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OUR REVIEW FOR THE PAST YEAR & OUTLOOK FOR 2022

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Beta, Gamma, Delta, Mu, Omicron: in fact, the past year has been all about the same thing. Indeed, without any surprise, 2021 was marked by a succession of reports on the covid pandemic.

The good news is clearly that the global vaccination campaign started in early 2021 and in record time protected a large part of the world's population. Pfizer, BioNTech, Moderna, AstraZeneca: companies that were unknown to the general public three years ago are now major players in our society.

Mass vaccination also became a divisive issue in the public debate over the past year. With some countries making vaccination compulsory and others making it a condition of access to certain activities, the covid crisis gradually turned into a social crisis. Booster shots and the emergence of new variants (such as Omicron by the end of 2021) have dampened hopes of those who expected this health crisis to be over quickly. But as we have seen in South Africa, countries with lower vaccination coverage (especially emerging countries) are a potential source of new variants. This, of course, raises the question of equity among countries worldwide; in Africa, for example, but also in some parts of Latin America, the vaccination campaign is still stalled, mainly due to a lack of supply.

Since Asia and Oceania mainly pursued a strategy of zero tolerance to covid, the vaccination campaign there is also lagging behind. The emergence of Delta and then of the highly contagious Omicron seem to be signing the death warrant of that zero-tolerance strategy. Only China and Hong Kong continue on this path, while Australia has just decided to take a different course.

LOOKING BACK AT 2021

The health issue naturally leads to economic uncertainty, even though global growth is expected to be 5.8% in 2021 (after -3.1% in 2020). However, several questions remain unanswered, starting with **inflation**, which **central banks** thought was transitory but which is proving to be longer-lasting. This prompted the US Federal Reserve to accelerate monetary normalization. Rising commodity prices and transport costs, wage pressures, production cuts in Asia and shortages of all kinds have led to one of the highest inflation rates in the last 20 years (albeit from a very low base of comparison).

The aforementioned **shortages** will persist mainly in the electronics sector, and more specifically in the semiconductor sector. The explosive increase in demand for 'connected objects' in 2020 and the interruptions in production will make it difficult for companies specialising in these highly strategic chips to catch up. This is particularly true in Asia, and more specifically in South Korea and Taiwan. This situation is also a challenge for Western countries, which are now aware of their dependence on Asia.

Moreover, **Joe Biden** is taking advantage of this issue to continue the confrontation with China (which had already been started by his predecessor, Donald Trump). Initially, one would have expected the Democratic president to be more inclined to ease tensions with Xi Jinping. Instead, he continues to increase pressure on his Chinese counterpart on both trade and military fronts.

These two protagonists have their hands full in their respective countries. With Joe Biden, a large part of his time was taken up by the negotiations on a **USD 1,200 billion infrastructure stimulus package**. Other packages may follow but, given the pitfalls in the negotiations, nothing is certain. On the Chinese side, **Xi Jinping** continues to receive criticism from the international community over his handling of the Covid crisis. However, the Chinese government has decided to act on its own soil by imposing a succession of new and very **restrictive rules** on a number of companies with a "too Western" business model: Tencent, Alibaba, JD.Com, Meituan were

severely affected. These drastic decisions even wiped out the activity of certain companies active in online education.

In between these two regions, **Europe**, for the first time in its history, managed to finance a recovery plan (EUR 750 billion) based on debt mutualization between Member States and driven by the Franco-German couple. Moreover, in 2021 Angela Merkel's term of office came to an end after 16 years of loyal service as German Chancellor. As a former Chancellor, Merkel is and will remain one of the great contributors to European expansion.

Financial markets were clearly boosted by the European and US recovery plans, combined with a still ultra-easy monetary policy. This is illustrated by the performance of the **MSCI World**, which climbed 20.14% higher in USD terms in 2021. However, this impressive performance must be put into perspective as the weighting of the FANGs and their contribution to that performance is significant. Nevertheless, 2021 was a very good year for stock markets.

Some sectors have done well again, starting with the **semiconductor sector**. The SOX index, the benchmark for the semiconductor market, closed 2021 with a 41.2% price climb in USD. Riding on excellent corporate results and their systemic role, players such as ASM International (+116%), ASML (+77.8%), Nvidia (+125.3%) and Lasertec (+191.4% in JPY) performed absolutely stratospherically.

In various sectors, good **corporate results** fuelled the financial markets. Even companies hit by various shortages or rising raw material prices are still maintaining a very positive tone. Stellantis is perhaps the perfect example of this, as the company is facing a shortage of semiconductors as well as unprecedented price increases in its value chain. Production volumes have never been so low and yet the operating results are still excellent. The adaptability that the companies have shown this year has therefore been key.

However, the biggest winners of the past year were again the S&P 500 and the Nasdaq with a respective climb of 26.9% and 21.4%. In Europe, the CAC 40 is the index that comes closest to the US performance, thanks not only to the various ESG-friendly industrial companies but also to luxury goods and some banks.

Finally, we note that the **emerging markets** and, more particularly, China, are the big losers this calendar year for the reasons already mentioned. For example, the Hang Seng Tech index took a 33% hit in 2021.

On the **bond side**, 2021 can be considered quite special as this segment suffered from inflationary pressure and then from the tightening tone of central banks in the course of 2021. This was also the reason why longer maturities were disappointing: US 10-year yield peaked at 1.70%, which obviously had a negative impact. Corporate bonds, on the other hand, performed strongly in both Europe and the US. Emerging market debt was particularly affected by exchange rate volatility, especially the TRY (-40.1% against the EUR) but also some South American currencies.

On the **foreign exchange** side, the US dollar was the biggest winner among the major currencies, climbing 7.4% against the euro. The single currency was rather weak over the past year, influenced by the epidemic but also by the ECB's still very accommodative tone. The JPY also depreciated in 2021 due to a new Prime Minister and the health situation which remained delicate for a long time (especially during the Olympics). In contrast, the CHF benefited from somewhat lower global cyclical dynamics and higher inflation, gaining 4.2% against the euro.

In the end of 2021, the main headlines continued to be the rapid spread of the Omicron variant and the tense situation in Ukraine as Moscow takes on an increasingly threatening tone. What is certain is that the pandemic, geopolitics (Ukraine, Taiwan) and politics (French elections, Brexit) will remain part of the news in 2022.

And now on to a new year.

Outlook for 2022

Macroeconomic situation

Two years after its outbreak, the pandemic continues to put a considerable brake on the course of the global economy. This is unfortunately illustrated by the recent restrictions imposed in several European countries even before the Omicron variant appeared. Each forecast implicitly incorporates an underlying assumption about the evolution of the coronavirus crisis. We assume that a **further normalisation in 2022** should be possible not only thanks to medical advances (in the form of broader vaccination, including boosters and new antiviral treatments) but also thanks to the capacity of economic actors to adapt to this new situation. The vagaries of the virus should therefore lead to fewer disruptions than before, but rather to volatility and delays in the cyclical recovery. This cyclical recovery would therefore not be fundamentally called into question.

The fundamentals seem very solid indeed. Indeed, **consumers** in the developed world are benefiting from a strong labour market and from the excess savings they have accumulated over the past two years; once a broader reopening becomes possible, these savings could flow to the service sectors that suffered most from the pandemic. In the meantime, businesses have seen their profits rise sharply and have ample access to credit, which will help capital expenditures. A rebuilding of inventories should also support production as supply disruptions in some sectors ease.

Finally, **fiscal policy** will continue to have a stimulating influence by shifting to multiannual investment programmes (along the lines of the European Recovery Fund and US infrastructure plans) despite a reduction in budget deficits. Even China, which had been very restrictive in 2021, seems to be adopting a more accommodative stance after the significant slowdown in its real estate activities.

On the bottom line, **growth is expected to slow somewhat compared to the strong recovery in 2021 but to remain strong and above its long-term trend**.

The biggest surprise of the past year was the **inflationary pressure**, which turned out to be higher and of longer duration than initially expected. Of the causes mentioned above, many seem to be directly or indirectly

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related to the pandemic and thus not of a permanent nature. We therefore believe that **inflation will slow significantly in the course of 2022 but the timing and magnitude of this reversal remain uncertain**. Apart from the current disruptions, it should also be noted that the economic recovery has been faster and stronger than in previous cycles; as a result, the output gap is closing more rapidly. Given that there is greater pressure on wages and rents in the US, there seems to be more inflation risk in the US than in Europe.

In the light of these developments, the attitude of **central banks is changing** significantly. Some emerging countries have already raised their interest rates significantly. In the developed world, we can also mention Norway, New Zealand and Great Britain, which also already raised interest rates. So far, **the Fed** only reduced the pace of its asset purchases but we expect it to **raise rates twice in 2022**. As is often the case, **the ECB and the Bank of Japan** are likely to be more patient with the interest rate weapon. We can probably expect a change in the parameters of asset purchase programmes in 2022.

A less accommodative monetary policy is therefore in the offing. However, this reversal should not be seen as a major brake. It is rather a gradual phasing out of the ultra-loose policy (introduced in the wake of the coronavirus crisis) in order to stabilise inflation expectations over the medium term.

IN THE BOND SEGMENT

Despite some volatility, **long-term interest rates** have shown an **upward trend** since the summer of 2020. We expect **this trend to continue**, driven by strong growth, falling unemployment figures, first rate hikes by central banks and the unwinding of their asset purchase programmes. Currently, bonds are still priced quite high, which could ease as the uncertainties surrounding the pandemic abate. We expect **a limited rise in long-term yields** (around 2.0% for the 10-year US government bond and 0.20% for its counterpart the German Bund), especially if the expected decline in inflation reassures investors. **Nevertheless, for the second year in a row, this admittedly limited rise in long-term yields will lead to slightly negative expected returns on the main developed markets**.

In this respect, within the bond universe, we again **prefer corporate paper**. Although the risk premiums are historically quite low, they logically reflect the very strong fundamentals of the corporate sector, namely earnings recovery, debt reduction and short-term refinancing at very favourable terms. This strength is reflected not only in extremely low default rates but also in improved ratings. Barring any negative surprises in the area of the pandemic or inflation, **corporate bonds should again** outperform government bonds and manage to deliver **a modest positive return on the riskier segments. However, given the limited margin of error, continued attention should be paid to security selection and sufficient diversification.**

IN THE FX SEGMENT

As a currency, the euro generally performs well at the beginning of the cycle when an economic recovery is supported by a fairly evenly distributed low interest rate environment worldwide. This phenomenon was in fact observed in the second half of 2020. The European currency failed to rise further in mid-2021 due to surprising inflationary pressures that led to a gradual tightening of the Fed's tone. As developed central banks begin to take action, **divergence in monetary policies should weigh** on the late-movers including the ECB. **The prospect of widening interest rate differentials should favour the USD**, especially since negative yields on a large share of the eurozone bond universe are anything but inviting for many investors. However, the market is already correctly anticipating the first interest rate hikes on the US side, which means that the USD is relatively expensive, limiting further gains and tending towards an equilibrium price of EUR/USD 1.10. This does not justify massive USD buying, but rather taking up some additional USD in case of a temporary correction.

IN THE EQUITY SEGMENT

What can investors hope for after a great year on the stock market? Are the markets too far ahead of the earnings cycle? Are valuations still in line with fundamentals? Have profit margins peaked while activity levels are close to or even above 2019 levels in many sectors? Will liquidity conditions continue to support asset prices? Will the new Omicron variant undermine recovery momentum? Do geopolitical tensions pose a threat to the global economy? These questions will drive the debate in the financial community throughout 2022. Nevertheless, it seems clear to us that the main theme of this new stock market year will be inflation as it will determine the future of monetary policy.

For now, the yield curve is still being steered efficiently by central banks. Indeed, they are afraid that financial markets (spoiled by abundant liquidity) will go into a tizzy; recall the painful episode of the last quarter of 2018. The normalisation of monetary policy (gradual reduction of asset purchases) should therefore not be synonymous with a rapid and brutal rise in interest rates, at least in the short term. Nevertheless, the Fed tightened its rhetoric by acknowledging that inflationary pressures were stronger than expected and, above all, more lasting and that it was therefore appropriate to normalise financial conditions more quickly. Nevertheless, financial conditions should still remain relatively accommodative given the stable size of the Fed balance sheet and the still negative real interest rates. On the ECB side (which continues to assume the temporary nature of inflation), caution will continue to be the main tone. For the time being, the anchoring of inflation expectations and the absence of a wage-price spiral is helping the credibility of central banks, which is good for stock markets.

As far as stock market valuations are concerned, we look mainly at **the expected average free cash flow yield**. This currently stands at almost 5%, which is in line with the long-term historical average and therefore **does not indicate a bubble**. The **exception is some specific sectors such as green technology, cloud, crypto currencies, etc., which are indeed overpriced**. As for **the earnings cycle**, we expect **a continued strong trend in 2022**. Tensions in the value chain, logistics, freight, components and commodities did not prevent corporate profits from exceeding consensus expectations in 2021. Indeed, those operating profits were supported by **very strong final demand** (operating leverage) and **higher productivity** that allowed wages to increase without jeopardising profitability. Public and private investment

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programmes in numerous sectors (energy, infrastructure, semiconductors, digital transition, electrification of the automotive sector, etc.) will support economic growth well beyond 2021. These investment plans take advantage of the good financial health of the private sector and the favourable financial conditions that allow governments to finance large infrastructure projects.

The question of asset allocation remains. Much will depend on how inflation develops in the coming months. The scenario of good economic momentum combined with slightly higher than expected inflationary pressure (without getting out of control) would provide an ideal basis for the further rise in corporate profits as central banks gradually normalise their monetary policy. This background is obviously favourable for stock markets in general and, more particularly, for the sectors known as "value" (financial institutions, energy, cyclical industrial companies, raw materials, etc.). However, we cannot rule out a slightly less favourable scenario for economic growth, influenced, for example, by the following factors: Beijing not adequately supporting its economy; the US fiscal stimulus being insufficient; a higher-than-expected impact of energy prices on demand; successive waves of the pandemic disrupting activity; production constraints in value chains persisting; etc. In this scenario, which is a priori not favourable for risky assets, monetary authorities are likely to slow down the pace of normalisation of their monetary policy. This would mean that we would have to deal with negative real interest rates for an extended period of time. Investors would again be confronted with the absence of a viable alternative to equities. This will leave them no choice but to allocate a significant portion of their portfolio to equities with an undoubted preference for the growth theme (especially the US) and for defensive equities (technology stocks, pharmaceutical companies, utilities, etc.). It is still too early to choose one scenario over the other; much will depend on political decisions taken in Beijing and Washington but also on the evolution of the pandemic and, of course, inflation, each of which could increase stock market volatility. Investors should therefore **maintain a good geographical and sectoral diversification in their portfolio while avoiding taking strong bets**.

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