

# 2022 Multi-Asset Outlook



Nanette Abuhoff Jacobson, Global Investment and Multi-Asset Strategist; Daniel Cook, CFA, Investment Strategy Analyst

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## MULTI-ASSET INSIGHTS

### Key points

1. We expect COVID concerns to fade, consumer spending to persist, and the economic recovery to continue but with higher inflation and less policy stimulus. On balance, we favor equities over bonds.
2. Within equities, we prefer developed over emerging markets (EM) given China's slowdown and the hardships EM countries face post-pandemic, including slower growth, high inflation, worse fiscal deficits, and greater political volatility.
3. We are most positive on commodities, given that inflation pressures are likely to persist longer than the market thinks.
4. Interest rates are vulnerable to a broader reopening, inflation, and reductions in central bank support.
5. Downside risks include a surge in inflation that forces faster-than-expected central bank tightening or a severe China slowdown. Upside risks include a "Goldilocks" scenario (just the right amount of monetary tightening) that extends the cycle or a lift in inflation-capping productivity.

## Our multi-assets views

Asset class	View	Asset class	View
Global equities	Moderately OW	Growth fixed income	Neutral
North America	Neutral	High yield	Moderately UW
Europe	Neutral	Emerging market debt	Moderately OW
Japan	Moderately OW	Bank loans	Neutral
Emerging markets	Moderately UW	Securitized assets	Neutral
Defensive fixed income	Moderately UW	Commodities	Overweight
US govt	Moderately UW	Crude oil	Moderately OW
European govt	Moderately UW	Precious metals	Moderately UW
Japanese govt	Moderately OW		
Global IG credit	Neutral		

OW = overweight, UW = underweight | Views have a 6 – 12 month horizon and are those of the authors and the Investment Strategy Team. Views are as of November 2021, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This material is not intended to constitute investment advice or an offer to sell, or the solicitation of an offer to purchase shares or other securities.

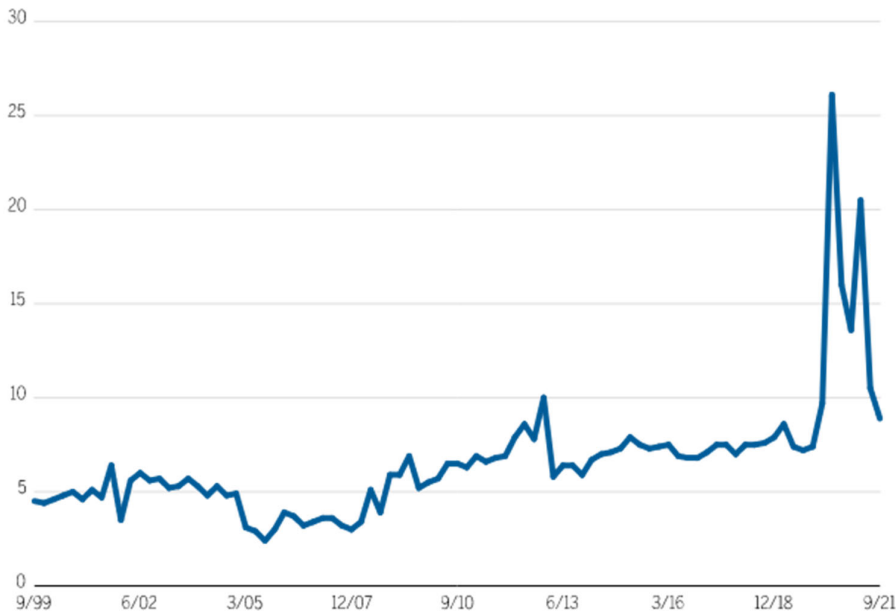
## Can central banks nail the landing?

We expect 2022 to be a year of transition, with the market’s focus shifting from COVID to the state of growth and inflation and the central bank response. Developed markets are close to moving from pandemic to endemic, with higher vaccination rates and better treatments reducing the risk of further lockdowns. Liquidity remains plentiful for consumers and companies. Consumers have bolstered their savings stockpiles significantly in recent quarters, wages should continue to increase, and spending should rise (**Figure 1**). Companies, for their part, are benefiting from ideal financing conditions, COVID-driven re-structuring, and strong nominal growth, all of which should continue and support earnings next year.

On the other hand, central banks now acknowledge that they underestimated inflation — both the level and persistence — and find themselves having to “nail the landing” by tightening policy just enough to tame inflation without derailing the cycle. In the end, we think the result will be reflation rather than stagflation, with the recovery from COVID underpinning stronger demand, especially in the service economy.

FIGURE 1

**Recent high consumer savings imply strong consumption**  
US personal savings as a percent of disposable income, per quarter



Source: Bloomberg | Chart data: September 1999 – September 2021

While the economic backdrop may not be quite as supportive for the market in 2022 as it was in 2021, we maintain a pro-risk stance and prefer to be moderately overweight equities relative to bonds, moderately underweight EM equities, and overweight commodities. As the global cycle improves, we think regions that suffered more from deflationary forces before the pandemic will benefit more from higher inflation. Thus, within equities, we favor Japan over Europe, the US and EM. Within commodities, we remain bullish on energy and industrial metals, in light of both cyclical and structural dynamics.

Turning to fixed income, we see more upside for yields in the US and Europe, and we think strong demand technicals will continue to offset rich valuations in spread markets. We also favor the relative value of EM debt spreads, particularly in corporates.

## Equities: Focusing on the benefits of inflation

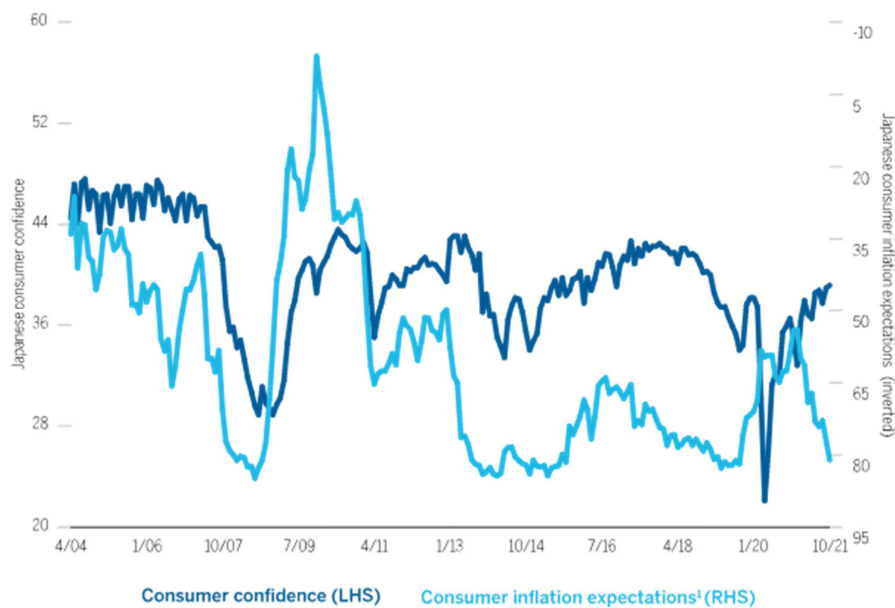
While Europe has flirted with deflation for several years, in Japan the struggle has lasted even longer. Higher inflation should incent consumers and businesses to spend and invest, rather than wait for cheaper prices ahead. On the flip side, higher inflation may be a headwind for the US, where, despite recent struggles to generate inflation, it has now moved above target, and for EM, where inflation is already much higher than target.

Japan should also benefit from a highly vaccinated population, a potential fiscal policy boost, and cheap valuations. The same arguments are true in Europe, but to a lesser extent, especially since inflation now exceeds the central bank's target. Meanwhile, the Bank of Japan faces less inflationary pressure than other central banks and, despite some early hiccups, new Prime Minister Kishida is likely to continue reflationary policies. We are encouraged that Japanese consumer confidence has shifted higher despite inflation expectations picking up, which we see as evidence that real incomes are perceived to be rising (**Figure 2**). We also think the country remains a rich hunting ground for bottom-up alpha.

FIGURE 2

**Japanese consumers bullish despite rising prices**

Japanese consumer confidence and consumer inflation expectations<sup>1</sup>



<sup>1</sup>Consumer inflation expectations reflect the net balance of those expecting higher versus lower inflation in one year | Sources: Haver, Wellington Management | April 2004 – October 2021

We maintain our neutral view on US equities. Despite valuation and inflation concerns, the economy is robust and supported by pent-up savings and rising wages. Our focus is on high-quality companies in value-oriented or cyclical sectors.

We are moderately bearish on EM, taking into account their vaccination challenges and lack of access to antivirals, potential for aggressive rate hikes to address double-digit inflation, poor fiscal dynamics, and political volatility — conditions that set the stage for a stagflationary environment. China has slowed, but there are signs of modest policy easing. However, we are concerned that until China drops its “zero-COVID” policy, a robust recovery is unlikely. Within EM, we favor commodity exporters, which should benefit from our base case of higher inflation and commodity prices.

## Commodities: An unloved asset class no more

While commodities have already enjoyed a strong run-up, we maintain our bullish view, given the global inflation picture and the historical sensitivity of the asset class to rising prices. We expect supply/demand imbalances in energy, metals, and agriculture to persist as recent underinvestment (in response to shareholder pressure) collides with increased demand. In addition, the growing effort to decarbonize the economy is helping to drive up the costs of a variety of commodities.

Against this backdrop, we encourage allocators to consider having commodities exposure, either through commodities futures, energy companies, or miners. Given ESG concerns, we favor companies that have clear plans and have made meaningful progress transitioning their business toward renewables and reducing their carbon footprint.

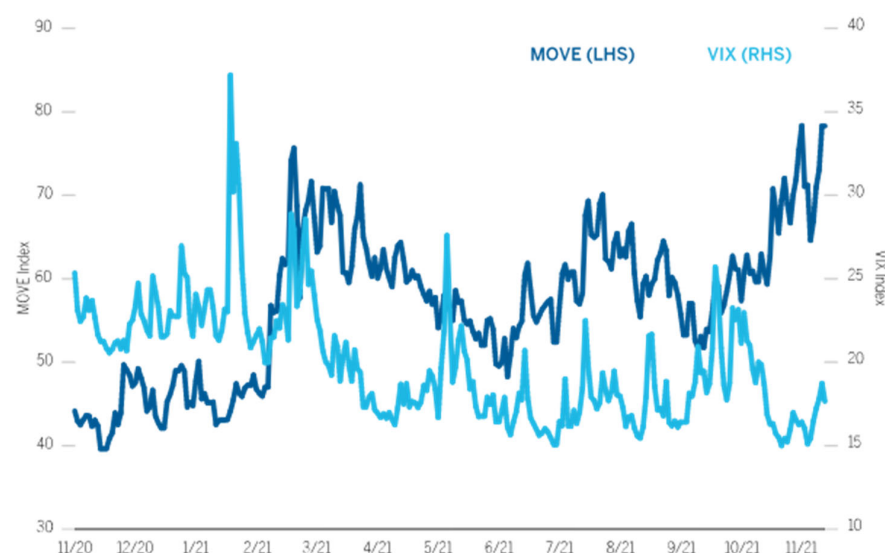
## Fixed income: Navigating unattractive valuations

We see a tumultuous period for rates in the months ahead as markets try to divine how central banks will respond to inflation pressures. We may be entering a paradigm shift for many central banks' reaction functions — one that, given higher inflation, is less focused on easing to address slower growth (**Figure 3**). As we have seen in the dollar bloc regions, markets could test central banks by pushing up the short end and flattening yield curves. That said, market expectations in the US have moved up the first rate hike to mid-year 2022, in line with the Fed forecast, so while we remain moderately bearish on US and European rates, we don't see much scope for a big rate rise.

FIGURE 3

### Could equity volatility pick up with higher rate volatility?

Move and VIX indices



The MOVE Index is a yield-curve-weighted index of the normalized implied volatility on one-month Treasury options. It is a weighted average of 1m2y, 1m5y, 1m10y, and 1m30y Treasury implied volatilities with weights of 0.2, 0.2, 0.4, and 0.2, respectively. The VIX Index is a market estimate of the expected volatility of the S&P 500 Index and is calculated by using the midpoint of real-time S&P 500 option bid/ask quotes. | Source: Bloomberg | Chart data: 12 November 2020 – 11 November 2021

In growth fixed income (credit), valuations are rich, with most spreads well inside of median levels. However, we think defaults are likely to stay very low and demand technicals are strong, as foreign demand for yield persists, and currency-hedged US credit yields are attractive to many non-US investors. Within credit, we prefer EM debt to US high yield as EM spreads are considerably wider. Credit valuations have been a reliable indicator of forward excess returns, a dynamic we continue to trust. We think Mexico, Russia, and various countries in Central and Eastern Europe are attractive.

We also prefer bank loans, which offer attractive valuations versus US high yield and could benefit from Fed tightening. Within securitized credit, we favor floating-rate structures in CLOs and CMBS. New risk-based capital factors being adopted by the National Association of Insurance Commissioners are likely to increase demand for AAA-rated and AA-rated bonds.

## Risks

Our base case is that the economic recovery will continue and demand will overtake the risks of higher inflation. Specifically, we think a high stock of savings and rising wages position consumers well to deal with higher prices. A policy mistake is a key risk if central banks are slow to react to inflation and inflation expectations de-anchor, leading to a rapid and significant rise in rates. Alternatively, if central banks are perceived to be too hawkish in their inflation policy, that could also derail the cycle. We think central banks can successfully thread the needle, but we are wary of a policy mistake.

COVID remains a risk as part of the world moves toward the indoor winter months and about five billion people remain unvaccinated, which could give rise to new variants. Unfortunately, the COVID overhang is likely to last for years in EM countries.

China's path is difficult to discern with its opaque system. If the country's credit clampdown and energy shortage become more severe or, as noted, there's no relaxation in the country's zero-COVID policy, we could see a more dramatic slowdown than expected, which could impact the global cycle.

On the upside, central banks may hit a perfect landing with their tightening decisions — a scenario that would justify a more bullish view on risk assets. In addition, our inflation concerns may be ameliorated by a pickup in productivity, though that is not likely in the near future.

Another upside risk is that antivirals, in combination with vaccines and warmer weather early next year, put an end to the scourge of COVID in developed markets, unleashing stronger consumer spending.

## Investment implications

**Stick with developed market equities** — We think developed market equities will continue to do well, but that Japan will outperform the US and Europe. Japan is likely to experience more of the benefits of inflation, given its prior struggles with deflation, and its governments is more likely to pursue reflationary policies.

**Get more selective within equities** — We continue to favor a value tilt in energy and financials and prefer cyclical sectors such as materials and some industrials. However, we think asset allocators should be more judicious about valuations in cyclical as many stocks are fully priced for a recovery. Travel and leisure is one area where valuations do not yet reflect recovery in the services sector. A key attribute to look for in any company in an inflationary environment, regardless of sector, is its pricing power.

**Remain cautious on EM** — China is key to the EM outlook and the government's credit clampdown has been engineered to wring excess risk out of the financial system, especially in the property market. Until that changes, continued sluggishness seems likely. Outside of China, countries will face major economic pressures from COVID as well as political volatility. Despite the grim overall picture, we see opportunities in commodity exporters and Central and Eastern European countries.

**Given the risks of inflation, pursue protection with commodities** — Inflation may reach higher levels or be more persistent than many asset allocators expect. While value-oriented equities may provide some protection, commodities (excluding precious metals) have historically been the most inflation-sensitive asset class. Real assets and inflation-linked government bonds may also play a role.

**Focus growth fixed income in shorter duration** — Central banks are on a tightening path, so we favor shortening duration and we prefer floating-rate structures, especially in CLOs and bank loans. Most spreads are rich, but we don't see a catalyst for them widening much. We think EM sovereign and EM corporate debt offer better upside potential from a spread perspective than US corporates and high yield.

**Maintain defensive fixed income for diversification** — While our views tilt toward an economic recovery, we think it is still prudent to consider an allocation to high-quality bonds in case of a sharp equity sell-off. A global fixed income universe gives investors more opportunity to add value, and we think Japan's central bank can support their market the longest. We think municipal bonds can play a strategic role for taxable investors, especially given the trend toward larger federal deficits. Precious metals and option strategies may provide additional ways to supplement bond exposure.

## ABOUT THE AUTHORS



### **Nanette Abuhoff Jacobson**

Global Investment and Multi-Asset Strategist, Boston

As a global investment strategist, Nanette shares her views on market trends and opportunities with subadvisory clients as well as their sales organizations and major broker-dealers and distributors. As a multi-asset strategist, she consults with clients on strategic portfolio issues and works with investment teams across the firm to develop relevant investment solutions.



### **Daniel Cook, CFA**

Investment Strategy Analyst, Boston

As an investment strategy analyst, Daniel analyzes and interprets markets and translates this work into investment insights for clients. He also consults with clients on strategic asset allocation issues and works with investment teams throughout the firm to develop relevant investment solutions across asset classes.

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