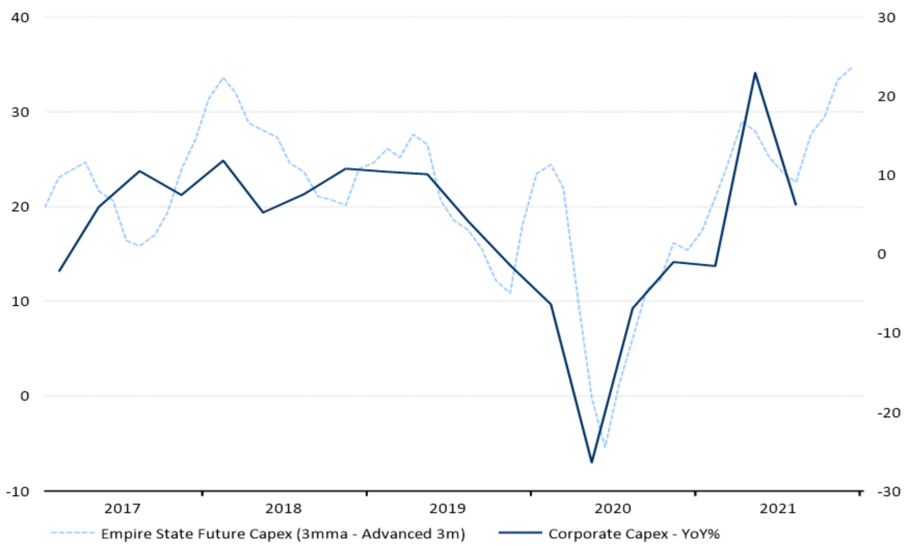


Source: *Refinitiv Datastream*

This confluence of factors gives us great confidence in the overall health of the US consumer and, when combined with some very positive early data with respect to the severity of the Omicron variant, we believe this year could be a very strong one for economic growth. We also see strength in the corporate sector where balance sheets are robust and capex intentions for next year have been rising.

We believe this year could be a very strong one for economic growth.

Future Corporate Capex Intentions Increasing



Source: *Refinitiv Datastream*

We also see strength in the corporate sector where balance sheets are robust and capex intentions for next year have been rising.

The reality of today's market environment however is that policy rates are far below the levels one should expect to see in an economy with an unemployment rate of 3.9%, headline consumer price inflation of 7%, growing wages, growing house prices, equity markets close to all-time highs, and broad economic output re-accelerating from an already high base. US policy makers appear to have now come around to this view, and have spent much time in recent weeks signaling the dawn of tighter monetary policy through a combination of higher interest rates, and an outright contraction in the size of their balance sheet (aka 'Quantitative Tightening').

interest rate markets are now pricing in four 25 basis -point rate hikes over the coming year, with the first most likely arriving in March.

As a result interest rate markets are now pricing in four 25 basis-point rate hikes over the coming year, with the first most likely arriving in March. What is interesting to us is that while interest rates at the short end of the yield curve (1-2 years) have risen, those at the long end (10-30 yrs) have done so to a much lesser extent. The implication here is that bond markets believe the Fed is likely to tighten policy too quickly in an attempt to alleviate inflationary pressure and, in so doing, may also neutralise their chance of achieving more sustainable long-term growth and inflation

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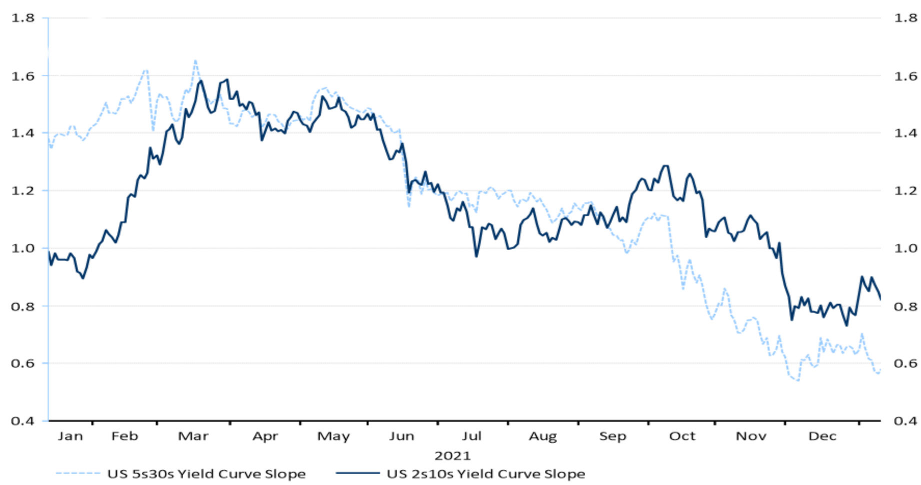
The strength of macro data through the first half of 2022 could lead bond markets to begin pricing this higher growth, driving interest rates higher at the 10 & 30 year tenors and facilitating a re-steepening of the yield curve.

Flattening Yield Curves Imply Lower Growth Expectations



Source: *Refinitiv Datastream*

Our belief is that the strength of macro data through the first half of 2022 could lead bond markets to begin pricing this higher growth, driving interest rates higher at the 10 & 30 year tenors and facilitating a re-steepening of the yield curve. This would theoretically be a positive development as yields rising for the 'right' reasons (i.e. higher growth expectations) has historically been good for equity markets in particular.

Our base-case is that inflation data begins to decelerate from Q1 onwards (largely as a result of base effects) and that short term interest rate markets are hence priced correctly with respect to policy.

The fly in the ointment on this occasion however is inflation, which has unquestionably become an issue for policy makers who do not wish to be seen as ignoring its risks. We suspect this nuance makes inflation data over the coming months *absolutely critical* in determining the path of asset market returns over the coming year. Our base-case is that inflation data begins to decelerate from Q1 onwards (largely as a result of base effects) and that short term interest rate markets are hence priced correctly with respect to policy.

King Dollar De-Throned?

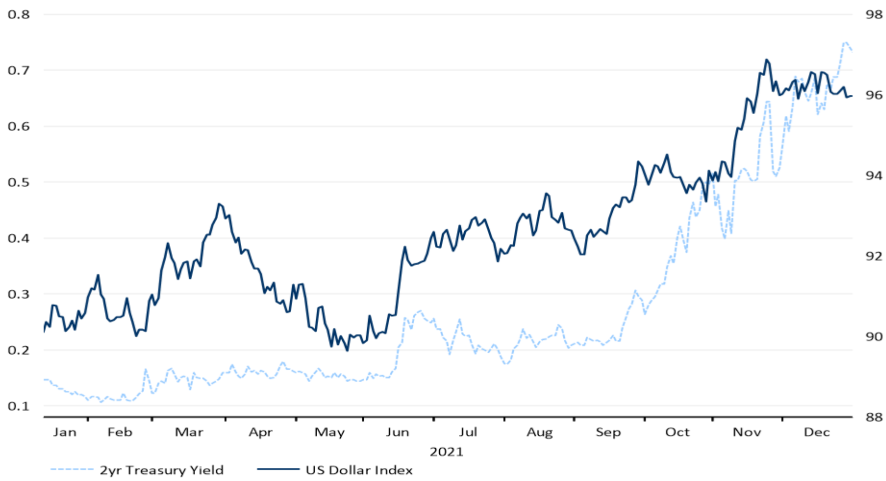
Another asset to which we pay significant attention is the US Dollar. As the global reserve currency its movements often dictate the path of numerous other asset classes, from commodities, such as oil and copper, to growth in emerging markets, many of which have significant exposure to the currency through borrowing.

We may well have reached the point, in accordance with our views, at which interest rate expectations have peaked in the near term.

After a particularly strong 2021 in which the Dollar Index (a measure of the currency versus a basket of its major trading partners) rose by more than 6%, we believe there are reasons to expect some softening over 2022.

Recent increases in interest rate expectations have supported the Dollar as the currency becomes more attractive to hold relative to its peers where expectations for cash returns may have risen less. In accordance with our views above we believe we may well have reached the point at which relative rate expectations have peaked in the near term.

Rising Interest Rate Expectations Supported the USD in 2021



Source: *Refinitiv Datastream*

After a particularly strong 2021 for the US Dollar, we believe there are reasons to expect some softening over 2022.

Given the global nature of today's inflation we believe that a world in which the Fed has to hike interest rates on more than 4 occasions is a world in which they are not likely to be alone in doing so. As currencies are valued on a relative basis this supports our view that the USD Index could well have passed its peak for the foreseeable future.

As currencies are valued on a relative basis this supports our view that the USD Index could well have passed its peak for the foreseeable future.

A weaker dollar should thus prove supportive of areas like commodities and emerging markets where we see opportunities at both the micro and macro level.

[i] Elgin, C., Yaman, A. (2021), 'Covid Economic Stimulus Index'
[ii] Bureau of Economic Analysis, Department of Commerce
[iii] Federal Housing Finance Agency National House

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