BERENBERG INVESTMENT REVIEW QUARTER 4 2021

Foreword

It feels right to be more optimistic about the future than twelve months ago. Notwithstanding the recent emergence of restrictions due to Omicron, we have greater societal and technical commitment to tackle Covid head on. We also remain hopeful that 2022 will bring a more equitable spread of treatment to countries and communities who have not benefitted from a rapid vaccination rollout like that seen in the UK.

New variants are probable but so are evolving vaccines and business models. The adoption of new technologies in business has accelerated in the last couple of years and alongside the focus on decarbonisation and economic changes post pandemic, it is not an exaggeration to suggest that we have entered a new phase for financial markets.

An increasing caution on the outlook for risk assets follows naturally after three years of rising equities. Inflation has risen sharply recently and how central banks react will be crucial for markets this year. Long term investors are having to select from a reducing list of investment options.

As my colleagues write, this year will see corporate profitability become more important, rotation between asset classes become more pronounced and policymaking in economics and politics become more decisive and diverse. Investors will face more tough decisions and tests of nerve this year.

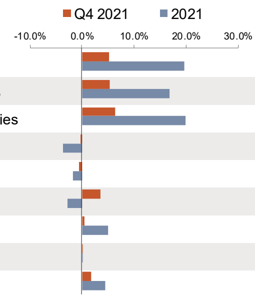
Despite the significant uncertainties of 2021, we enjoyed a successful year both in terms of portfolio performance and business growth. Although it is likely to be similarly challenging, we are confident that together we will enjoy similar success in 2022.

Yours sincerely,

Richard Brass
Head of Wealth & Asset Management, UK

SECTIONS

Chart 1: Multi-asset performance (Q4 2021 and YTD)



12 Month Performance Over Last 5 Years

	31/12/21 - 31/12/20	31/12/20 - 31/12/19	31/12/19 - 31/12/18	31/12/18 - 31/12/17	31/12/17 - 31/12/16
UK Equities	19.6%	-13.2%	16.4%	-8.8%	11.7%
Europe Ex UK Equities	16.9%	7.6%	19.8%	-9.9%	15.9%
World ex Europe Equities	20.0%	15.3%	22.3%	-2.4%	12.8%
Gilts	-3.7%	3.6%	2.6%	1.0%	0.7%
Corporate Bonds	-1.8%	6.3%	8.8%	-1.2%	4.8%
Gold	-2.8%	21.6%	13.7%	4.4%	3.6%
Alternatives	5.1%	0.7%	6.3%	-5.8%	5.5%
Cash	0.1%	0.2%	0.7%	0.6%	0.3%
Sterling (T/W)	4.4%	-1.8%	5.0%	-1.5%	1.0%

Source: Bloomberg Finance L.P.
Total Return in Sterling to Close of Business 31/12/2021

Q4 asset performance

We entered the year with optimism and whilst it was a good year for riskier assets, 2021 will not be missed. The year was replete with a number of gyrations related to the pandemic.

In early Autumn Covid-19 cases were falling which meant economic recovery was again in vogue – and cyclical assets outperformed to the middle of October. Monetary policy prognostications and procrastinations from the Federal Reserve and the Bank of England respectively created enough uncertainty to give markets pause for thought just in time for the emergence of the omicron COVID-19 variant to spook markets.

In the event, returns for equities were positive in Q4 in both local currency and sterling terms, except in the emerging market segment. Gilts and corporate bonds struggled to make any headway whilst gold enjoyed a strong quarter on the back of a difficult year. After a volatile year, sterling ended stronger.

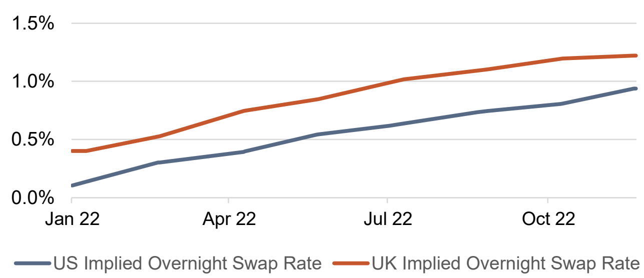
Inflation prompts global monetary policy normalisation

2021 saw global aggregate demand notably recover after its Covid-19 induced slump the year prior. However, a variety of factors caused supply bottlenecks combined with a notable rise in energy prices, which meant that this demand spike could not be met with an offsetting supply recovery. The net effect from the imbalance has driven inflation in most regions higher than initially forecast for the year and has left central banks playing catch up as they seek to temper the impact of rising prices.

The Federal Reserve was the first major central bank to tilt its stance hawkishly. The US has been grappling a tight labour market in addition to rising inflationary pressures, and thus the shift was widely anticipated by markets. While base rates remained static in the 0% – 0.25% region, the central bank announced an accelerated pace of the tapering of its asset purchasing programme which would therefore end by March. Following this, interest rate hikes would come to the forefront. We expect 4 x 25bp increases in 2022.

The Bank of England hiked rates for the first time since the outbreak of the virus, raising its main interest rate to 0.25% from 0.1% previously, making it the first of the major developed banks to begin hiking rates. The move caught markets largely by surprise, as in November, as the Monetary Policy Committee was overwhelmingly against raising rates contrary to markets expectations, by a vote of 7-2. Therefore, the complete U-turn in December which saw votes in favour of raising rates come in at 8-1 signalled a stark change in stance from the bank in its approach to tempering inflation pressures, which was stated as a medium term concern with the headline rate hitting 5.1% in November, the highest level in 10 years.

Chart 2: UK & US overnight interest rates implied by the swap futures market



Source: Bloomberg

Omicron takes centre stage

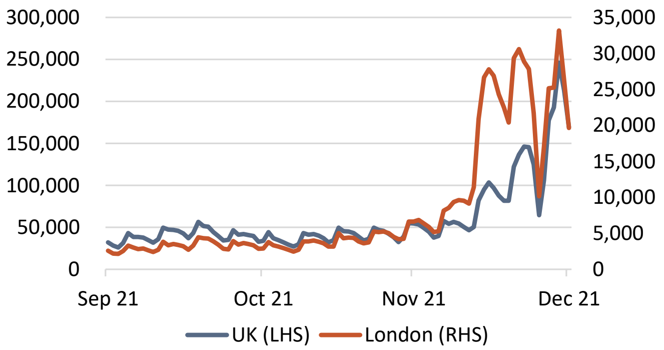
Towards the mid-point of the fourth quarter, markets turned their focus to the new Omicron variant of the Covid-19 virus that had emerged in South Africa. Coupling the emergence of the more infectious variant with the seasonality of viral infections, the number of recorded cases globally rose sharply.

Market volatility increased significantly in the wake of the discovery of the virus, particularly given the extent to which the virus had mutated and that early research showed it was more contagious than the previous delta variant.

Soon after the virus was detected within South Africa, cases began to emerge within the United Kingdom. While the virus spread rapidly across the region, most notably in London, towards the tail end of the month of December, the rise has begun to abate, thus alleviating its effects on market volatility.

Of greater concern than the rate of transmission is the danger to health from contracting the virus. Early data suggests that symptoms following from contraction of the virus are milder than that of the delta variant, given the variant primarily affects the upper respiratory tract rather than the other variants which affected the lungs significantly more and thus lead to more severe health issues. Although several nations, notably European, increased Covid-19 induced restrictions over the later parts of December, we have already began to see easing, which has alleviated concerns that the delta induced global lockdowns we saw in the first quarter of 2021 will not be necessary.

Chart 3: Number of new Covid-19 cases by specimen date



Source: UKHSA

Corporate earnings steady the ship

Given the prospect of interest rate hikes combined with rising inflation and a new variant of Covid-19 dominating the majority of the fourth quarter, it might seem nonsensical that equity markets delivered such strong returns, particularly given such a weak September. The explanatory factor was the strength of corporate earnings in the Q3 reporting season which calmed fears of companies missing expectations.

The primary concern was margins and the ability of businesses to maintain profitability in the face of rising input costs.

Fortunately, overall companies delivered better than expected results, with c.80% of S&P 500 companies beating analyst expectations, while c.60% of the European Stoxx 600 companies similarly beat earnings estimates.

Although the robust earrings seasons gives some evidence that corporates have been able to mitigate some impact of input cost inflation through passing through price rises or by improving operating leverage, an increasing number of firms are citing inflation as a risk to forward looking earnings. As we enter 2022, the base effect of Covid-19 induced economic disruption will begin to recede, making earnings comparisons to the prior year a more difficult task to demonstrate strong year over year growth.

Portfolio Review

2021 was another good performance year. In absolute terms, all our equity focused multi asset strategies enjoyed double-digit returns, with relative returns of around 5% and above ahead of benchmarks. More bond focused multi asset mandates did not fare as well, but even here returns were positive in absolute terms and well ahead of their respective benchmarks.

During the quarter we reduced equities a smidgeon to account for performance drift and made some stock selection changes. In asset allocation terms this meant increasing our exposure to China and UK mid-caps. We also sold our exposure to sovereign index linked bonds as the expectations for inflation baked into their valuations was, in our opinion, excessive. We will revisit index linked bonds at more favourable valuations.

We hold positions in both gold and industrial metals, whilst retaining a large underweight to sovereign bonds (preferring investment grade credit with some high yield). Our interest rate exposure very limited. We have a moderate overweight in equities and prefer assets in Europe, and small and midcaps. We still like technology and healthcare despite the difficulties that the rate environment might engender as it is here that we find the highest growth and most innovative opportunities.

Outlook

The global economy is currently going through a transitionary phase from recovery to mid-cycle, but fundamentally several factors support the outlook – pent up consumer demand from lockdowns, the need for companies to rebuild their inventories and increase investment in technology and the strong labour market are just some. Signs that the Chinese economy is stabilising are also welcome. Although fiscal and monetary support remains supportive, the impact is beginning to slow and supply bottlenecks and labour shortages are hampering output.

The extent to which inflation is transitory or persistent is really a question of time horizon. Several factors support a declining inflation rate in 2022. Energy prices should stabilise and supply bottlenecks should be unwinding by the end of the year, both of which have a significant base effect. We expect US inflation to be around 3% by year end, for instance. However, a number of issues persist – labour market tightness is likely to mean a period of wage inflation, especially in the US. This is largely caused by people leaving the labour force and whilst they may be tempted back by higher wages and improved job availability, this reversal took several years after the Great Financial Crisis.

Longer term issues tilt the risks to inflation to the upside - like declining working age populations and deglobalisation of trade, as countries attempt to secure their supply networks in a more fractious world. Decarbonisation is also likely to be inflationary as everyone rushes for the door at the same time.

Labour force dynamics are a headache for the Federal Reserve. They have met their objective of full employment, but labour force participation has fallen significantly and they cannot wait for this to reverse ; emergency policies need to be removed now that the crisis is over. The central bank reaction function to rates of inflation this year will be critical for capital markets. Should inflation prove stickier than anticipated they will be forced to hike faster which will result in a disorderly correction. If inflation does fall and settle at a lower rate than anticipated, an environment of falling yields and strong growth would ensue.

In a central case, there is little room for valuation expansion in equity markets and so positive returns will be dependent upon the environment for corporate earnings. Whilst many sectors will face margin pressures, and earnings growth will be much slower in 2022, it is still expected to be in double-digit territory in aggregate with upside potential from there. This should mean decent if not spectacular returns for equities in 2022. There will however be significant periods of rotation between defensive and cyclical assets. Larger sell-offs are more likely as markets flit between optimism and uncertainty.

Government bonds remain outright unattractive and are even losing their diversification benefits; corporate bonds still offer some carry, but this is expensive meaning that higher returns can be found in high yield segments. The outlook for gold is more challenging as we expect real yields to increase the opportunity cost of holding it, but in a world of expensive insurance, it remains a diversifier. Industrial metals should do well.

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Data Sources

UK Equities	MSCI UK Net Total Return Local Index
Europe Ex UK Equities	MSCI Daily Net Total Return Europe Ex UK Euro
World ex Europe Equities	MSCI ACWI ex Europe Net Total Return USD Index
Gilts	IBOXX GBP GILT TR 5-7
Corporate Bonds	IBOXX GBP CRP TR 5-7
Gold	Gold USD Unhedged
Alternatives	Hedge Fund Research HFRU Hedge Fund Composite GBP Index
Cash	ICE LIBOR GBP 1 Month
Sterling (T/W)	UK GBP Broad Index 2005=100 Trade Weighted

Important Information

For the explanation of used terms please visit our online glossary at http://www.berenberg.de/en/glossary

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