Drivers of global equities in 2022

Peter Rutter, Head of Equities at Royal London Asset Management, discusses his market views for the year ahead, what themes we can expect to emerge and assesses the market performance of 2021.

Peter Rutter
Head of Equities

Peter is Head of Equities at RLAM as well as the Global Equities team, and a Senior Portfolio Manager with over 19 years of experience. Prior to joining Royal London Asset Management, Peter was Head of Global Equities at Waverton Investment Management, where he worked alongside Will Kenney and James Clarke under the same team construct. Prior to this, Peter was a partner and global equities fund manager at IronBridge Capital Management for six years, where he co-managed the £3bn IronBridge Global Select equity strategy.

Previously, he worked in the Global Equities team at Deutsche Asset Management. Peter graduated from Christ's College, Cambridge University, with a starred double first-class degree in Geography, is a CFA Charterholder and a chartered management accountant (CGMA). Peter has also achieved the CFA Institute Certificate in ESG Investing.

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What worked well in european and global equities in 2021?

Semiconductors, consumer cyclicals, energy and software companies have been particularly strong areas of the market. Weaker areas were those particularly reliant on resumption in international travel as well as the temporary beneficiaries of Covid-19 disruption/lockdowns in 2020 where that boost is not filtering through to 2021, such as auto insurance.

Discuss a stock you identified early

Old Dominion Freight Line (ODFL) is an example of a company we identified a few years ago. It's done well for our clients, but we were relatively early this year in recognising the potential pricing power of this business coming out of a Covid-19 recovery. ODFL has a national network of depots and trucks in the US, moving goods in pallet size units for a very diverse range of suppliers and customers across most industries. With capacity being tight in logistics and shipping, ODFL's superior physical network, exceptionally well managed logistics operations and leading customer service, have allowed it to be selective in the business it takes on and/or generate pricing power. This pricing power alongside rising volumes as the economy recovers has led to significant profit growth which is likely to be sustained given physical barriers to entry in less-than-truckload logistics and positive network effects embedded in ODFL's business model.

Was there a stock in the portfolio which underperformed this year?

A stock that has underperformed this year has been Ocado. This company is in two parts: the first, Ocado's UK online grocery and home delivery segment may be well known to many readers; the second is Ocado selling its technology, robotics and expertise in automated grocery fulfilment centres and home delivery on a global basis. Our long-term thesis is that the cost and capital that Ocado may be able to remove from what is a very large global grocery market, alongside potentially improved customer service (more choice, home delivery, time savings) could drive structural demand and gains for this business and technology. This year has seen a relative slowdown in growth post lockdowns and the sale of technology internationally has been hampered by the lack of executives, customers and salespeople being able to travel.

Why are you positive on global equities in 2022?

We are generally positive on global equities at this juncture because we are pragmatic. An acronym currently well used by financial market commentators is 'TINA' (There Is No Alternative) and we have a lot of sympathy with this viewpoint. With bond yields, credit spreads and interest rates as low as they are, equities continue to be a relatively very attractively valued asset class. This is somewhat anomalous as absolute basis valuations are at or close to record highs, but it is the lack of any real yield on most alternative assets that leaves us what one might call 'pragmatically bullish' at this juncture. The main risk to this view would be rising interest rates and discount rates which would impact nearly all asset prices negatively, and in the equity sphere 'growth' equities would be particularly vulnerable to such a development.

There are other reasons for us to be optimistic on equities. First, we see unparalleled levels of innovation and improvement occurring in the corporate economy in areas such as software, technology, healthcare breakthroughs, green and sustainability investments, climate transition and significant efficiency improvements. This is driving corporate profit growth as companies create significant wealth for society with disproportionate levels of wealth creation. Second, inflation is likely in our view, to be a bit higher structurally (but not out of control) in part due to the Covid-19 supply chain after effects but also due to elements of deglobalisation and cost pressures from climate transition. Equities and real estate have tended to be strong inflation hedges in environments of moderate inflation, as companies can over time pass on cost increases, retaining and growing profits in real terms as a result.

How important is it that ESG continues to be embedded in your investment process?

It's always been important, but we are witnessing ever more 'ESG anomalies' in markets where either over bullishness on an ESG theme at the stock level is causing a stock to become overpriced, or there are stocks with 'hidden' ESG credentials that the market is missing which are potentially valuable.

As such, the investment value and alpha potential of genuinely insightful ESG analysis has actually risen over the last 12-24 months, in our view. An example in our portfolio is Steel Dynamics (US), which has historically rated poorly with third-party ESG ratings agencies as a result of being a steel company with relatively poor ESG disclosures. In reality, Steel Dynamics makes steel in a very different way to the majority of the industry. It uses electric arc furnaces (not coal) to melt scrap steel (not iron ore) to make high quality steel. This is the circular economy in practice and increasingly Steel Dynamics is able to source renewable electricity to power its production. So, in this case, understanding this dynamic ahead of the 'off-the-shelf' data providers is potentially to our clients' advantage, especially as the longer term rewards for such a company being part of the solution, rather than the problem, have arguably never been higher.

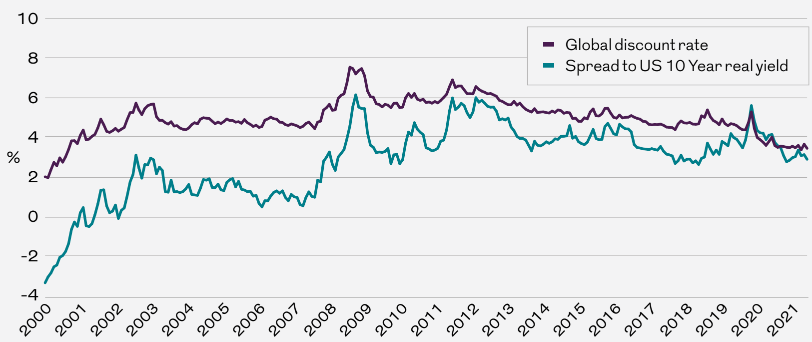
What themes will be prominent next year?

We think that interest rates and inflation will dominate the market discourse for the near future given the impact on discount rates. This will manifest itself in markets in two ways: asset prices in general and style performance within asset classes. On asset prices in general, we see a lot of evidence that the key determinant of nearly all asset prices and volatility in them is less to do with variances in the fundamentals and expected change in fundamentals for securities and asset classes but rather changing investor discount rate expectations. That makes sense to us given how low discount rates are and how sensitive asset prices have become to them (see chart on following page).

When it comes to style, there are groups of stocks in equity markets that react very differently to changing assumptions and realities for growth, inflation and discount rates. Examples might include 'quality', 'growth' or 'value' companies – depending how investors want to define them – but the reality is should we see volatility in expectations around interest rates, bond yields and inflation then we believe we are likely to see significant volatility in the performance differentials between different styles of stocks.

We therefore expect discount rates to be the dominant mover of markets and constituents going into 2022. Within that we see four themes of particular interest as we seek to understand the wealth creation and valuation of companies: First, will innovative disruptors keep delivering sales growth and surprises in innovation and disruption? There is much excitement about the potential of early-stage growth companies. However, given current valuations and expectations they need to deliver. Second, what are the credible responses to climate transition in the industrial, materials and energy economy? Third, in the event of wage inflation globally, how does that ripple through the profit structures of different companies? Fourth, what are the true long-term impacts on activity from Covid-19?

Global discount rate and spread to US 10 Year real yield



Source: RLAM, as at October 2021

What will be different in 2022?

The starting point when it comes to valuations is different. 2021 started with cautious optimism after the announcement of vaccines in November 2020. The world economy is much healed, less disrupted by Covid-19 and the outlook significantly more positive.

It didn't take much to be delivered to support markets in 2021, whereas now given price appreciation stocks and markets will need to deliver much more to sustain investor optimism.

2021 was also very much a year of recovery and 'normalisation' of the global economy and corporate economy. What will be different about 2022 will be investors coming to grips with what a post-Covid-19 world actually looks like. The complexity in this is partly cyclical and related to Covid-19 – how has the pandemic, lockdowns and disruption changed the world? It is also partly related to structural issues and challenges that were in development even before Covid-19. The structural impacts of ageing populations, potential deglobalisation, China-US economic relations and technological conflict, climate change, the long-term impact of low interest rates, significant debt burden in parts of the world economy and so on. In 2020 and 2021, many of these structural issues took a 'back-seat' as Covid-19 and policy responses dominated financial markets. 2022 is likely to see the re-emergence of investor focus on some of these significant and longer-term challenges and opportunities.

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