

# Q1 outlook: New year, new narrative

Even though 2022 has begun with an abrupt change in the macro narrative, stoked by the Fed, we hold the line on our bullish outlook for risk assets.



**Emiel van den Heiligenberg**  
Head of Asset Allocation

Last year was a great period for risk assets, but not an easy one for investors. Our morning meetings were packed with discussions about the pandemic, inflation and China. This year is likely to be even more challenging, with lower expected returns and higher expected volatility, as Tim explains below.

Indeed, the first quarter has begun with bang, with an abrupt change in the macro narrative stoked by the US Federal Reserve (Fed), which market participants now expect to be more hawkish than previously anticipated. Nevertheless, we hold the line on our bullish outlook for 2022.

## Yield spike

Not completely unexpectedly, the S&P 500 rallied 5% in December, clocking yet another all-time high on the 29th and topping up a strong fourth quarter for a 10% return over the period.<sup>1</sup> As you can imagine, this kind of market strength does not happen too often.



Minutes from the Federal Open Market Committee's December meeting, published earlier this month, revealed that the US central bank is prepared to normalise the size of its balance sheet faster than during the previous cycle. Real yields increased, while equities wobbled.

On a day-to-day basis the correlation between interest rates and equities can be negative, especially when yields spike.

But we believe that over the longer term, at these low levels of interest rates, rising yields don't matter too much for equities until monetary policy becomes more restrictive later in the cycle. Equity drawdowns caused by spikes in bond volatility usually correct themselves when bond markets stabilise. Yields don't necessarily have to come down; they can just stop rising for equities to revert.

1. Source: Bloomberg as at 31 December 2021

## Grey swans

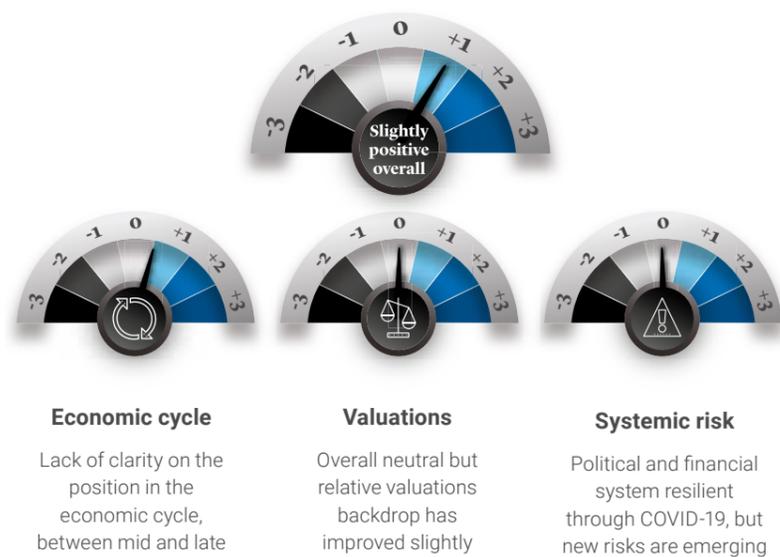
With this in mind, we hold the line on our bullish equity view, detailed by Lars and James below. Tighter monetary policy is to be expected, and our outlook is to some extent priced in, but overall liquidity conditions are still extremely loose.

Our research shows that even a late-cycle view isn't necessarily bad for risk assets as long as recession risk remains very low. Our economists think [12-month recession risk](#) will increase only marginally from close to zero at the moment.

And while equities look expensive – not least in the US – with some pundits going as far as to proclaim that markets are in a bubble, I believe [several conditions](#) of this phenomenon are not yet met. There is still plenty of money on the side lines, leverage is low, and – although stock-market enthusiasm among retail investors and the media is increasing – we are nowhere near the frenzy we saw in the 1990s.

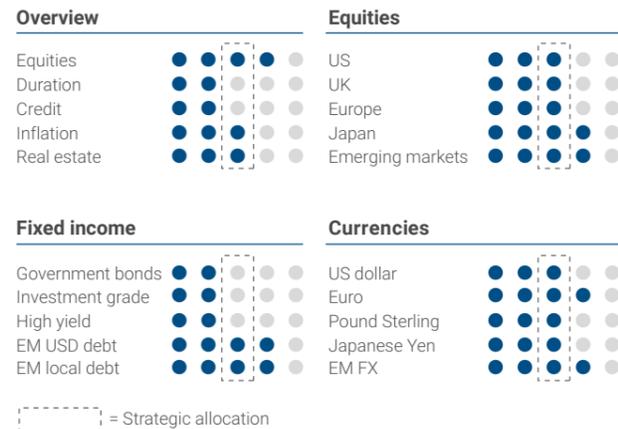
Meanwhile, we continue to watch out for 'grey swans' fluttering on the horizon. These are events that are possible but not necessarily probable, which could cause market ructions. Examples include a conflagration in the Middle East, triggered by Iran's nuclear ambitions; and another spate of leaks about governments, worsening social tensions and strengthening anti-establishment leaders.

## Summary of LGIM's asset allocation core view



Source: LGIM. Views current as at 12 January 2022. **Forward-looking statements are, by their nature, subject to significant risks and uncertainties and are based on internal forecasts and assumptions and should not be relied upon.**

## Our key asset class views



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 6 December 2021. Asset allocation is subject to change. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point. **The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**



**Christopher Jeffery**  
Head of Rates & Inflation Strategy



**Tim Drayson**  
Head of Economics

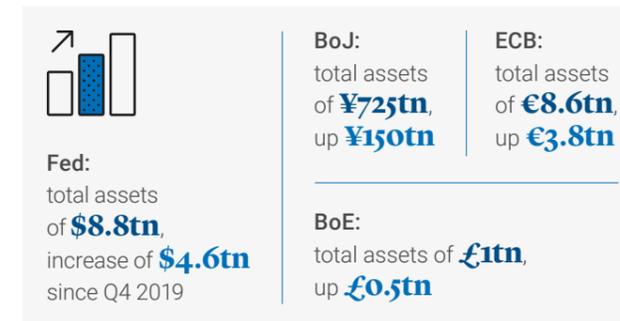
## What does the end of QE mean for markets?

Since the start of the pandemic, the combined balance sheets of major developed-market central banks have expanded by nearly \$8 trillion, with dramatic implications for asset prices. Now, as policymakers look to unwind this emergency stimulus, the process will clearly be a key determinant of the market outlook in 2022 and beyond.

Electronic money-printing on such an enormous scale has facilitated the purchases of a range of assets. And while these have been focused on government bonds, we have also seen buying of corporate bonds, commercial paper and even, in some cases, equities.

That tide of liquidity has washed through financial markets. Debate is raging about the extent to which these purchases have suppressed real yields, contained credit spreads, and pushed up equity multiples. But the direction is not really in question.

## The central bank splurge



Source: Bloomberg, as at 31 December, 2021

## The impact of QE

The stimulatory impact of asset purchases flows through two broad channels. First, by buying such large quantities of government debt, central banks have effectively bankrolled the unprecedented fiscal response to the pandemic, which prevented a protracted slump in economic activity.

That real world channel is complemented by a financial channel: by buying assets, central banks have displaced private sector holders. Investors unwilling to operate with sustained higher cash balances have driven up asset prices as they rebalance their portfolios.

We believe we have now reached the high watermark. The Bank of England (BoE) has signalled that balance sheet reduction will begin when its Bank rate hits 0.50% – a threshold likely to be reached in February. Across the Atlantic, the December FOMC minutes suggested the Fed could move quickly to 'quantitative tightening' as early as mid-year.

In continental Europe, meanwhile, the European Central Bank will probably be slower to adjust, having committed to a programme of asset purchases throughout 2022, but its run rate is steadily tapering off. And even in Japan, the talk about policy normalisation has started.

## Smooth and steady

We believe central banks will try to keep this process as orderly as possible. The BoE has laid out criteria for both a passive run-off of its portfolio and later active sales. In the US, balance-sheet shrinking can contribute to monetary tightening, but it is intended to be conducted in a smooth and predictable way.

Once the timing and speed has been determined, this will be on a relatively steady course, in our view, unless the macro environment changes dramatically. Because the maturity of their holdings is so much shorter, we think that unlike the BoE, the Fed will not have to actively sell any of its holdings to reduce their portfolio.

Markets will have to learn to cope without the presence of steady, predictable and price-insensitive buyers.

As the transfer of risk from private to public sectors goes into reverse, it seems reasonable to believe that the price of holding that risk will also have to adjust. This does not mean that the transition from quantitative easing to quantitative tightening marks the market top, but we believe it will probably entail a greater focus on fundamentals and likely heralds an increase in market volatility.



**James Carrick**  
Global Economist



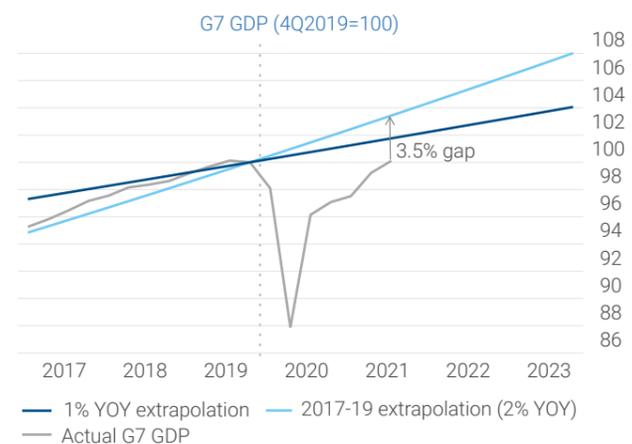
**Lars Kreckel**  
Global Equity Strategist

## Slower long-term growth and the outlook for equities

The G-7 group of advanced economies grew by 2% between 2017-2019, a number that is often used as a counterfactual to judge how much output can bounce back when economic troubles stemming from COVID-19 end. This means there's a gap of 3.5% between the previous trend and the latest GDP estimate – although, this likely overestimates potential G-7 growth.

That's because advanced economies were growing at an above-trend pace pre-pandemic, with unemployment falling to historical lows. Pay growth was picking up – albeit from depressed levels – thanks to record low inflation expectations. Extrapolating that 2% GDP trend implies even lower rates of unemployment.

### How close to full capacity are advanced economies?



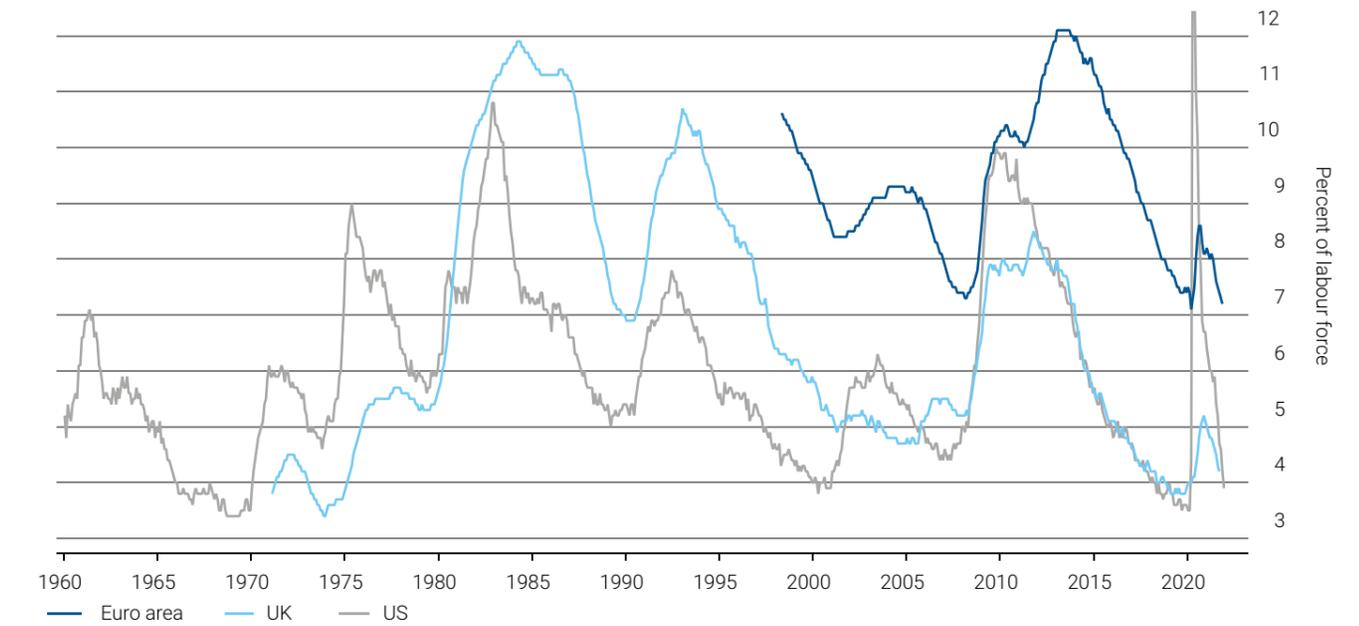
Source: Macrobond, as at 14 January, 2022. **There is no guarantee that any forecasts made will come to pass.**



The rate of G7 GDP growth consistent with stable unemployment seems much closer to 1% than 2%, in our view. Trend growth has slowed, primarily as a result of ageing populations. As time progresses, the chasm between these two trends widens further.

There's optimism that adoption of new technologies as a result of COVID-related restrictions can boost potential output. For example, working from home appears to have increased labour market participation of mothers of young children in the UK. But in the near term, the negative effects of early retirement and lack of immigration during the crisis years are bigger drags. This problem is particularly severe in post-Brexit Britain, where the stock of EU migrant workers is much lower than the counterfactual.

## Unemployment rates



Source: Macrobond, as at 14 January, 2022

### Fiscal largesse

While many manufacturing and labour market bottlenecks should ease as societies (and demand for goods vs services) revert towards normal, we worry that we'll still be left with tight labour markets.

Moreover, while memory of and expectations for inflation were depressed before the pandemic, thanks to the sharp fall in energy prices in 2015 and post-financial crisis austerity, we've seen the opposite in recent years. Bottlenecks and fiscal largesse have spurred goods prices to soar, while Europe is experiencing an energy crisis.

Tight labour markets and higher inflation expectations suggest GDP needs to slow to prevent overheating. In the near term, corporate earnings can be supported as firms pass on higher costs. But any wage-price spirals would increase recession risk further out.

### Pricing power

What are the equity market implications? In isolation, rising wages and input costs from inflation and bottlenecks clearly weigh on corporate profits. But last year's experience served as a reminder that most companies can cope well in an environment where these costs are driven higher by strong demand. Against such a backdrop, most companies enjoy abundant pricing power, with operating leverage helping profits to rise.

As a result, we believe equity investors should remain focused on recession risk, as the timing of the next bear market will most likely be determined by the timing of the next contraction. But the earnings growth generated in the period until that point will be the key determinant of how much further stocks can rise.



**Martin Dietz**  
Head of Diversified Strategies



**Patrick Greene**  
Strategist

## The role of commodities in strategic asset allocation

Commodity investments can provide diversification and hedging benefits against inflation risk, but are far from a panacea for asset allocators.

Good performance in inflationary periods is typically offset by lower long-term return expectations. As a result, the trade-off suggests a small strategic allocation to the asset class is appropriate, for the portfolio diversification benefits.

### Back in vogue

Commodities have drifted in and out of favour among investors. Having grown in popularity during the China-led supercycle in the early 2000s, they fell out of favour in the 2010s. The spike in inflation, and strong commodity performance, has unsurprisingly led to a resurgence in interest.

A key feature of commodity exposure is inflation hedging. Commodities themselves are often a driver of inflation (e.g. oil prices), but they are also real assets. These are physical goods or infrastructure that have an intrinsic value: for commodities this is linked to their use in production or energy generation. The intrinsic value of real assets tends to cause their prices to rise in inflationary periods, maintaining their real value.

Commodity exposure also typically provides diversification across the business cycle. Commodities tend to do well later in business cycle expansions, when demand is strong and commodity producers are bumping up against capacity constraints. The late stage of the business cycle is often associated with central bank tightening and greater uncertainty, when commodities can offer valuable diversification for a multi-asset portfolio.

## Roll yield and total return

These helpful hedging and diversification properties are balanced against low return expectations. Commodities do not generate a cashflow or have an associated return premium. In real terms, spot prices for many commodities trend downwards over long time periods, as technology improvements lead to more discoveries and cheaper production.

To be clear, supercycles, like the one seen in the early 2000s, can cause prolonged and significant price gains, but they cannot be relied upon for strategic allocation horizons.

In addition, investors can no longer rely on other sources of commodity returns. When the spot price is above the price of longer-dated contracts (a process known as 'backwardation'), buying the longer-dated contract can generate a roll yield – the price gain from futures contracts converging to the spot price as they approach expiration date.

Historically, backwardation added to commodity returns but over the last ten years this roll yield has been negative: -4.5% p.a. according to the BCOM index, as the chart shows. And while commodity markets are currently in backwardation, this reflects an expected normalisation in energy prices rather than a reversal of structurally negative roll yields. Enhanced commodity strategies might avoid some of this negative return, but not infallibly so.

Taken together, these mixed characteristics inform our view within the Asset Allocation team as to the appropriate exposure to commodities within our portfolios. We believe a small strategic allocation adds the hedging and diversification benefits, without lowering the expected return of the portfolio too much.



## The gap between commodity prices and the returns achieved by investors



Source: Bloomberg, as at 10 January, 2022. The Bloomberg Commodity (BCOM) index represents a diversified basket of commodity futures. It is weighted to reflect both trading volumes and global commodity production. It includes metals, energy and agricultural commodities with no single commodity accounting for more than 25% of the index. **The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

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