Global perspectives 2022

The new year will be one of change. We face a world of economic repair in which markets and investors must consider the impact of the unprecedented fiscal and monetary stimulus being withdrawn as the fight against COVID-19 continues. Our investment leaders reflect on 2021, talk about what to expect in 2022 and emphasize why being active will matter.

William Davies
Deputy Global CIO

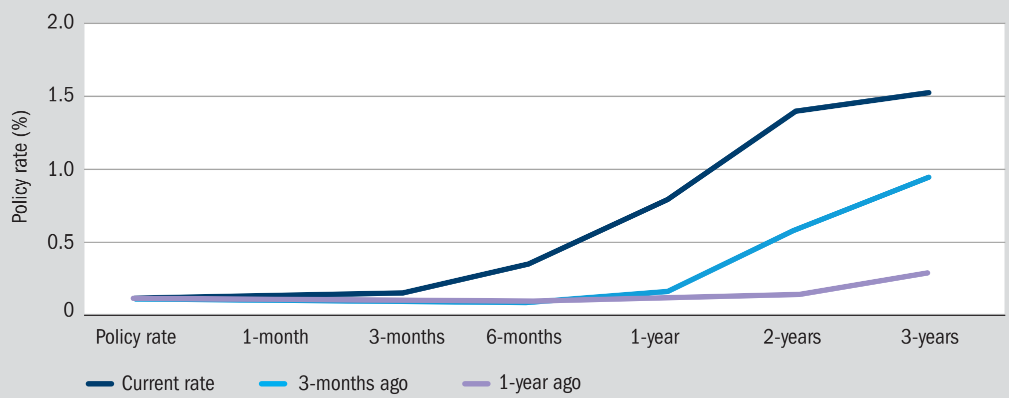
Capital markets: Changing monetary environment sets the backdrop for 2022

The monetary and fiscal backdrop change

Interest rates have been historically low for more than a decade, dampened by the flood of monetary stimulus introduced in the wake of the global financial crisis. In 2022, we expect this to change. As we move towards economic recovery from the COVID-19 pandemic, the new year will be marked by a reversal in monetary policy: Crisis support, stimulus and spending replaced by recovery, repair, reduced fiscal stimulus and a return towards "normal." Political compromise will be key, not least in the U.S., as governments tackle the transition.

Helpfully, central banks continue to look through inflationary pressures. For example, the U.S. Federal Reserve has not appeared overly concerned by higher and persistent U.S. inflation, which in previous cycles would have been perceived as a major headwind. Investors and markets are also fairly sanguine. This is in stark contrast to previous shifts in monetary policy in 2013 and 2018, which induced negative market reactions, not least the taper tantrum. Now, the market feels more poised, having waited so long for clarity. This makes us more confident for 2022, albeit in a slowing growth environment.

U.S. interest rates expectations and history



Source: Bloomberg, Columbia Threadneedle Investments as of December 7, 2021.

One reason we believe inflation will fall in 2022 is improvements in the supply chain. Regardless of whether you believe COVID or other structural and political factors (in Europe especially) are to blame, many of us underestimated the degree to which the supply chain would impact the corporate backdrop. It is our belief that the supply chain headwinds will continue to become less dominant in 2022, but it may well be towards the latter half of the year before the positive impacts are felt.

Quality will out

We have seen a good recovery in earnings this year, a reflection of relatively strong balance sheet management by corporates — with stricter cost controls and strong discipline around dividends and share buybacks. The reopening trade and enduring rebound in demand has resulted in heightened cash flows, which have boosted corporate coffers, giving companies the tools to reduce leverage.

But given those supply chain bottlenecks and the persistence of inflation, it will be harder for companies to beat forecasts in the way they have in 2021. At least in the short term. For companies, we anticipate next year will be a return to the familiar cycle of earnings disappointment as opposed to positive surprises.

In previous cycles, when the yield curve has flattened, the impact on equities has shown investors seeking quality companies that could survive any impending rates shock. As we near the end of 2021, we have seen the yield curve steepen, flatten and rise across the curve again. And that has led to a more mixed scenario in terms of what is leading the market. We do not see that changing in the short term, but some areas that outperformed more recently might struggle, such as “meme” stocks — those that become popular among retail investors through social media platforms. The companies we like — quality businesses with solid balance sheets and competitive advantages — stand a better chance of weathering volatility.

Regions

Looking regionally, many investors have turned away from China this year because of its well-publicized regulatory crackdown coupled with an imbalanced property market. We recognize the concerns about regulation, not to mention COVID outbreaks, extreme weather affecting food production and transportation, and slowing growth. But China recovered first from COVID and did so with a tighter policy framework than other regions. While growth in the country is of major concern, it increases the likelihood of Chinese authorities providing stimulus in 2022. There is opportunity in China (and the rest of the emerging markets universe), but it requires fundamental research and a bottom up approach — building portfolios company-by-company — rather than a thematic approach.

In Japan, Prime Minister Fumio Kishida does not represent a positive catalyst in the way Shinzo Abe did. Without this political spark and the expectation of meaningful change, Japan has become a less exciting region for us as investors, notwithstanding improvements in supply chains that will help the country’s industrial nature. That said, as active investors we are not devoid of opportunities and there is often more breadth in the Japanese market than we give it credit for, not least in the technology and service sectors. The latter is unusual given COVID, but there are ongoing initiatives designed to improve productivity that are unearthing opportunities for us.

Looking to Europe, we expect strong growth, albeit with the potential for supply chain shocks — already evident in the lack of truck drivers and the reduced labor pool. These factors will likely lead to higher than anticipated inflation and peak stimulus. There is also a theme of change in the region: Angela Merkel in Germany remains a strong presence, but has stepped down. Germany, now led by the SPD's Olaf Scholz along with the Greens and FDP, could see more volatility and a preponderance of stimulus. There will also be a presidential election in France in April, and French elections are notoriously difficult to predict. These events will be market influencers, but to what extent it is difficult to estimate.

Melda Mergen, CFA
Global Head of Equities

Equity: A bumpy ride higher for equities

The coronavirus continues to introduce uncertainty, but investors should expect cyclicals continue to outperform in the first half of the year, especially because of ongoing economic reopening and above-average GDP growth. We should expect a focus on COVID and a return to normal life to continue in 2022. Gauging a company's exposure to lingering COVID impacts — and lasting changes — will be an important component of research in the year ahead. Here are the key catalysts for equity markets in 2022:

Supply chain disruptions will start to improve — eventually

We expect elements of the supply chain to improve over the course of 2022, but there is still a significant backlog to work through and wide variation in companies' access to materials and success in passing costs on to consumers. The seized gears of the supply chain caused many to speculate that the world would move manufacturing away from China or even onshore production. But the considerable capex required to drive that radical change seems unlikely. What is likely to change is how much inventory companies decide to hold, and that means focusing on inventory levels and pricing power as part of fundamental research takes on heightened importance.

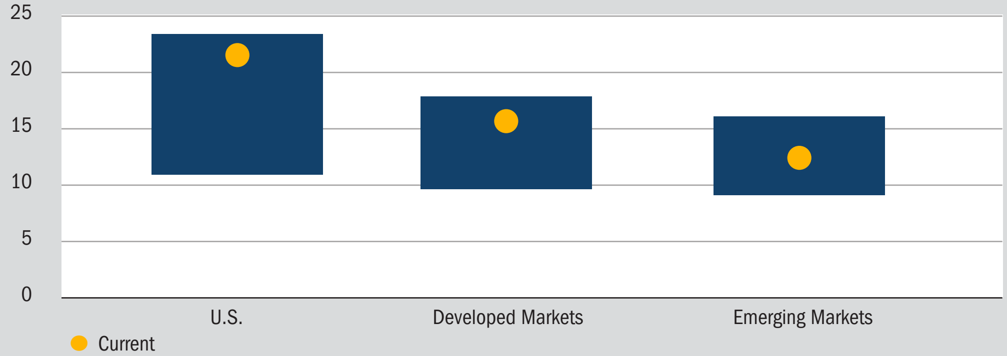
Higher rates, lower valuations?

Historically, higher interest rates have correlated with lower equity valuations. Higher interest rates in 2022 could put equity multiples under pressure, which means it's important to know what you are paying for. For investors whose value exposure is below their strategic allocation, 2022 is a good environment to increase that allocation. That said, cheap is not an investment thesis; in an environment of greater dispersion, understanding the fundamentals of a company relative to the price is essential.

Investing in the U.S. versus elsewhere

Equities are expensive in most regions. But on a relative basis, valuation metrics are more attractive in Europe and emerging markets than the U.S. Headlines on China, and inflationary pressures may cause some anxiety around investing in emerging markets. But a strategic allocation still makes sense as long as it fits your risk tolerance.

Equity valuations are high, especially in the U.S.
Range of price-to-earnings ratio (P/E), 10/2011–10/2021



Source: Source: Columbia Threadneedle based on IBES estimates. P/E is calculated using the following indices: U.S.: The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the U.S. market. Developed Markets: The MSCI Europe, Australasia, Far East (EAFE) Index is a capitalization-weighted index that tracks the total return of common stocks in 21 developed-market countries within Europe, Australasia and the Far East. Emerging Markets: The MSCI Emerging Markets Index (EMI) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. It is not possible to invest directly in an index.

Real capital is flowing to responsible investment

Responsible investment has been rising over the past few years and that will continue to accelerate in 2022. Environmental challenges like a warmer climate, limited water or wildfires all pose risks to companies. Considering these risks throughout the fundamental research process can protect portfolios.

A bumpy ride higher

We expect headline risk in 2022 — especially around inflation, interest rates and energy prices. We don't see a catalyst for a big equity swoon, but that doesn't mean we get to a place that's higher than the beginning of the year smoothly. We expect greater dispersion among winners and losers, because of the stresses of supply chains, inflation (and the cost of doing business), and higher rates. Investors need to be selective about what they own.

Gene Tannuzzo, CFA
Global Head of Fixed Income

Fixed income: Focus on improving corporate and consumer balance sheets

As we see central banks pare asset purchases, we expect a very different backdrop for short-term interest rates, pricing in rate hikes for most major central banks. We also expect the market narrative to transition to the traditional expansionary phase of the business cycle. This waning monetary support, coupled with expensive starting valuations, warrants a more selective approach to fixed income in 2022:

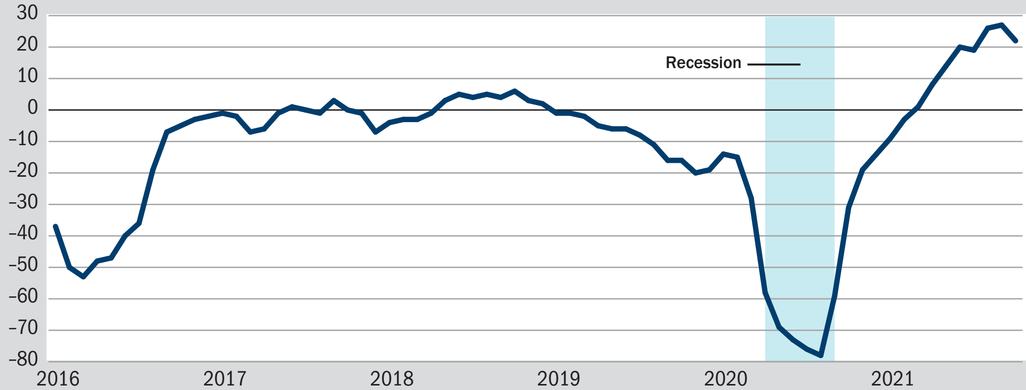
From recovery to expansion

In 2022, we expect the market narrative to transition from the "shock and awe" of the pandemic to the traditional expansionary phase of the business cycle. In this stage, bond investors benefit far less from owning generic market risk as central banks move toward the exits. A much more targeted approach, focused on improving corporate and consumer balance sheets should lead to better outcomes in 2022.

Star potential

During recessions, it's common for rating agencies to downgrade companies whose economic fortunes start to dim. The volume of these "fallen angels" during the pandemic was historic — $184 billion of corporate debt lost its investment-grade status. Aggressive management of costs, capital expenditures, dividends, share buybacks and capital structures all helped stabilize corporate cash balances. As demand steadily returned, profit margins and free cash flow grew rapidly, allowing companies to pay down debt and improve credit quality. We believe 2022 will be a strong year for "rising stars" as many high-yield companies achieve investment-grade status. In an environment where price appreciation appears muted, rising star candidates could represent a rare opportunity for gains. Risk premiums between BB- and BBB-rated bonds still offer value and prices could rise as investors anticipate higher ratings.

Rising stars: Credit upgrades for high-yield companies are outpacing downgrades post-recession
High yield credit migration rates: Trailing 6-month net upgrades as a % of market value, 01/01/06–10/31/21



Source: Bank of America and Macrobond.

Off benchmark benefits

The COVID-induced liquidity wave pushed investors back into financial markets globally and drove valuations to historically expensive levels across most liquid bond markets. The notable exceptions are bonds that are less liquid, less followed or less benchmarked. This is particularly true in structured credit and municipal bonds. Nearly 40% of mortgage- and asset-backed securities are not included in any benchmark, including most of the higher yielding opportunities in that universe. The same dynamic occurs in the municipal bond space, where a high degree of fragmentation, small issue sizes and frequent absence of credit ratings mean that muni benchmarks don't include a lot of the opportunity set.

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