Outlook for 2022: Focus on real assets

Equities are still the keystone in the portfolio

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Confidence that the end of the pandemic is drawing nearer has characterised the investment year and buoyed sentiment on the stock markets. 2020 was a year of crisis management. 2021 marked the start of a return to some degree of normality. Despite the continuing aftershocks of the pandemic, a number of positive developments have been key in boosting our optimism. Both the economy and society need to get back sustainably on their own feet so that both can flourish again as soon as possible without any need for central bank or government support. It is absolutely essential that action is taken to deal with structural problems such as pensions, demographics, and debt levels.

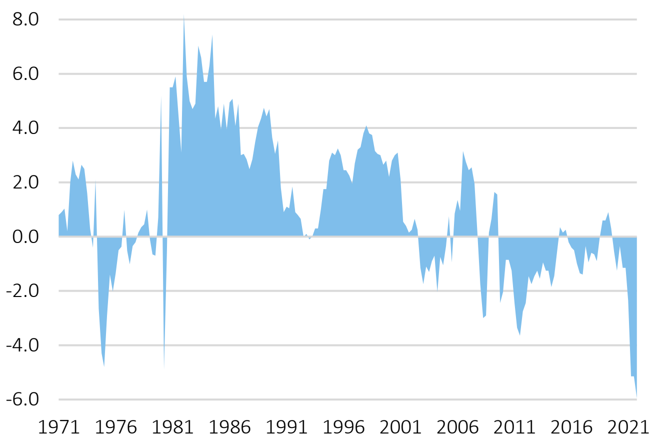
The current situation is "special". This does not refer to the fact that the pandemic is not yet entirely over, but rather that we are dealing with something new – which we have not had to think about for what seems like an eternity – **inflation**. A pandemic-induced supply shortage has coincided with demand stoked by loose monetary policy and government support packages. This has resulted in rampant increases in energy and commodity prices. Wages have also ticked up. Although energy prices are likely to remain high, the situation is likely to ease within supply chains and on labour markets. Considered in the abstract, inflation is neither a bad thing nor a problem – as long as it does not spin out of control, and evens out at a manageable level, albeit with the odd upward spike. We are presuming that this will be the case.

The outlook for 2022 is marked by vagueness. Variants of the virus bring indirect risks of higher and/or more sustained inflation and weigh down global growth rates. This could slow down or delay the **recovery**. However, thanks to tweaked vaccines and potential medications on the horizon it is unlikely to be stifled completely. If necessary, central banks will churn out even more cheap money in order to finance government packages. The differing opinions amongst experts and stock markets on which volatility – i.e. jitters and uncertainty – has increased are another indication of how unclear the immediate future will be.

We are in a "fragile" situation. The economy has been put back on track by the glut of money from central banks and government support packages, as well as Covid vaccines. Although consumers saved a little during the crisis, some of these savings have already been eaten up. In addition, higher prices for basic goods such as electricity and food have driven up the cost of living and reduced purchasing power. Rising rents are only anticipated as a delayed reaction to higher real estate prices. There is a risk that consumer spending – as a linchpin of the economy and its driving force – may be inhibited or even crumble away. **Financial repression** – fuelled by the central bank/government tandem, coupled with money creation, abnormally low interest rates and stimulus packages – could end up being a problem in the long run. Real interest rates (interest rates minus inflation) are at record lows, and have almost never been so far into negative territory.

Negative real interest rates at a record low – financial repression in full swing

Graph 1: USD real interest rates since 1971 (in %)



Source: Bloomberg, Belvalor; USD real interest rates: Federal Funds Rate less US Consumer Price Index (CPI) per quarter

Savers are being intentionally expropriated – almost as if they were subject to a wealth tax – as the value of cash at zero interest is eroded by inflation. On the other hand, due to their debt burdens, governments benefit from their debts being devalued by inflation and are dependent on low interest rates. Anyone wishing to save is therefore being forced by governments to take on more risk.

It is **interest rates** that have the potential to tip the scales – the lodestar for the economy, for politics, as well as for financial and capital markets. Central banks continue, as ever, to orchestrate events. The effects of changes in interest rates are varied and complex, and the reasons for them are no less important. Should central banks be forced by inflation to hike interest rates despite a sputtering economy, a recession would be practically unavoidable. Stagflation – a combination a stagnating economy and inflation – is also an extremely dangerous risk scenario. This must be avoided under all circumstances, and central banks are aware of this. An extremely delicate touch is therefore called for when turning the interest rate screw. Things are likely to get a little more unpleasant before the pandemic has ended. We are anticipating a challenging economic environment in the near future, although are proceeding on the assumption that government stimulus packages will play a supporting role from 2023.

A further layer of complexity results from the fact the pandemic has to be put behind us whilst at the same time promoting **sustainability**. Pro-climate policies have to be reconciled with the action taken to deal with the pandemic. Geopolitical and social **stress points** – such as "income and wealth inequality" – are on the increase. The divides that need to be filled up or bridged have become larger as a result of the crisis, and the related decoupling of asset growth from the actual economic reality.

On the investment side, persistent low returns are the biggest challenge. The relative attractiveness of equities has increased even further. Since investment classes will tend less in one and the same direction in the future, portfolio construction will take on increasing importance.

Economic environment

The economy (gross domestic product, GPD) and corporate profits bounced back strongly in 2021. They have already returned to pre-pandemic levels, or are set to do so in most cases in 2022. Variants of the virus will not change the picture, unless they end up being extraordinarily deadly or resistant to vaccines.

The recovery from the 2020 recession has been stronger and faster than even the boldest of us had dared to dream. Demand, and with it economic growth, has risen enormously. Bottlenecks have prevented even greater growth and spurred inflation.

Asia and the Pacific region were initially successful with their "zero Covid" policy, although now this approach is starting to wear thin. China's idiosyncratic and highly ideological policy has weighed down the rest of this region, and even the rest of the world. In pursuing a rigorous vaccination policy, the USA once again gained a competitive edge along the path to recovery. As usual, the USA will return to growth more quickly after the crisis. Europe battled back astonishingly quickly, although travel and movement restrictions have been having a negative effect due to geographical factors and the divergent interests of individual countries. As a result, Europe has been held back the most.

Despite the momentary stumble in the economic recovery, thanks to stimulus packages we are expecting global growth in 2022 to outperform the long-term average GDP growth rate of 3.0–3.5 % per annum. Failing to reach the consensus forecast of 4.5 % could be perceived as a disappointment and could stand in the way of a gradual normalisation of momentary policy, at least in the short run.

With its pent-up demand, Europe could – exceptionally – experience the strongest growth. The USA is leaving nothing to chance, as the Infrastructure Programme (USD 1 trillion) along with the "Social Safety and Climate Change" Programme (USD 1.75 trillion) will contribute 10–15 % to the economic output over the next decade from the summer of 2022. This should also make up for any falls in consumer confidence. Nevertheless, the long-term growth prospects in the western world are modest. Without structural reforms, problems such as rising debt and the increasing burden of the welfare state as a result of demographic shifts cannot simply be kicked into the long grass as they are becoming steadily larger, and thus an increasingly significant risk.

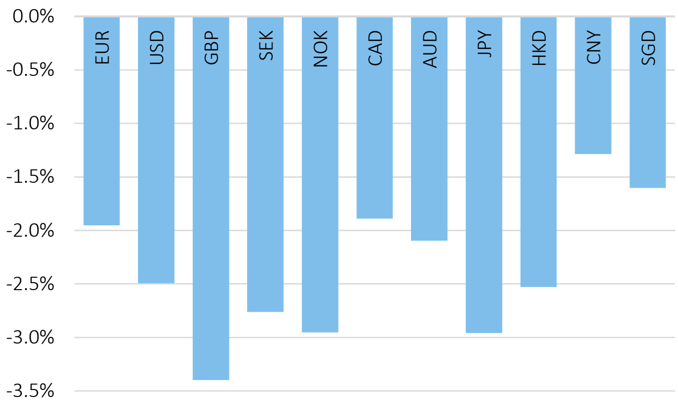
Switzerland has weathered the crisis well to date from an economic perspective. This recovery is a reflection of its innovative companies in exporting sectors. Growth prospects remain good, although are dependent on the global economy. The challenges will not become any smaller in 2022, and may be compounded by further weakness in the EUR or even the USD. This would also hit tourism, which ultimately recovered better than forecast in 2021.

Currencies

Interest rates in all western currencies, including in particular the Swiss franc, are near to historic lows. We anticipate that the Swiss franc strength, which has persisted for some years (see Graph 2), will continue into the future due to the strong fundamentals.

The Swiss franc is the strongest currency

Graph 2: Annual loss in value by other currencies against the CHF since 2000



Source: Bloomberg, Belvalor; average per annum (01/01/2000 – 08/12/2021)

In contrast to the previous year, the consensus position this time is for a stronger USD. As the USD is fundamentally overvalued, we consider that it has limited upward potential. The EUR remains structurally weak, despite its attractiveness from a purchasing power parity perspective. The European Central Bank (ECB) has been focusing increasingly on political challenges, fuelling the trend towards a weak currency. We recommend minimising foreign currency risks. This applies in particular for investors who have the Swiss franc as their reference currency.

Interest rates / bonds

Central banks' expansive monetary policies have continued unchecked in 2021. In late autumn, the US central bank (Fed) started to rein in securities purchases (known as "tapering") and was the first major central bank to embark upon a tentative reduction in expansive monetary policy. The ECB has announced similar action as it is planning to reduce its pandemic-related support. In the current environment, we consider it unlikely that the ECB or the Swiss National Bank (SNB) will give up their negative interest rate policy. In Europe only the Norwegian central bank has dared to make an initial interest rate hike. The market is expecting the Fed to increase rates for the first time in the middle of 2022. We think this is a bit early and are expecting one closer to the end of 2022. In general, we are anticipating a continuation of the loose monetary policy.

Investors are being confronted with the problem of negative real interest rates in all major western currency areas. The last time we experienced anything similar was in the 1970s. Most central banks are expecting the current inflation to be temporary, and for it to drop back down to the 2–3 % range in the medium term. This forecast could turn out to be overly optimistic, and there is a risk of consensus inflation prognoses following an upward trajectory. In the current environment, we are not expecting a normalisation of monetary policy any time soon. On the other hand, we think it is inevitable that central banks will back away from the ultra-expansive monetary policy in order to avoid stoking inflation any further.

Bonds are an "interest-free risk"

The risk associated with bonds is in most cases no longer adequately compensated. Due to the improved economic outlook, resurgent inflationary expectations and/or increased default risks, a steeper yield curve (rising returns for longer maturities) is not unrealistic. This would result in falling bond prices.

Good-quality CHF and EUR bonds give barely any positive returns, or only do so if long maturities are accepted. The situation is a little better in USD and GBP. Nonetheless, bonds could make sense to a limited extent in investor portfolios for the reasons of diversification and reducing risk. Besides making selective individual investments, we invest in strategies and segments such as convertible bonds, cat bonds, contingent convertible bonds ("CoCos", hybrid capital of banks) or US "municipal infrastructure" via selected collective instruments. Quality and liquidity are becoming increasingly important due to the uncertain outlook.

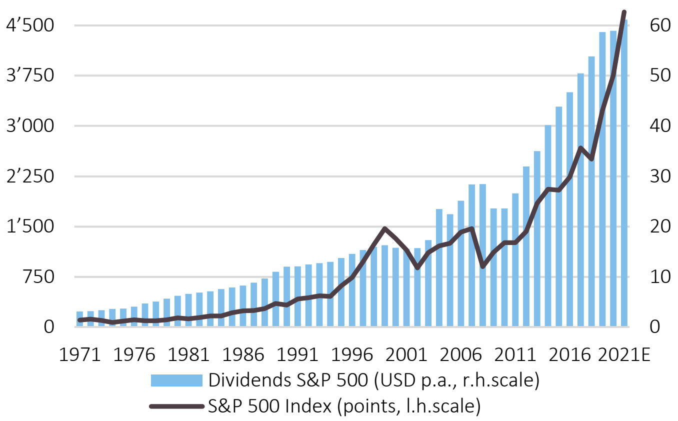
Equities

It is remarkable how deftly a number of companies have navigated through the Covid-19 crisis and have even been able to improve their market position further during this period.

Average profit margins in the USA are at historic highs. This trend is being impacted by the high profitability of technology companies. Pressure on margins has gone up as a result of increases in the prices of many input factors, such as labour, raw materials and logistics. As a consequence, picking quality equities remains the core element within our investment process. Companies with pricing power will be better placed to deal with the challenges and to shore up their margins and profits.

The air becomes thinner in the short run, but corporate profits grow by 5–7 % per annum over the longer term – and equity prices are focused on this. Accordingly, equity allocation with a long-term focus is at the heart of our investment policy.

Graph 3: S&P 500 – prices and dividends since 1971



Source: Bloomberg, Belvalor

Momentum on the major equity indices is still positive. A number of equities are offering attractive dividend yields. However, warning signs must not be ignored. Prices have reached historic highs and an extremely optimistic view of the future has been increasingly apparent in relation to IPOs.

The watchword "ESG" (Environment, Social, and Governance) has become a prominent feature of investment decisions. Sustainability is an integral part of our quality analysis, and is not focused exclusively on the environment.

Quality is the top priority for equities

A winding down of the ultra-expansive monetary policy and increasing uncertainty is set to cause higher volatility. Against this backdrop, we advise a greater focus on the equities of quality companies. A portfolio should also contain "value" equities. Plenty of equities are available in good, under-valued companies, especially in the commodities and energy sectors.

Despite reservations on the valuation front as well as the risk of a market correction, equities remain attractive compared to other investment classes and are strategically our number one choice. We continue to recommend that only financial resources that can be invested over the long term and that will not be needed in the foreseeable future be invested in equities. Despite all of the short-term fluctuations, equities are the most suitable way of protecting and growing capital over the long term.

Commodities and alternative investments

2021 saw significant price increases in the commodities sector on the back of the economic upswing. Supply was unable to keep up across the board with the strong rises in demand. Energy prices in particular soared massively. The reasons can be found in both, low levels of capital investment in energy sources over the last few years as well as the aspiration of refocusing the energy system on alternative energies such as solar, wind, and other sustainable sources of energy, both of which call for significant resources.

Although the further upward potential within commodity prices appears to be limited, equities of companies from the oil and commodities sectors with an ESG strategy for the future remain selectively attractive. Sustainability is being taken seriously by these companies and progress is becoming increasingly apparent. It is advisable to include gold within the mix in a portfolio – for the purpose of both hedging and diversification.

Resources are attractive

Crypto assets, which are gaining in acceptance, have encountered growing interest amongst investors – especially from the younger generations. We are monitoring developments and take the view that in particular the blockchain technology will change the world in future.

There is still demand for alternative investments within a context marked by low interest rates and high prices. Alongside the equities of leading providers in the private equity sector, we are focusing on first-class investment funds that invest flexibly across various asset classes (private equity, private debt, real estate, and infrastructure).

Swiss real estate

The pandemic has had a negligible impact on rental incomes from Swiss real estate. Property prices have risen and are in some cases astronomically high, amongst other things due to sustained excess demand on the real estate market. Coupled with low interest rates, this will continue to drive up prices. Real estate equities and funds offer more attractive distribution yields than bonds. However, caution must be exercised in relation to investments with high premiums above the intrinsic value.