Investment Insight

INVESTMENT THEMES AND OPPORTUNITIES IN 2022 — A YEAR OF RECOVERY AND INVESTMENT

2021 was a volatile year. Although great progress was made towards recovery and reopening, the path to normality was nevertheless uneven and incomplete, repeatedly disrupted by the resurgence of the variant outbreaks and subsequent restrictions.

As we start the year, we would like to share some of our expectations for markets, industries and the companies we invest in.

We expect that 2022 will thankfully be a year of greater population immunity, either through vaccinations or natural infections. With the aid of medical toolbox options such as antibody therapy, anti-inflammatory and antiviral drugs, we are in a much better place than ever before to manage future outbreaks.

We foresee continued recovery from the impact of the pandemic, although as last year it is unlikely to be a straight line. We also believe that investment will join globalization and digitalization as major drivers for the global economy. Finally, we think that inflation and interest rates are a normal part of economic recovery and growth, and that while there will be bouts of volatility as markets react to economic data and policy changes, the positive fundamentals will prevail. That is why we remain constructive in our outlook for this year.

Equities

Healthcare and Consumer

The healthcare sector was relatively resilient in 2021 because the industry was at the forefront of developing vaccines and treatments for Covid-19. The pandemic, however, also posed challenges for the sector.

Source: Unsplash

For pharmaceuticals, the uptake for several newly launched drugs was slow as patients were reluctant to see doctors and try new therapies. In addition, vaccination schedules also had temporary impacts on the administration of some therapies. In 2022 we expect both sentiment and performance to improve over the course of the year. Our optimism is based on the relatively healthy sector fundamentals, improving pipeline prospects, attractive valuations and potential additional clarity on US drug price reform. The last point has been a significant overhang on the overall valuation of the sector and could provide a catalyst for the sector to re-rate.

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For medical technology, 2021 was a year of contrasts. Covid-19 had a disproportionate impact on companies with large exposures to elective surgeries as hospitals prioritised treatment for Covid-19 patients. 2021 was supposed to be a year of recovery, but instead turned out to be another year of delayed elective surgeries exacerbated by staff shortages.

On other hand, companies that supplied Covid-19 testing kits and materials relating to vaccine production benefited from strong demand during the year. In 2022, these headwinds and tailwinds are likely to persist as we go through waves of Omicron and potential future variants, although the impact on hospitals' ability to function is likely to be progressively smaller as we learn to live with the virus.

The long-term fundamentals for the sector remain strong. We expect continued robust pipelines and healthy new innovation cycles, coupled with strong balance sheets that allow for reinvestment, accretive M&As and share buybacks. We are optimistic that those stocks that have been hit hard in the past two years will return to a normalised growth trend which should support multiple expansions and share performance.

In the consumer sector, recovery from Covid-19 is well under way, fuelled by strong consumer demand and the windfalls from accumulated savings during the pandemic. This strong demand, together with supply chain disruptions, caused cost inflation in raw materials, logistics and in some cases wages, creating potential time-lagged margin pressure on the sector. As we progress through 2022, we expect these cost headwinds to persist in the near term but ease over the course of the year.

Over 2022 we also anticipate consumer demand to hold up, helped by low unemployment rates, potential wage increases, the possibility of more fiscal stimulus packages like the Build Back Better bill in the US, and a policy shift in China from counter-cyclical to pro-cyclical early in the year. We favour companies with pricing power that allows them to mitigate cost pressure through price increases, as well as companies with economies of scale and geographic diversity. In spirits, we expect the premiumisation trend to continue, with the on-trade continuing its recovery and the off-trade remaining resilient.

We also expect some recovery in emerging markets. In cosmetics, the return to offices and social gatherings will drive the recovery in make-up, while other categories will continue with their momentum.

In luxury, we see demand from Chinese consumers – which accounts for one-third of sector consumption and almost all of the growth – to hold up, despite the recent economic slowdown. Consumer spending should benefit from the recent return to pro-cyclical policy by the Chinese government. China's 'common prosperity' initiative should also ensure an enlarged middle-class base with an increasing appetite for the consumption of luxury goods. Recent reports by luxury companies for the Christmas quarter are encouraging.

As we recover from the pandemic, mobility and international travel will resume. This should provide a catalyst for the recovery of travel retail, which is an important growth driver of consumer driven sectors but is still at a very depressed level. Anticipated rising interest rates during the year will put some pressure on the sector P/E multiple, although growth in revenues and earnings should offset the multiple contraction over time. Together with dividend increases and share buybacks, we expect consumer stocks to deliver solid positive total shareholder return in 2022.

Digital and Technology

The Covid-19 outbreak in 2020 led to rapid growth for digital and technology companies as the pandemic accelerated many of the changes and disruption caused by digital transformation.

The timing of this growth varied by company and business and has made year-on-year comparisons difficult and often misleading. "Stay at home" companies were immediate beneficiaries in 2020 but saw slowdowns in 2021. Software companies had a slower 2020 as companies cut spending but experienced significant growth in 2021 when they realised they had to invest in their digital capabilities, in particular in CRM and other front-office applications.

Companies do not grow in a straight line and a year of strong growth can be followed by a weaker one because of the difficult comparison without threatening the company or its prospects. The market likes growth and dislikes slowdown but for us as long-term fundamental investors dislocations and disappointments are a source of opportunity.

In 2021 the broader market rose at higher rates than the Nasdaq technology index as macro concerns about inflation and interest rate rises increased and investors preferred companies with more cyclical businesses and lower price/earnings (P/E) valuations over longer-duration assets with growing businesses and higher P/E valuations. Many stocks in the technology stocks experienced significant share price declines, including several of the highest-performing companies, including Peloton, Zoom and DocuSign, which had all previously been Covid-19 beneficiaries.

S&P 500 returns were also skewed by the performance of a small number of mega-cap companies with a high weighting in the index, several of which have been long-term holdings in our portfolios.

2021 saw a large number of new issues in the form of IPOs and SPACs that flooded the market. With almost 1,000 companies being listed – approximately 400 new IPOs and 600 SPACs – investors were required to devote time and resources to examine their business models. The increased number of issues represented twice the number from last year. Many of these were technology companies, taking attention, focus and incremental money flows away from existing public companies.

The fact so many of these new listings are trading below their offer price emphasises the importance of assigning appropriate valuations to these companies. Investors attracted to new listings often have a tendency to sell shares rather than sticking with them, given the large number of available opportunities and the difficulty of having sufficient knowledge on each. We expect there to be a range of attractive opportunities in the technology sector where the share prices have been oversold, especially in companies with sound underlying technologies and business models that also have underappreciated and long growth runways ahead. As Microsoft's recently announced highly opportunistic acquisition of Activision Blizzard, one of our long-term holdings, shows, if investors are not prepared to fairly value companies because of concerns about short-term issues or valuations, there are strategic buyers that will.

The metaverse and Web3 are important new drivers for the next computing paradigm to succeed mobile. Facebook changed its corporate name to Meta Platforms and disclosed that it had invested around USD 10 billion into the metaverse this year alone. The increasing market for digital collectables and non-fungible tokens is also part of this new frontier in computing.


Source: Unsplash

It is not yet clear how the metaverse will operate and what standards it will be based on. There is no single accepted currency or code for how users will be able to move between experiences. Prior computing paradigms of mainframe, PC and mobile were created for military and enterprise needs. In contrast, the metaverse targets consumer applications and the next generation of streaming, video game and social media platforms. With the focus on consumer applications, their appeal may be subject to the whims and tastes of users. Microsoft's acquisition of Activision shows how valuable franchises, content and programming are for future success.

Meta Platforms, the social media platform formerly known as Facebook, clearly views the metaverse as a new and innovative interface. The company has decided to disrupt itself, rather than let other companies do so. The acquisition of hardware company Oculus allows Meta Platforms to develop hardware and software in tandem with its subsidiary. The metaverse also potentially allows a direct relationship with the user, compared with the current operating systems which requires users to access it through iOS or Android on mobiles or macOS or Windows on PCs. As online advertisers experienced with Apple's iOS IDFA changes this year, this reliance on proprietary operating systems as gateways to users can be highly problematic if their owners change their approach for technological, strategic or commercial reasons as Apple did with such significant impact on the information provided for the billions of users of its devices. Incidentally, we expect Apple's antitrust exposure to rise significantly as a result.

If the metaverse as developed by Meta Platforms is an open platform that allows users to have a direct link with applications, websites and each other, it could be highly disruptive to the existing providers of operating systems. It could enhance user experience, increase choice, lower dependency on individual companies and improve access. The large social networks are already grappling with issues of privacy, safeguarding and content moderation, in terms of principles and policies as well as of governance and policing, in their existing businesses, and are spending billions each year to manage them. These issues could be even more problematic in the metaverse unless proper frameworks are established early.

Edge computing is another important innovation that could emerge as the next evolution of cloud computing in 2022. The internet was built for human applications, like email, web browsing or streaming, where latency affects the user experience but does not matter to the underlying application or functionality. We are frustrated by the time it takes to load a webpage or complete an e-commerce purchase, or by the lag on our video stream, zoom call or video game. However, with more machine-based applications using the internet, such as drones, industrial machinery and autonomous vehicles, the internet relies on instant communications and latency of a few milliseconds matters. The internet will therefore need to be re-architected with more computing power located closer to applications at the edge of the network.

Providing the infrastructure for edge computing will be important. American Tower, the global leader in wireless infrastructure, has made an early first move into edge computing with its recent acquisition of the data centre company CoreSite. The success of its acquisition will depend on how mobile-phone towers combine with data centres to capture the burgeoning demand for edge computing.

2022 should also be a year of significant growth in e-commerce, after the rapid acceleration the sector has experienced in 2020 and 2021. Last year, many e-commerce companies suffered from the worldwide supply chain disruptions and hangover from the demand increases from the previous year. They have now been able to adequately expand their logistics and infrastructure to support this demand, and we anticipate that once the supply chain has been redesigned to avoid these bottlenecks, e-commerce companies will be well positioned to capture the demand and deliver a strong 2022.

Industrials

In our December Insight *Global Economic Transformation, Transition to a Net-Zero Economy and the Upcoming Super-Cycle in Capital Investment*, we highlighted that moving to a net-zero economy will require the complete bottom-up transformation of the global economy. This transformation will touch all areas of industrial activity, including the power, transportation, industrial, agricultural and building sectors. We highlighted that this process will translate into a once-in-a-generation super-cycle of investment in the global capital stock for decades to come, with a USD 3–5 trillion spend required annually to meet the stated climate goals. However, the industrial sector is facing additional pressures that translate into accelerated investment needs going forward.

The infrastructure stock of many developed countries is ageing, with the US providing one of the most notable examples. In its 2021 *Report Card for America's Infrastructure*, the American Society of Civil Engineers gave the country's infrastructure a C- rating, with 11 out of the 17 categories assessed given a D rating. For example 42% of the country's 617,000 bridges are at least 50 years old, and 46,154 (7.5%) are considered to be structurally deficient. 43% of the country's four million miles of public roadways are deemed to be in a poor or mediocre condition.

The majority of the country's transmission and distribution lines are exceeding their 50-year life expectancy, and its 640,000+ miles of high-voltage transmission lines are at full capacity.

The country's drinking water infrastructure system, made up of 2.2 million miles of underground pipes, suffers from a water main break every two minutes, with an estimated six billion gallons of treated water lost each day, enough to fill over 9,000 swimming pools. The country's 3.5 million miles of storm sewers and 270 million storm drains were built as far back as the 1970s or earlier, and are reaching the end of their useful life. Finally, the country's more than 300 coastal and inland ports – which handle over 26% of the nation's GDP – suffer from significant underinvestment, as does the associated on-dock rail and trucking connecting infrastructure.

These deficiencies not only create structural weak points in the ability to transition to net zero and adapt to the disruptive effects of climate change, but they also expose it to significant supply chain shocks. Covid-19 exposed some of these weaknesses. Following the initial economic freeze at the beginning of the pandemic, consumer demand came back strongly in the summer of 2020. As global supply chains worked to catch up with elevated demand despite Covid-related restrictions, congestion at key bottlenecks became a pressure point. At the end of November last year there were over 75 container vessels waiting to unload their cargoes outside the ports of LA and Long Beach, two ports responsible for c. 40% of imports into the US. Some of the biggest issues emanate from a shortage of drayage drivers for transporting container cargoes from ports, a lack of necessary digital infrastructure, and equipment shortages. The cost of shipping has soared as a result. In the first three months of 2020, the average rate for moving a 40-foot container from China to the US West Coast was approximately USD 1,400, yet this cost peaked at over USD 20,000 in September.

Source: Unsplash

Covid-19 has caused companies to rethink their manufacturing footprint, just-in-time inventory practices and global supply chain structures, whilst governments are similarly reassessing their national resiliency plans. This comes on top of increasing concerns regarding the effects of geopolitical dynamics on the vulnerability of global supply chains. The semiconductor supply chain is the most critical example of these concerns. Over 80% of the world's semiconductor manufacturing is located in Asia. As industrial processes and consumer goods become increasingly digitalised and connected, US and European governments are seeking to on-shore foundry capacity on the back of national security and supply chain concerns.

A fundamental rethink is therefore occurring about how to structure the global economy to meet the challenges of climate change, black swan events like Covid-19 and a shifting geopolitical landscape.

Governments are already putting financing in place to try to provide solutions to these challenges. As we noted in last month's investment insight, the Biden administration's USD 1.2 trillion infrastructure bill contains significant allocations towards climate change-related initiatives, in addition to investments in upgrading the country's road, bridge and port infrastructure. Similarly, the EU's EUR 1 trillion Green Deal seeks to transition the region's economy to net zero and drive investments in transport and building infrastructure. Company capital expenditure plans are also starting to reflect this changing landscape.

That is why we are in the early stages of a multi-decade super-cycle in industrial investments as global infrastructure, transport, factory and building stocks are redesigned to meet the challenges of tomorrow. This will create ample opportunities for companies that are solution providers in key verticals, including grid infrastructure, factory automation, sustainable buildings and digitalised supply chain solutions, amongst others. These trends will create significant structural tailwinds for our holdings across the industrial sector, placing them favourably for 2022 and the decade ahead.

Fixed Income

Multi-Asset Income

Following exceptional performance in 2020, last year was another year of strong returns. Political events and the pandemic impacted markets but volatility was contained as central banks and governments actively provided support to the global economy, and indirectly to risk assets. The year was also marked by rapid equity market rotation between economic sectors (and to a lesser extent asset classes) as investor inflows continued mostly into equities.

The Multi-Asset Income strategy delivered a very strong performance of 10% in USD terms, well above the 6–8% expected net return per annum target, including a very attractive 3.5% cash-on-cash yield. This was achieved thanks to our balanced positioning between growth companies and more economically sensitive holdings (both on the equity and the credit side).

Our outlook for 2022 is constructive. However, we are cognizant of a number of headwinds that could weigh on performance this year.

From a macroeconomic perspective, low interest rates and low treasury yields helped risk asset prices last year. The US ten-year treasury yields ended the year lower than most expectations, despite economic growth and higher inflation globally. Yields began to edge higher towards the very end of the year, when the US Federal Reserve indicated that the monetary support it had provided to the US economy since the start of the pandemic would be withdrawn at a faster pace.

Similarly, market expectations for global interest rate rises were also rapidly brought forward. Rising interest rates imply higher market discount rates and impact asset class valuations and price performance. We believe that interest rates will remain low for a reasonably long time and expect the recent sharp increases in input prices to subside in the first part of this year. However, any negative surprise on inflation could disproportionately impact longer-duration and higher-valued equities. On the positive side, yields have corrected to a greater extent short-term than long-term so we would expect short-term yields to be less impacted in the medium-term. This should benefit our fixed income portfolio, which we intentionally built with a short three-year duration. Energy prices recovered steadily last year but many energy securities have not fully reflected the more positive outlook for the sector. Part of this lag is explained by ESG concerns but we also believe that energy transition to mitigate global warming can only be achieved progressively and with the help of the strong cash flows generated by legacy producers. We expect the energy-related holdings in our fixed income portfolio (such as *Tullow Oil*, *YPF*, *Kosmos* and *Pemex*) to gradually reflect improvements in profitability, cash flow and credit quality over the course of the coming year.

2021 saw few major political events, with almost no major elections. By contrast, this year countries including France, Italy, Brazil and the US will hold major elections, with news flow that could add to overall market volatility. The lead-up to the US mid-term elections in November especially could impact on the deployment of the fiscal package negotiated between the two main US parties. Turkey has no election scheduled this year, but a presidential election is due to take place in 2023. We reduced some of our high quality long-term holdings in Turkish bonds to reduce our exposure ahead of the recent turmoil and are now looking to buy them back at attractive returns.

After an exceptional year that saw very high GDP growth and extraordinary earnings growth, we expect some level of slowdown consistent with the pattern of the recovery from the pandemic. Our balanced asset allocation has allowed us to generate strong returns with low relative volatility over the past two years of the pandemic. Our portfolio offers a combination of visible earnings growth potential for our equities and attractive yields and improving credit quality for our credit holdings, which have a (7.3% current yield and a 9.3% yield to maturity. We have focused our efforts on further diversifying the portfolio whilst improving its quality, including through the addition of a number of high-quality investment trusts to our alternative investments.

We look forward to another year of solid performance, strong cash generation and low relative volatility.

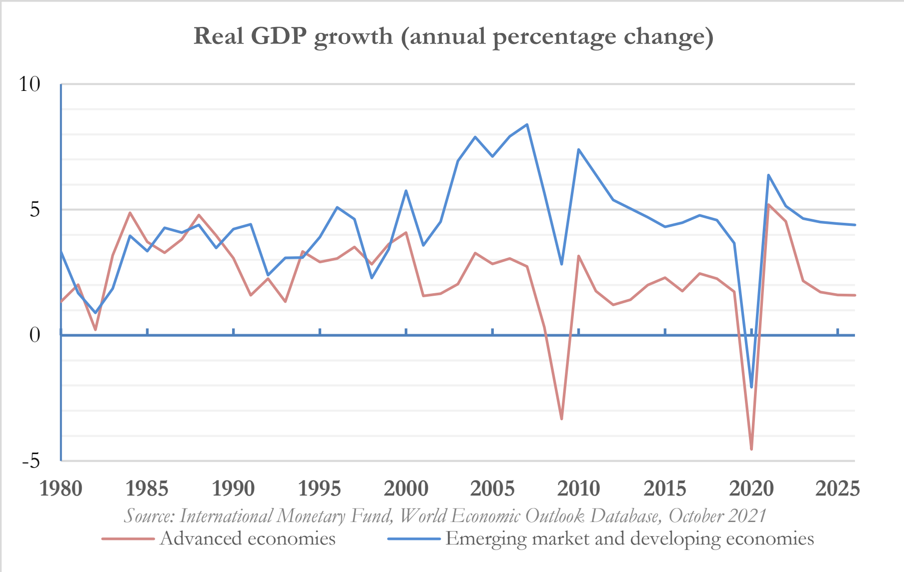
Emerging Market Bonds

2021 was a challenging year for corporate debt in emerging markets (and for most other fixed income asset classes). Improved credit fundamentals supported by the economic recovery occurred in some regions, competing with macro factors in higher US interest rates and politics/policy-induced volatility. While these overarching dynamics are likely to remain in place despite slower global economic growth, there are compelling reasons for a constructive outlook.

Global growth is set to continue into 2022, albeit at a slower pace as we set out on a path of normalisation after the anticipated post-pandemic bounce-back. The IMF is forecasting developed markets (DM) and emerging markets (EM) to grow at 4.5% and 5.1% respectively in 2022, and both of these forecasts are still above pre-pandemic trends. This narrow

EM/DM growth differential is likely to be temporary as policy support in DM (particularly in the US) is withdrawn. Regional growth should revert to trend with EM being the dominant growth engine once again.

Within EM, near-term growth is unlikely to be synchronised. Countries at earlier stages of reopening their economies and commodity exporters should see faster economic growth. On the other hand, economies that have been quick to tighten monetary policy in response to rising inflation are likely to see somewhat slower growth.



As the global growth recovery moves to the next stage of the cycle, sectoral and country differentiation will start to play a bigger role and synchronised moves in EM corporate debt will become less likely. This is clearly illustrated in default rate expectations, which stand at 3.9% for EM as a whole in 2022, or at a much more benign 1.1% when excluding China.

Commodities, and particularly energy, are likely to perform strongly. Oil prices should be well supported given robust demand from the return of global mobility and the release of pent-up demand from consumers and corporates, along with relatively tight supply thanks to cautious OPEC production increases and falling global inventories. We continue to see attractive opportunities, particularly in the CEEMEA region, where companies can de-leverage their balance sheets at USD 60 per barrel, well below the current value of USD 80 per barrel. There are similarly tight balances across industrial metals and agriculture that have propelled these sectors to higher levels.

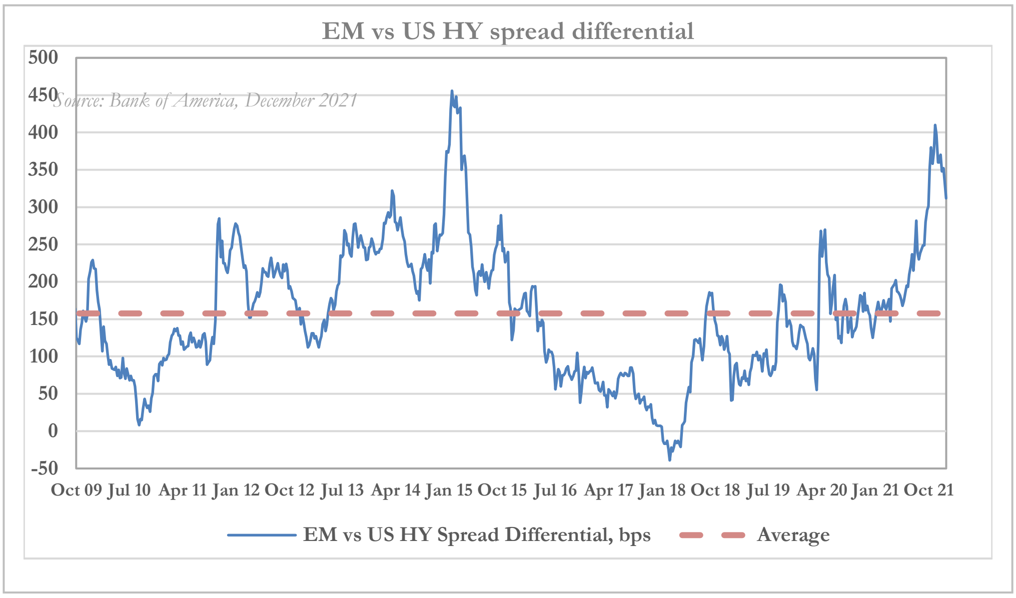
We also have a constructive view on the financial sector. EM banks generally entered the pandemic with large capital buffers and robust profitability, meaning they were able to weather domestic pandemic-induced headwinds. Although we are not out of the woods yet, going forward, economic recoveries should continue to support loan growth and better net interest income whilst visibility. Asset quality has been better than expected so far and should continue to improve. We remain positive on telecommunications, given appealing demographics, increased data usage and ongoing digital transformation. We are also optimistic regarding some utilities transitioning to renewables that are set to benefit from government targets to achieve carbon neutrality, whilst also having inflation-linked contracts priced in US dollars.

Political risk may create intermittent volatility and provide opportunities. In Turkey, the government's persistent use of unorthodox monetary policy to tackle inflation saw significant depreciation of the lira last year, leading to political unrest and calls for an early presidential election (which is currently scheduled for June 2023). Should this materialise, and should President Erdogan lose, we could see market re-engagement for strong Turkish corporates which have diversified business models and strong balance sheets.

In Latin America, concerns about fiscal credibility in Brazil have already led to market stress, and general elections in October 2022 may cause further volatility given the resurgence of left-wing former president Luiz Ignácio Lula da Silva, whilst underlying corporate fundamentals should remain robust given the export commodity nature of many business models. Both Argentina's ongoing negotiations with the IMF and Mexico's potential recall referendum on President Andrés Manuel López Obrador could also lead to uncertainty.

From a technical angle, EM corporates look favourable in 2022, with increasing investor allocations to EM and minimal net financing requirements. Specifically on the demand side, we could see a reallocation between US high yield (HY) and EM corporates, given the outperformance of US HY seen last year, which means the spread differential between the asset classes has widened to levels not seen since 2015 – especially considering that net leverage in EM corporates is approximately one to two times lower than that of DM comparables.

This environment of robust stand-alone corporate fundamentals, low default rates and favourable technicals should be supportive for EM corporates, with the main headwind coming from a potential further repricing of the US treasury yield curve. However, given the moves seen so far (a 100 basis points and 80 basis points widening in three-year and ten-year



US treasury notes, respectively, over the last 12 months), our view is that much has already been priced in, and that there is even some room for credit spread compression in the year ahead. Our EM corporate debt strategy is well positioned to navigate this environment and deliver on its total return targets of 4% to 6%, primarily through income yield not capital gains. The portfolio currently has an average yield to worst of 7.3%, an income yield of 6.7% and a short average duration of 3.2 years.

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