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Investing for a
world of change

Multi-Asset Strategy Quarterly

January 2022

Foreword



Jimmy Elliot
Head of Multi-Asset

Welcome to our latest Multi-Asset Strategy Quarterly. In this edition, Philip Saunders explores the possible challenges that markets may face as central banks return to conventional monetary policy. Deirdre Cooper, Michael Spinks and Stephanie Niven discuss the engagement of the private sector in helping address externalities at November's COP26 and Russell Silberston reviews the policy announcements by the major central banks over the past quarter. Finally, we close with a succinct summary of our higher conviction asset class views, beginning with equities, moving on to fixed income, currency and closing out with commodities.

Contents

Prepare for re-entry: the challenges of normalisation



Philip Saunders
Co-Head of
Multi-Asset Growth

As every astronaut knows, re-entry can be the most dangerous part of a mission. Financial ‘normalisation’ – central banks’ return to conventional monetary policy after years of abnormally accommodative stances – may be a similarly difficult transition, potentially exposing markets to significant stresses in the year ahead.

But it was business as usual in 2021 from a policy perspective, with Western central banks sticking with super-easy policies. This was accompanied by a continuation of the ‘V-shaped’ recovery in markets and economies, despite some setbacks caused by new variants of COVID-19.

However, the dramatic recovery in demand has not been accompanied by an ability to supply it. Supply-chain disruptions have led to bottlenecks and sharply rising prices in many areas. Indeed, concern about inflation intensified as 2021 progressed, with market participants beginning to doubt that the surge in prices would prove as ‘transitory’ as the US Federal Reserve (Fed) and other central banks had suggested.

What should investors do? As discussed in detail in our [2022 outlook](#), we suggest a number of ways to navigate this environment.

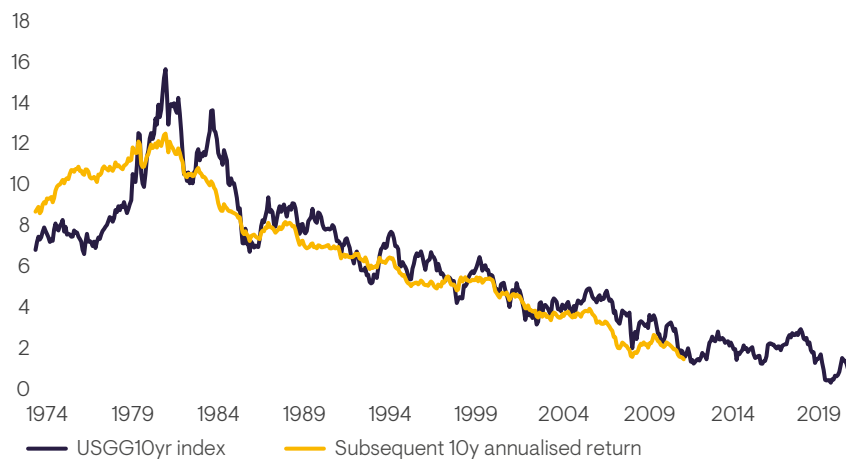
Keep duration short

We had long been on notice that quantitative easing in the US would be tapered, however the Fed surprised the market in December by stating that it would stop adding to its portfolio in March 2022, several months ahead of prior expectations. This will pave the way for increases in official interest rates. Our central case is that, although supply constraints should progressively moderate, price pressures are likely to remain uncomfortable for longer. This will force the Fed to normalise financial conditions more rapidly than the market expects. Real rates will have to adjust from the current negative levels, and we ascribe a low probability to this being a smooth process.

The withdrawal of asset purchases – which have been running at about US\$120 billion a month as part of the Fed’s response to the COVID crisis – implies a reset along the yield curve to the natural market-clearing levels. The Fed now owns over 54% of 10–20-year maturity treasuries, the buying of which has had the deliberate effect of suppressing long-term interest rates. As things stand, bonds are at historically expensive valuations, and prospective longer-term real returns are poor under most scenarios (Figure 1). The combination of firm economic growth and the removal of the Fed’s support suggests higher long-maturity US Treasury bond yields.

Although short-term interest rates diverge between countries, developed government bond markets tend to be highly correlated beyond maturities of about five years, with the US Treasury market setting the tone. So, we can expect liquidity conditions to tighten internationally.

Figure 1: Future returns on US government bonds look weak
Current 10-year yields and subsequent 10-year total returns on US government bonds (1-10 years) (%)



Source: Bloomberg, December 2021.

For defensive diversification, consider US dollars

The US dollar didn't weaken to anything like the extent many commentators were expecting in 2021. Although the greenback is expensive on valuation grounds, it remains well below its pre-COVID levels (Figure 2). With growth and monetary policy set to diverge materially in 2022, the US dollar has the potential to extend its rally. Real interest rates should rise in both absolute and relative terms and returns on capital in the US should continue to act as a magnet for global capital. True, the US current-account deficit is likely to widen to record levels in these circumstances, which could eventually become problematic, but the correlation between current-account deficits and US-dollar weakness has generally been low.

We expect weaker growth to limit the eurozone's ability to follow the US along the path of financial normalisation. Meanwhile, Chinese policymakers are likely to respond to emerging economic weakness by implementing incremental policy easing and allowing the renminbi to weaken, as will probably be the case for currencies elsewhere in Asia. A stronger US dollar suggests tighter international liquidity conditions, which in turn is not supportive of emerging market currencies generally, and particularly those of the major debtor nations.

Figure 2: The US dollar remains below its pre-COVID level Trade-weighted US dollar index



Source: Bloomberg, December 2021.

Companies with pricing power

We are unconvinced that it is especially useful to talk in terms of the conventional equity style labels. But if we must, 'high growth' stocks are evidently the most exposed. They have been the primary beneficiaries of declining interest rates in the period of so-called secular stagnation in the West, and their valuations are the most extended. Indeed, many 'growth stocks' in particular would appear to have been lifted excessively by the common tide, heavily outperforming other styles since the global financial crisis (GFC). However transitory the current burst of inflation proves to be, our medium-term expectation is that the US inflation rate will be somewhat higher on average than it was in the post-GFC period. Real rates are set to rise quite materially and, as remarked on earlier, the removal of quantitative easing will free the longer end of the US yield curve to adjust. The best defence against the risk of inflation continues to be pricing power, the most valuable characteristic companies can possess in an inflationary environment, together with a reasonable starting valuation. Selectivity will be key.

Geopolitical flashpoints are unlikely

With the 'Chimerica' model broken and the Biden administration pursuing an aggressive policy to frustrate China's rise, geopolitical risk is a consideration for investors for the first time since the Cold War. Where Biden's approach differs from Trump's is in the consistency with which it is being pursued. The effect of this has been to accelerate reform on a number of fronts in China, most notably in technological innovation and more generally in China's pursuit of self-sufficiency in certain sectors. Investors have begun to mull a serious escalation of geopolitical tensions between the US and China as a rising tail risk. We beg to differ. Unlike during the Cold War, today's global economy is highly inter-connected. China's exports to the US are booming and US corporates have been notably slow to shift their supply chains away from China. China itself is addressing some very significant domestic structural challenges and seems to have everything to gain from playing a long game.

On that note, any significant bouts of volatility that materialise in 2022 – for whatever reason – may provide the chance to add exposure to longer-term thematic opportunities, such as those analysed in our [Road to 2030 research project](#).

Externalities: The world's measure of success is changing



Deirdre Cooper
Co-Head of Thematic Equity

The persistence of smog across London baffled economists in the late nineteenth century. The theory at the time held that market forces would address the negative impacts on health, laundry and lighting. In the end, the government had to intervene to address these externalities.

Roll forward to COP26, a conference aimed at tackling a giant externality: climate change. A notable difference to previous COPs was the engagement of the private sector. Where once governments were relied upon to incentivise better behaviour, companies now appear to be taking up the baton. We think that's because they increasingly recognise that orientating towards sustainable business models – including ones that contribute to the world's net-zero ambition – is critical to their future growth and license to operate.



Michael Spinks
Co-Head of Multi-Asset Growth

Uncovering opportunities

Externalities linked to emissions are already being priced, via carbon credits and related mechanisms. We expect a wider range of externalities to be priced in future, with potentially significant implications for investors. Our externality framework sets out to map the range and materiality of the externalities relevant to each company and country. At present, we see a broad dispersion in the extent to which material externalities are reflected in asset values – suggesting opportunities for active investors.



Stephanie Niven
Portfolio Manager





Making a better assessment

Traditional investment analysis focuses on matters relating to financial capital, such as generating profits, paying salaries and contributing tax revenues. By also assessing how companies and countries use and manage natural capital, social capital and human capital, we believe we can make a better assessment of companies' long-term potential.

Externalities need careful analysis and a contextual approach. The semi-conductor industry highlights the potential complications: in this industry, commonly used metrics like carbon-footprint per unit of revenue can be misleading; footprint per wafer is far more informative. And in comparing semi-conductor companies, the extent to which manufacturing is outsourced needs to be factored in. Medical technology and insurance are two other examples of industries that need more custom approaches to analysing externalities.

Our bottom-up Multi-Asset research processes on both corporates and sovereigns include this understanding of all the 'capitals'. We believe that companies that incorporate an awareness of externalities into how they do business are more likely to exhibit this characteristic. Such companies are often well placed to build a sustainable and persistent competitive moat, because their genuine understanding of their externalities reinforces their brand and operations from a customer and shareholder perspective. They typically have strong leadership and a culture of innovation, which promotes reinvestment into the business and careful capital allocation, further strengthening the moat and supporting higher profitability.

Figure 3: Externalities framework – positive and negative

 Natural capital	 Social capital	 Human capital	 Financial capital
<ul style="list-style-type: none"> – Deforestation and land protection – Productivity and food security – GHG emissions and pollution – Marine protection – Extractive industry policies – Water and waste management – Ocean acidification – Biodiversity and land use change 	<ul style="list-style-type: none"> – Diversity and equality – Transport and communication – Affordable housing – Community involvement and investment – Infrastructure 	<ul style="list-style-type: none"> – Education and training – Employee health & safety – Health outcomes – Wellbeing 	<ul style="list-style-type: none"> – Profits – Taxes – Dividends – Salaries – Rents – Interest

Source: Ninety One.

Company culture is the glue

This results in a ‘sustainability flywheel’ where, once a business has momentum, these characteristics become self-reinforcing and maintain the returns of the business. We observe the converse to be true: companies that fail to identify and manage externalities are likely to be over-earning in the short term. This can lead to capital misallocation and longer-term value destruction to shareholders and other primary stakeholders. The risk of such businesses to shareholders, and other stakeholders, is significantly higher.

The glue that holds a positive approach to externalities together is company culture and leadership, backed by a genuine desire to put sustainability at the core of a business. Management teams that excel in this regard will have more positive engagements with investors, building a shareholder base with a long-term mindset. Companies that set out to operate in a sustainable manner also have policies and business models in place to minimise their negative externalities and maximise positive impacts. Analysis of corporate culture provides a useful lens into how companies understand and manage the externalities they face. We believe that our research in this area, and the resulting analytical framework we have developed, help us to understand whether a company can execute on its business goals, including its sustainability agenda.

By applying this framework consistently across our opportunity set, our asset allocation process across all of our Multi-Asset strategies incorporates these sustainability considerations and the impact of externalities management. From a top-down country perspective, the influence of climate change through physical and transition risk, as well as analysis of socio-economic resilience, are also integral to our decisions to invest or not invest in particular markets.

To watch a webinar where a panel of experts from Ninety One discuss this in greater depth, click [here](#). Further detail about the Multi-Asset team’s approach to evaluating the investment risks and opportunities arising from companies’ externalities can be found [here](#).

Rushing for the exit



Russell Silberston
Strategist

In our last [policy review](#), we discussed how many central banks were heading for the monetary exits. In the final quarter of 2021, this sedate pace turned into a disorderly rush, as inflation exceeded expectations and policymakers found themselves with inappropriately easy monetary policy.

At the front of the queue was the Federal Reserve (Fed), which switched to risk management mode following higher and more persistent inflation than previously expected. In response, the long-heralded taper of their asset purchases was accelerated and is now expected to collapse from buying US\$120 billion per month in October 2021 to zero by March of this year. This gives the Committee flexibility to raise interest rates early to offset the inflationary pressure, if so desired. With the economy still not at full employment, the Fed has little choice other than to neglect one half of its dual mandate in order to ensure inflation – the other half – stabilises and expectations remain in line with its target. Looking ahead, the Fed is clearly uncomfortable, and whilst inflation is widely expected to moderate in 2022, it will not risk its credibility by allowing above target inflation to become entrenched, in our view. As such, expect a series of interest rate hikes, with a promise of more to come in 2023 and beyond. The Fed may also begin to shrink its balance sheet earlier than expected too, given it has doubled in size to US\$8.7 trillion over the pandemic. Fiscal policy, however, will be a headwind in 2022, as the enormous pandemic measures roll off and the Biden administration struggles to pass its large ‘Build Back Better’ infrastructure programme.

The PBOC pivots

The People’s Bank of China (PBOC), in complete contrast, pivoted in the opposite direction, as the Politburo tacked to supporting the property market and stabilising growth amidst the significant slowdown in housing activity. Shortly after this directive, the PBOC released CNY 1.2 trillion into the banking sector by reducing the bank reserve requirement ratio and sanctioned a modest reduction in the one-year loan prime rate. With the Politburo direction so clear, it seems highly likely that both monetary and fiscal policy will see further easing measures into 2022, although given concerns over aggregate debt in the economy, this will likely remain targeted and focused on favoured sectors. One example of this approach is the PBOC’s new green lending scheme, introduced in November, which offers to lend 60% of the required funds for green lending at 1.75% versus a loan prime rate of 3.80% for one year and 4.65% for five years.

Avoiding a cliff edge

With eurozone inflation running at 5.0%, the Governing Council (GC) of the European Central Bank (ECB) was always going to struggle to convince its hawkish northern European members to extend the sizeable Pandemic Emergency Purchase Programme (PEPP), which is due to expire at the end of March. However, to avoid a clear quantitative cliff edge, which would have seen ECB purchases drop from €90 billion per month to €20 billion per month, the GC decided in December to temporarily double its long standing but much smaller Asset Purchase Programme (APP) from €20 billion per month to €40 billion per month in Q2 2022, reducing that to €30 billion per month in Q3 and then reverting back to the current sizing by the end of next year. However, with inflation expected to fall back and settle modestly below target in the medium term, President Lagarde was keen to stress that “it is very unlikely that we will raise interest rates in the year 2022”. And with the APP expected to continue until shortly before interest rates rise, the ECB’s policy divergence with the Federal Reserve is notable.

Taps remain on in Japan

With Japanese inflation running at just 0.6% year on year, the Bank of Japan (BOJ) is under no pressure to pull back from its super-accommodative monetary policy stance and so, in the words of Governor Kuroda, will “persistently continue with powerful monetary easing under the current quantitative and qualitative QE with yield curve control”. In its most recent meeting, the BOJ extended its enormous COVID bank loan scheme, which now accounts for 19% of its entire balance sheet, although it closed two much smaller schemes aimed at keeping financial conditions loose. The new administration of Prime Minister Fumio Kishida also passed a large fiscal easing package, with a headline amount of 10% of GDP. The Cabinet Office thinks this will boost GDP by 5.6%, however, the multiplier effect of government spending is always uncertain, and most economists expect the boost to growth to be considerably lower than official estimates.

BOE readying additional hikes

The Bank of England (BOE) adopted a tightening bias back in August and so a hike in the base rate has since been a question of when, not if. Having opted to wait for more clarity over the employment status of those remaining workers on the government’s Job Retention Scheme (JRS), the Bank passed in November but hiked 0.15% in December once it became apparent that unemployment was not going to spike as the JRS expired and inflation remains uncomfortably above target. Looking forward, further increases in the bank rate are highly likely, with quantitative tightening of the BOE’s balance sheet starting when rates get to just 0.5%. However, whilst there can be no doubt this makes the Bank one of the most hawkish major central banks, markets are discounting over 100 basis points of additional hikes, a degree of tightening that seems quite steep given the expected balance sheet run off.

Summary of high conviction asset class views

Defensive Bonds

The outlook is now more mixed for defensive bonds with real interest rates very rich and implied inflation now above realised historical levels. This is now true across developed markets, with inflation premium recovering in Europe to catch up with the recovery we had already seen in the US. The US long end is increasingly looking distorted given excessively rich real yield valuation. Some areas remain attractive such as New Zealand and Korea which have already repriced significantly above medium-term fair value and are sensitive to weak Chinese growth.

Positive – China, New Zealand, Korea

Negative – Implied inflation to fall, real rates to rise, US long-data nominal bonds

Growth Bonds

The EM macro score remains negative, whilst our quality scores continue to move more negative reflecting higher inflation which has eroded institutional strength scores, as well as a deterioration in fiscal scores. Valuations remain attractive across the board, in particular real interest rates on a relative basis. We are neutral the asset class but favour those areas that have nominal and real rate advantages to DM, as well as attractive carry dynamics as these should continue to benefit from yield advantages to DM.

Positive – Mexico, Peru, Colombia, Brazil, Russia, Chile

Negative – European peripheral spreads

Credit

While issuance remained robust in all asset classes high yield saw outflows across regions. Despite recognising the underlying balance sheet quality of many companies in the credit universe, we turn negative on the asset class to reflect the deterioration in macro dynamics, rich valuations, particularly in the US, and our expectation that real yields will rise. The pivot in Chinese policy stance creates opportunities in Chinese Property Credit given the elevated risk premia.

Positive – Asian HY

Negative – US/EU high yield

FX

The Federal Reserve continues to guide for a quicker policy normalisation than expected by the market. This comes at a time when the slowdown in the Chinese credit cycle is feeding through into economic data and we have seen growth momentum decline rapidly. Hence there appears to be upside risk to the USD over the next 12 months as macro and policy divergence emerge between the US and major regions. We believe it is likely we will see weakness in China spill over to global growth, notably EM and EUR.

Positive – USD, GBP, CZK

Negative – EUR, CNY, TWD, NZD, SEK

Regional Equity

Asia has structural tailwinds however the cyclical outlook looks challenged with relative earning dynamics poor and increasing regulatory incursion. The US benefits from further evidence of resilient capital allocation however elevated valuations and the threat of tighter policy offset this. Cyclical growth catchup in Europe ex UK offset by structural headwinds and expensive valuations.

Positive – No conviction views at present

Negative – Europe ex UK

Sector Equity

Prefer asset light compounders with structural growth underpinning although increasingly wary of high valuations in some areas. Substantial opportunities which benefit from accelerating structural change in cyclical technology and consumer sectors. Pharmaceutical and Consumer Staples sectors offer an attractive combination of high quality and reasonable valuations.

Positive – Materials, Cyclical Tech, Staples, Pharma, Healthcare Tech

Negative – Energy, Telcos & Utilities, Real Estate, Consumer Goods

Commodities

Supply disruptions continued with lockdown measures reintroduced to varying degrees, but the severe tightness of the summer months appears to have eased. However, with inventories either still low or in the wrong places, commodity prices look likely to remain high and volatile. The impact of tightening financial conditions in the West as China looks to loosen will determine commodity performance in 2022.

Positive – Fertiliser, Energy, Aluminium, Copper

Neutral – Iron ore, Zinc, Nickel, Steel

Equity views

We have downgraded the **US equity market** to neutral from positive given the headwinds from tighter US monetary policy, higher real yields and even more stretched relative valuations. We believe these now offset the constructive fundamental drivers which had underpinned the previously positive view. Record negative real yields reflect an expectation that the US Federal Reserve will keep monetary policy exceptionally loose for the foreseeable future and that this interest rate cycle will top out at 1.5% in 2024. Recent comments from Fed Chair Powell describing inflation as a risk to both the growth outlook and meeting the employment component of the dual mandate are at odds with this market pricing, suggesting a risk that a more substantial policy cycle is required. Historically, the initial phase of monetary tightening has been firmly positive for equity returns but the starting point of such negative real yields and high valuations add particular risk factors in this cycle.

There has been a significant shift in Chinese policy communication, but we retain our neutral view on both **Asia ex-Japan** and **emerging market equities** versus **developed markets**. November's monetary policy report removed phrases around indiscriminate easing, providing flexibility to ease aggressively if needed and the Politburo statement removed the phrase that "property is for living in not for speculation", also hinting at a more lenient approach going forward. In our view, slower growth across the rest of the world and local COVID restrictions mean that the window of opportunity for reform is closing rapidly. Given the scale of the slowdown underway in China, any easing will need to be substantial if it is to have a material impact; given that stimulus takes time to have effect, any measures that generate positive surprises this calendar year need to be bold and implemented immediately.

In addition, with property responsible for such a large portion of activity, a meaningful downturn in the sector does not appear to be compatible with meeting GDP growth targets. There are indeed lower tail risks, but weak growth provides a better background for Chinese credit than equity, in our view. Weak Chinese growth and tighter US monetary policy remain headwinds for much of the

rest of emerging markets, arguing against an immediate shift to a more positive overall view. Within emerging markets, select banks may offer a potential return improvement opportunity where the loan growth outlook is improving, balance sheet risk appears relatively low, and valuations are attractive on both an absolute and relative basis. This includes **Asian financial inclusion lenders**, which combine sustainable structural growth with a cyclical recovery opportunity and discounted valuations.

We have downgraded **industrials** to neutral from positive. Cyclical support for industrials has faded over recent months as growth momentum has peaked and we look ahead to tighter liquidity and monetary policy conditions. There is some evidence that the worst of the recent supply chain problems are behind us – including in shipping markets – but we do not view an easing of supply chain bottlenecks as a clear positive for the sector even though the initial impact is likely to be positive for volumes and revenues. The risk is that lower supply disruption allows a clearer picture of the true state of underlying demand to emerge, revealing that some of the apparent strength has been inflated by over-ordering. Many industrial companies insist they are seeing little evidence of double ordering amongst their customers, although there is likely to be a tendency for corporates to downplay this type of risk.

Part of the explanation for the extreme levels of input purchases also lies in a one-off adjustment in inventory management as companies shift from running on a lean as possible, just-in-time basis, to holding increased levels of inventory as defence against short-term supply issues. Substantial use of double ordering as a route to secure scarce supplies could presage a painful adjustment once disturbed supply chains normalise, and excess capacity is revealed. We believe expectations for a reacceleration in manufacturing growth once supply chain constraints work themselves out are liable to disappointment as this will take place at a point where cyclical momentum is fading and base effects make for challenging comparisons.

Equity views (continued)

As part of this downgrade to the industrial sector we have closed our positive conviction view on **US defence**, a fairly material subgroup within the industrial sector grouping. The industry is experiencing a downturn in orders and increased costs pressures, which are both expected to be more persistent than for other industrial products given the long lead times involved in defence manufacturing cycles. Supply chain disruption is proving particularly problematic given the complexity and fragmentation of defence suppliers, and reorganising or substituting supply is not feasible in short or medium term. With no visibility on when a new growth cycle may emerge and scope for further downward revisions to earnings, we have closed the view.

We have an unchanged neutral view on **media & online retail**, although within this, we have a new positive conviction view on **Asia ex-Japan internet**. The Chinese internet sector is one of the clearest and largest (in terms of scale) long-term growth opportunities available in global markets, and we believe the phase of intense regulatory reform has created opportunities to re-enter this structurally advantaged sector at significantly discounted valuations. We have gained confidence in the regulatory outlook over recent months as greater clarity has emerged.

Our bottom-up analysis has assessed the new competitive environment, and we note that further discussion of internet regulatory tightening was absent from recent Politburo minutes. Furthermore, we see this sector as less sensitive to the near-term cyclical momentum in China given it is underpinned by this structural growth. We do note, however, that current price and earnings momentum remain weak for Chinese internet assets and it may be some time before earnings headwinds reverse given the weak backdrop for advertising spending in the near term.

Fixed Income views

As detailed in the policy review, high inflationary pressures in the US have persisted and pushed the Federal Reserve to shift its stance away from the view of ‘transitory inflation’ and more open to a faster tightening of policy. The ECB on the other hand continues to take a more dovish stance, pushing against market pricing for rate hikes in 2022 and continuing the Asset Purchase Programme (APP) indefinitely at least until its inflation target is met.

Government bonds: Given the above the team continues to have conviction in the policy divergence between the ECB and the Fed. We maintain our neutral view on **European yields**; policy remains negative due to the weaker credit and monetary impulses, and less aggressive balance sheet expansion. Growth and inflation are slowing; however, valuations remain rich. In the US, the team maintains a high conviction that real rates will rise particularly at the longer-dated end of the curve and have downgraded **US treasuries** to negative from neutral as a result. In other developed markets, we prefer **New Zealand** and **Korean** sovereigns on valuation grounds where yields have moved beyond their structural fair values.

Emerging market local currency: Emerging market central banks have been more proactive than their developed peers, building in a supportive interest rate buffer that should prove helpful on a relative basis as the US begins its own hiking cycle. Valuations remain attractive across the board, in particular in real interest rates on a relative basis. However, given the outlook for real yields in the US – which we expect to rise – we remain cautious on the EMLC outlook, and highly selective in our approach. **Latin America** remains our highest conviction region with recommendations in areas that benefit from highly elevated risk premia, such as **Peru** and **Chile**.

Emerging market hard currency: Emerging markets continue to benefit from positive growth and inflation momentum generally with the exception of China, which has diverged and surprised to the downside. We have found the swift monetary and regulatory response by Chinese authorities encouraging; while this does not necessarily mean growth will re-accelerate, this policy easing significantly reduces the risk of a property sector melt-down. Our preference remains for high yield names, with exposure tilted to individual countries rather than broad market exposure.

Developed market credit: The outlook for credit assets going forward is challenging with weakening growth and inflation momentum in aggregate globally combined with central banks, particularly the Fed, pulling back on the high levels of liquidity support we have seen. Typically, such policy tightening cycles have downside sensitivities to credit assets and hence we are negative on the asset class overall. Valuations similarly remain challenged across the board and momentum has ebbed since spreads troughed in July, driving less supportive technicals. Our preference is to shorten spread duration where convexity at the long end is constrained and our preference is for equity over credit risk at this point.

After the shift in focus of the PBOC towards growth stability in China and given the significant size of the property sector within the economy we believe the highly elevated credit spreads in the sector should begin to see some relief from targeted loosening measures. It would be inconsistent with the goal of growth stability for property growth to slow or even remain stable at this point and hence we expect easing measures to be introduced and have a shifted to express a positive view on the Chinese property credit sector.

Currency

Currency views

The **US dollar (USD)** has been upgraded to maximum positive, reflecting further evidence of policy and macro divergence between the US and other major economies. We see the US's economy performing strongly in 2022, supported by the high level of excess savings and prior money supply growth, while we expect the Chinese economy to continue to slow and for this to feed into European data, albeit with a lag, resulting in easing from the PBOC and limited policy action from the ECB. There is also an increasing risk of a further acceleration in Fed policy withdrawal, strengthening the case for further upside risk to the USD over the next year.

There is a more challenging backdrop for dynamics in **emerging markets (EM)**, and the potential repricing in US real yields means we are increasingly cautious on EM currencies, with our recommendation remaining negative. Some areas now have very high-risk premiums following rapid rate hikes, including **Chile** and **Russia**, but it would require a more benign global environment to begin shifting to a more positive stance. Under our current central scenario, tightening by the Fed will occur just as China is likely to be slowing and the PBOC is easing, hampering the outlook for EM currencies.

Our view on the **euro** remains negative, reflecting increasing evidence of weaker growth and the shift in the Fed towards tighter policy, while the ECB continues its APP indefinitely. We have recently increased conviction in this divergence, with further restrictive measures on the continent being implemented likely to hurt growth prospects. The **Czech koruna** is attractive given the degree of policy divergence that is emerging versus the eurozone, as well as the significant positive carry that has emerged as a function of Czech rate hikes. Czech koruna has been added as conviction position versus the euro.

Commodity views

2021 saw the strongest year-on-year rise (27.1%) for the Bloomberg Spot Commodity Index since 1979. Energy was the standout performer, despite the price slumping as Omicron appeared. Industrial metals and agriculture also performed well with precious metals falling modestly as the recovery in asset prices settled markets.

Entering 2022, the outlook is for tightening financial conditions in the West, the effects of which are very uncertain. Slower growth may be the result with moderating inflation but, with consumers still holding record cash levels, there is no certainty that the current strong recovery will abate soon. With commodity inventories tight in many markets, initially due to COVID-related disruptions and now because of high energy prices reducing supplies of many materials, prices may well have to rise higher to choke off demand. China's performance in 2022 will be critical for commodity prices. Slowing demand from construction looks likely, but loosening financial conditions should support activity to some extent. As China continues to focus on environmental improvements, supply of many commodities looks likely to be reduced for export markets, which should support prices.

Energy issues affecting many commodities

Higher inflation, logistical problems and rising interest rates are all on investors' minds coming into 2022, and all are themes that have been scarce in recent years. After the strong recovery in commodity prices in 2021, it is natural to be wary of further strength this year, but it is also difficult to see why prices should correct sharply in the short term. Oversupply is not evident in most commodities and in energy there is clearly tightness in Asia and Europe. Concerns over the Omicron variant dented sentiment for oil demand in early December, but this has quickly reversed as its impact appears milder. China still looks vulnerable to its spread, as its vaccines appear less effective, but if the West continues to open up then oil demand this year could exceed that of 2019. The supply side is also not without uncertainty; OPEC continues to add back production that was cut heavily during the first COVID-19 outbreak. Iranian production will be a significant swing factor in 2022, while US shale producers are embracing their new-found capital discipline, although this might be tested if oil remains above US\$70 per barrel.

Similarly, in metals, demand remains robust in most regions and inventories low. Traders report being sold out of aluminium in Europe through to Q2 2022 where premia for billet remain at record levels. Some of these orders may be 'just-in-case' or early ordering, not least as 900 kilotons per year (ktpy) of aluminium smelting capacity is under threat across Europe from elevated power prices. In zinc, significant smelter cuts (250ktpy) are also happening in Europe due to power prices and some of these may never return as plants are old with outdated technology.

Copper tight for now

Copper prices have been rangebound since June 2021 after a strong rally in the first five months of the year. The metal has been stuck around US\$9500/t, boosted by strong Western demand but held back by worries over a Chinese slowdown. Entering 2022, visible inventories are the lowest for many years and the bulls are arguing that looser financial conditions in China could boost demand in the spring just as the West is still strong, sending copper prices to new records. This certainly is possible especially with low inventories, but it is also clear that there is a wave of new supply coming in from mid-2022 to mid-2023. As this draws closer, investors are wary of getting too far ahead of the fundamentals, but with politics in Chile and Peru more uncertain following the election of left-leaning administrations and now Kazakhstan seeing unrest, the risk of disruption to copper supplies has increased. The demand story for copper is obvious as the world moves to electric power – the question is whether supply can keep up?

Commodity views (continued)

Grains grinding higher

The backdrop for the agriculture sector remains constructive, with grain prices rising into year-end. Strong demand from China and other importers is expected to continue, while supply concerns around the cooling La Nina weather pattern are developing. Sub-surface ocean temperature indices are not extreme at this stage but pointing towards the climate condition that is typically associated with dryer environments in large parts of South America's production zones. Healthy farmer profitability has led to improved consumption of inputs such as fertiliser and crop protection products. We expect this to continue in 2022 and currently favour potash and nitrogen as subsectors that should benefit. Despite cost inflation from higher energy prices (mainly natural gas) we see further margin expansion compared to 2021, in addition to volume growth.

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