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Head of Multi Asset

Trevor Greetham is an investment strategist and fund manager with 24 years of experience. Prior to joining Royal London Asset Management in 2015, Trevor was Asset Allocation Director for Fidelity Worldwide Investment, where he was responsible for implementing tactical investment decisions across a wide range of institutional and retail funds. From 1995 to 2005, Trevor was Director of Asset Allocation for Merrill Lynch, advising fund manager clients on their multi asset investment strategy. Trevor qualified as an actuary with UK life insurer Provident Mutual and has a Master of Arts in Mathematics from Cambridge University.

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## Activity has recovered – what next for markets?

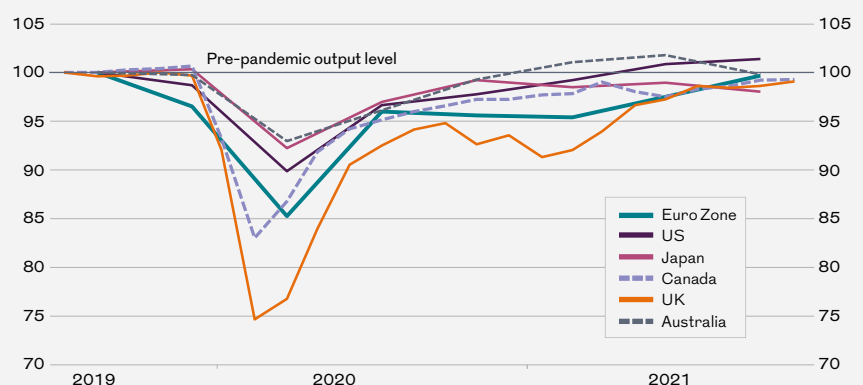
Two years have passed since Covid-19 emerged on the world scene. The appearance of the more transmissible Omicron variant reminds us that the pandemic is, sadly, not over. High vaccination rates make a return to a deep and prolonged lockdown unlikely, though, and global activity measures have made the round trip back to their pre-pandemic levels. What's different are policy settings and inflation dynamics. Our base case is that loose policy keeps global growth strong in 2022, while inflation drops from its highs as supply chain disruption eases. This backdrop should be positive for stocks, despite a gradual tightening of policy. We see clear two-way risks to growth and to financial markets, however. Broad diversification across asset classes and active management, both between them and within them, will be key to navigating the challenges ahead.

The longest US business expansion on record was followed by its shortest and most unexpected recession as the pandemic hit, with global activity plummeting and stocks suffering their worst crash since 1929. Massive policy support and the rapid development of vaccines have turned things around remarkably quickly, with economies broadly back to pre-pandemic levels (Figure 1) and global stock market indices significantly higher.

When thinking about what may happen next, we find it useful to compare the pandemic-induced interruption to activity before and after a weekend. The collapse in early 2020 was like the sudden drop in activity that happens every Friday night when most people knock off work for the week. The re-opening from summer 2020 to summer 2021 was like the revival that happens every Monday morning. Tuesdays aren't so different

**Figure 1:** Global activity levels near pre-pandemic highs

Real GDP, level (rebased), Q4 2019 = 100



Source: Refinitiv Datastream as at 15/08/2021

from Mondays and that is why the last few months have felt like a slowdown. The critical question for investors now is the underlying trend of growth and it is going to be hard to separate signal from noise for several months, especially with Omicron in the mix.

We use an Investment Clock approach to guide our asset allocation decisions, identifying different stages of the global business cycle by analysing growth and inflation trends. We have spent the last few months in 'Stagflation', with growth slowing from its breakneck re-opening pace and inflation rising. Our base case is that a drop in inflation and a pick-up in growth will see the Clock move steadily back into the 'Recovery' quadrant in 2022, which would be supportive for an overweight position in stocks (Figure 2).

While economic activity is back where it started in December 2019, policy settings are still substantially looser. Growth prospects are rosier in the US, where the Federal Reserve is still printing money and fiscal policy is focused on 'building back better' and helping the transition to a net zero carbon future. China is in a very different

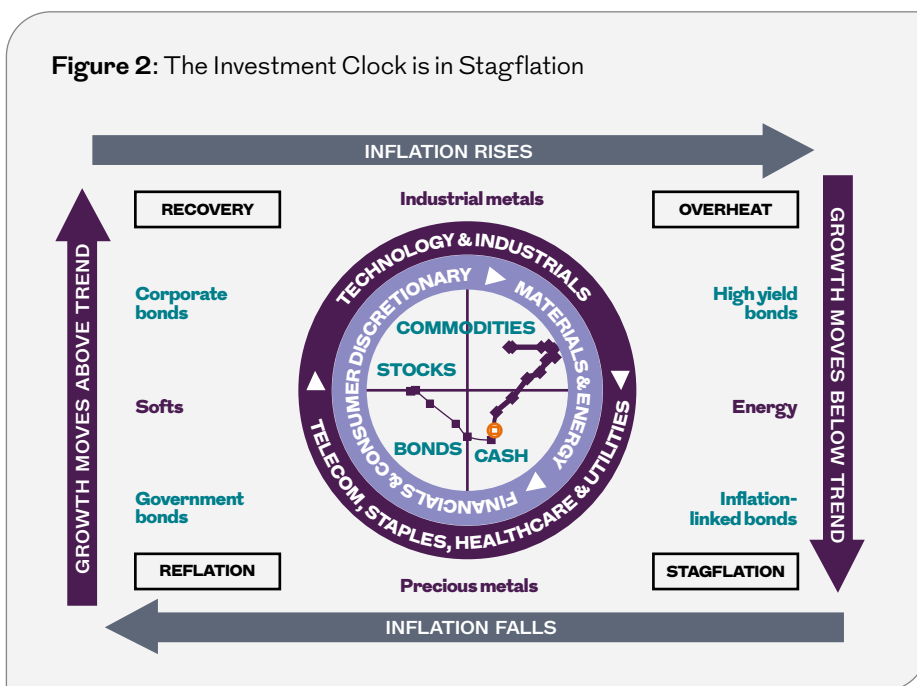
place. With its zero Covid-19 policy, there was no prolonged lockdown but there was no major stimulus programme. A wobbly property market points to slower growth. The UK sits somewhere in between. Interest rates are likely to rise, but from ultra-low levels, and fiscal policy is likely to be tightened, though with real interest rates sharply negative it is hard to believe it will be done with great conviction.

There are obvious two ways risks to growth, however, that mean we're starting the year with relatively neutral positioning at the broad asset class level. On the downside, we are already seeing the return of lockdown conditions in some European countries and these could be broadened and extended as the more transmissible Omicron variant spreads. This may not be such a pessimistic case for global equity markets beyond the initial reaction, as a further period of economic weakness would keep bond yields low as central banks push out their planned policy tightening. This in turn would probably work in favour of the US market and growth sectors like technology which dominate global indices.

It's also quite plausible that growth comes in significantly stronger than expected. The current ultra-accommodative policy environment seems out of sync with a business cycle that has already bounced back strongly. In some ways, Covid-19 merely interrupted and then supercharged a business cycle that was becoming mature. Perhaps the Omicron variant will turn out to be extremely mild, making Covid-19 more like its common cold cousins. In this sort of scenario, excessive liquidity and a return of animal spirits could trigger a 1970s style boom-bust cycle with strong growth and sustained upward inflation pressures leading to faster than expected interest rates rises. The upswing could be good while it lasted – particularly for property markets, value sectors, commodities, and resource-heavy regional equity markets like the UK – but rapidly rising interest rates would most likely hurt growth sectors and bond markets and could raise the spectre of a recession in 2023 or 2024.

With such a high level of uncertainty about the future, general investment principles are more important than ever. In the multi asset world this means ensuring you are running the right level of risk, diversifying broadly across asset classes, and employing a flexible and active tactical asset allocation approach that can adjust exposures to keep them appropriate for what could be a fast-moving macro backdrop.

**Figure 2:** The Investment Clock is in Stagflation



Source: RLAM. For illustrative purposes only. Trails shows monthly readings based on global growth and inflation indicators. Yellow dot is the current reading as at December 2021. The fainter trail is the RLAM base case projection for the next six months.

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