Watson French
INDEPENDENT FINANCIAL PLANNING
& INVESTMENT MANAGEMENT

Investment Outlook 2022

Although the pandemic is far from over, with cases in some areas rising to the highest levels seen since the beginning of the pandemic and the threat of a new variant always around the corner, the volatility from the pandemic seen in markets is decreasing, as investors become more accustomed to the ebbs and flows of an endemic virus.

That said, there are still risks and Covid can still cause considerable damage in the worst-case scenarios. If rising numbers of Covid cases do cause further lockdowns and restrictions which disrupt global activities, this will have a negative impact on investment returns.

Other key risks for the coming year remain the same as reported late last year; namely inflation and rising interest rates.

Many central banks in developed markets are starting to wind down their supportive monetary policies. They are not yet hitting the brakes – only decelerating their support. Relative to past actions, central banks are not being as aggressive in tightening monetary policy. Whether a more aggressive approach is eventually adopted will depend on how inflation and supply issues related to Covid lockdowns evolve over the coming months.

The worst case scenario will be if monetary policy is tightened too aggressively and stagflation (which is high inflation combined with low economic growth) sets in.

There are no clear answers as to where economies and asset classes are headed and there are many variables which will affect returns over the coming year.

Different possible scenarios are being tested to try and trim risk if circumstances change for the worse (or better). In our view, as always, ensuring an investment strategy is widely diversified is as important as ever.

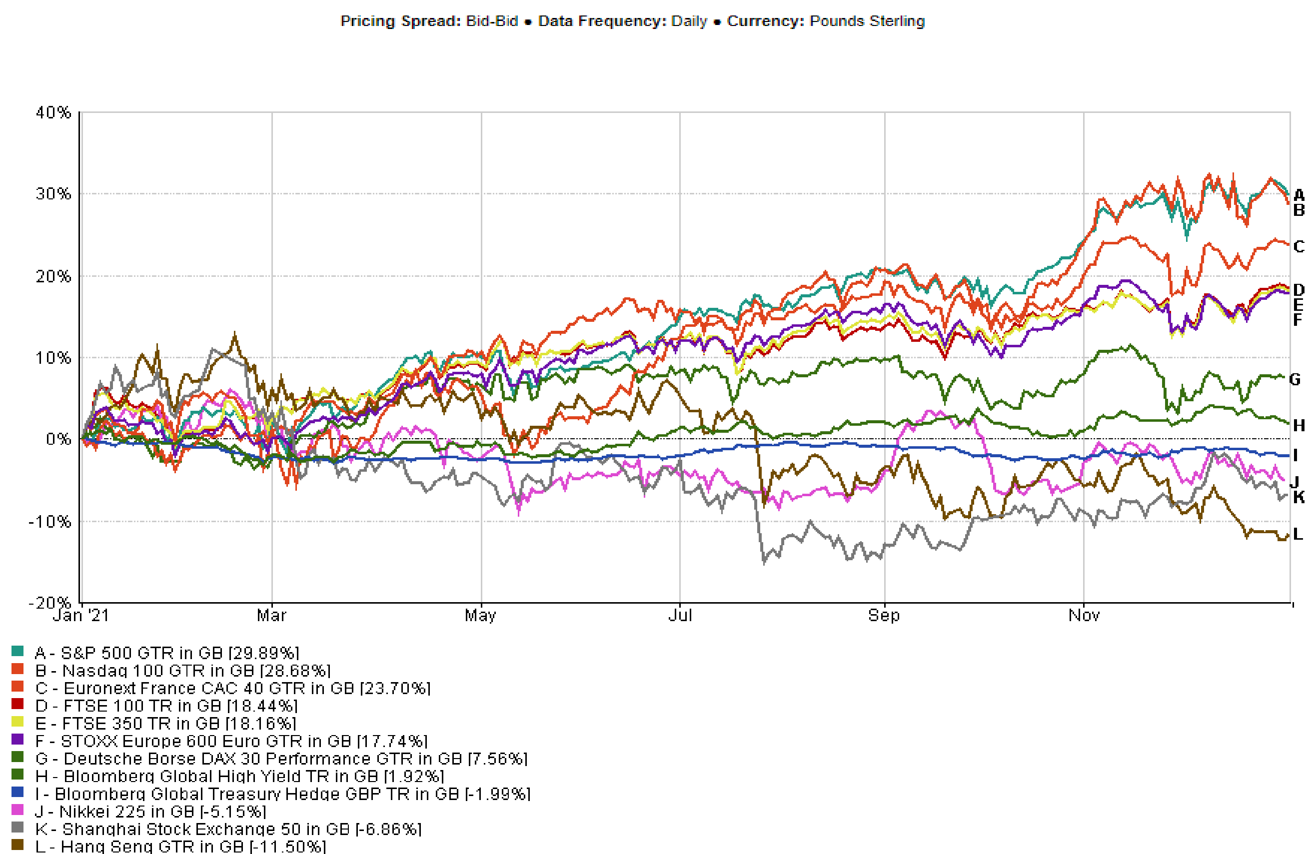
Key points

- Inflation and interest rates will continue to be at the front of investors' minds.
- European equities are poised to do well as valuations looks attractive and industries such as autos and green energy will benefit from accommodative European Central Bank monetary policy.
- Uncertainty clouds US equities as analysts disagree on what direction indices are headed.

- Japanese equities are also set to do well in the short-term, helped by a supportive monetary policy backdrop and inflation beginning to pick up.
- The decision over whether value or growth stocks will outperform is fading and stock selection across the board will be key.
- Industries predicted to provide positive upside include secular tech, healthcare, energy and financials.
- Fixed Income is predicted to underperform again, as it did in 2021.

Backdrop

Equity markets across the board are positioned to do well in the coming year and are expected to outperform fixed income, as they did in 2021. Over the year to 31st December, global equities returned 19% while fixed income fell 5%. Growth will most likely not be as high as in 2021 for equities as returns begin to normalise and economic conditions tighten, but is still predicted to be positive (although naturally this cannot be guaranteed).



2021 Calendar year performance of major stock indices and Bloomberg composite bond indices.

Both growth and value stocks are expected to perform in line with each other, a departure from last year's prediction that value stocks were primed to outperform. This coming year

may therefore be less about sector and style rotation and more about stock selection, emphasizing the role actively-managed funds still play in any well-diversified portfolio.

Inflation will no doubt still provide volatility in equity markets, but high inflation rates also provide the backdrop as to why equities are a good investment. Different companies will manage inflation pressures differently, and some will be able to pass on rising costs to the consumer more easily than others. A more pressing issue whether supply issues and Covid restrictions will push inflation higher (or at least keep it at higher levels for longer than expected).

Central banks globally have started to reign in their accommodative monetary policies. In the UK the BoE raised interest rates in December by 0.15% to 0.25% showing a more aggressive stance than other developed market central banks. In the US the Federal Reserve has started to taper its monthly asset purchases. If inflation does move higher this could see the asset purchases tapered at a quicker pace, with future interest rate rises being bought forward.

The Fed has already signaled this with its more hawkish comments in their latest minutes from December. They said that “a very tight job market and unabated inflation could require it to raise interest rates sooner than expected”. Traders are now betting the first rate rise will come as soon as March and markets dropped on this news.

In total three US rate rises are expected in 2022. It is the sum of these rises, not the quantity, that really matters. The Fed is not being as aggressive as it has been in the past and as long as it stays that way, investors should not be surprised by the Fed’s decisions.

It is also important to remember that small rate rises will not be too bad for equities anyway, as rates are currently at historically low levels. Even if rates are increased in nominal terms, when taking account of inflation, real rates are still negative. This is a supportive backdrop for many stocks, although bonds will be negatively affected.

Sector Selection

The general consensus in terms of sector selection is that defensive sectors such as healthcare, secular technology and financials will see the best upside in the coming year.

Sectors predicted to underperform include consumer cyclicals, consumer goods and cyclical technology stocks as supply and demand dynamics normalise as supply bottlenecks begin to ease. The big issue is when the supply issues will be resolved. Although many think the issues will begin to subside later in 2022, increasing Covid cases could stop this as workers struggle to get into the workplace.

Comments from many manufacturers suggest the shortage of processor chips will persist into 2023 and further as they currently see no solution to meet the increasing demand. This has reduced many companies’ profits (including Apple, which has reduced manufacturing as a result of the shortages in key components for their products).

Financial stocks such as banks always tend to perform well in high inflation and rising interest rate environments. Further increases in interest rates will boost banks earnings,

although this will vary from bank to bank. Valuations currently remain attractive for banks, further supporting the case for investment.

Many investors have a fear of investing in traditional energy stocks due to the growing popularity of ESG investing.

However, the investment case for traditional energy stocks is still strong. The uncertainty around rising costs could be exacerbated by issues such as the potential for Russia to invade the Ukraine. Stocks at the consumer end of the energy supply chain faced limited growth, and rising prices that cannot be passed on easily which threatens their solvency.

At the other end, exploration and production companies face higher growth prospects. The transition to a green economy is a long road and these traditional energy stocks will still have a role to play for some time to come.

Healthcare stocks currently trade at a discount to the wider stock market. Labour shortages and Covid closures have hampered areas such as medical devices, but as these come back online, quality companies are likely to bounce back.

Global Asset Classes

European equities are expected to deliver positive performance as the ECB retains an accommodative monetary stance and corporate earnings are expected to be positive. Although earnings across the board are expected to be higher, any earnings “surprises” are expected to be lower (inclusive of all developed markets).

The rate of these surprises is already trending back towards its long-term average, after rocketing up in 2020-2021. Another positive for Europe is the market leading renewable energy companies it boosts. In comparison to US equities, analysts believe the lower valuations of European stocks relative to their US counterparts will make them attractive for investors.

There are discrepancies between analysts in regards to US equities. Some analysts predict the S&P 500 will rise by double digit growth, some believe it will grow modestly and a few analysts believe it will drop slightly. The discrepancies come from differing views on how cost pressures, corporation tax increases and interest rate rises will affect valuations.

The most likely view is that although interest rates will rise as soon as March, strong corporate earnings will support the valuations of lots of companies for now. Certainly for the NASDAQ, secular tech companies such as Netflix and Apple will continue to perform well – their share performance is driven long-term by earnings and short-term economic influences tend to have short-lived effects. Other tech companies such as Tesla should have growth driven by long-term structural changes, such as the push for a greener economy. If supply bottlenecks do subside then we will see these companies’ revenues increase as manufacturing picks up again.

The outperformance of US markets in recent years has been driven by superior and continuously growing earnings. Although the consensus varies, a key point that most analysts agree on is there are better opportunities in Europe and Japan and more upside

potential. The risk of over-valuation in US equities is being highlighted again, and whether this turns out to be true will depend on how the US economy evolves.

While UK equities are considered undervalued in comparison to their global counterparts, many fund managers are still hesitant to invest more in the UK as long-standing Brexit issues still remain. Certain sectors of the UK market are predicted do well, such as financials and energy.

UK equity income funds should also provide reasonable yields for investors in 2022. JP Morgan have reported that for 2021, UK equity dividend yields are expected to have been the highest globally. The growth in 2022 will be modest and smaller than the growth seen in 2021. This is due mainly to cost pressures.

A key risk with UK equity income is concentration risk. Fifty percent of the dividends expected in 2022 are set to come from just 10 stocks, while the top 20 stocks are expected to generate 70% of the income. Companies such as Rio Tinto, Shell and BP also face pressures from ESG investors to shift their business into renewable areas more quickly than they are currently doing so. This will require a great deal of resources which could impact their dividend payouts. As they make up a large percentage of UK dividends this will impact the overall yield achieved by UK equity income funds. It is important to look at the underlying holdings of UK funds to see where the dividends are coming from and what any individual yield changes will have on the overall funds yield.

Research shows that the dividend cover (the ratio of earnings per share to dividends per share) of UK companies increased last year. This could indicate that companies are retaining more earnings to fuel future growth rather than pay them out as dividends. Although this impacts yields in the short-term, longer term this retention and reinvestment of profits should mean increased future yields.

UK dividends are currently at very attractive levels and should continue to grow modestly in the next year. There are many challenges that UK companies face (such as cost pressures and corporate changes) and this could impact yield growth in the future and is something to monitor. Other areas such as Australia also offer reasonable dividend yields and so a combination of global income funds will provide better diversification in the event UK yields underperform.

Another point to note for investors seeking income from dividends is the increase in dividend tax rates for the 2022/2023 tax year.

The increase across all tax bands is 1.25% (figures below in table). Basic-rate taxpayers receiving £10,000 in dividends must pay dividend tax on £8,000 (assuming their £2,000 dividend allowance is available) and will see their tax bill rise from £600 to £700 due to the dividend tax increase from 6th April 2022.

	Basic Rate	Higher Rate	Additional Rate
Current Tax Rates (2021/22)	7.50%	32.50%	38.10%
Dividend Tax Rates from 2022/23	8.75%	33.75%	39.35%

There are many headwinds for the UK economy. Increased taxes (both corporate and individual), rising energy costs and reduced unemployment benefits are set to hit income and consumption.

Coupled with rising costs, lower incomes can result in a further reduction in consumption which would dampen economic growth. Businesses such as restaurants and hospitality could see their profits hit as demand decreases, although economic growth is still positioned to grow at around 5% in 2022.

Japan is expected to perform well over the coming year as economic stimulus increases. Investors currently have a low weighting in this region and so inflows are expected to increase modestly.

In the longer-term however, there remain many hurdles that Japan needs to overcome – an ageing population, corporate issues and the long-term need for sustained inflation and monetary support to name a few.

Fixed income is again expected to underperform equities in 2022. Negative real yields and a more muted policy response than has previously been adopted are likely to subdue bond market returns.

Inflation linked securities should provide better returns as inflation stays high. When inflation does settle back down it will most likely be above normal levels.

Conclusion

What will happen in the coming year is far from a certainty and for this reason a well-diversified portfolio is key.

The biggest risks are inflation and how central banks deal with it, and delays in activity restarts from wider-spread Covid infections causing further lockdown restrictions. Another key question that investors are focused on is when supply bottlenecks will fade.

Although bonds in general are not expected to deliver good returns, they are still a key part of the portfolio for risk management in the event expectations change.

Inflation linked bonds in particular could provide some comfort for investors this year.

A globally diversified equity portfolio with a higher tilt towards Europe, Japan and to a lesser extent, the UK, will in our view provide a good risk and reward profile for investors.

Exposure to the US is still an important part of any portfolio, but with higher valuations there is now a greater downside risk.

Robert Dougherty, January 2022.

This article is not a recommendation to invest and should not be construed as advice. The value of an investment can go down as well as up, and you may get less back than you invested.