Investment Strategy

Quarterly Investment View | January 2022

بنك أبوظبي التجاري
ADCB
ASSET MANAGEMENT LIMITED

2022 Outlook: Catch'22

Global economic growth was strong but uneven in 2021; inflation proved less transitory. Looking ahead, should economic growth start to moderate and inflation appear to remain more persistent than initially expected, central banks in developed markets could face a catch-22 situation. The risk is a 'perceived' policy misstep. How should investors position under these scenarios?

The one macroeconomic aspect that we would be monitoring closely over the course of next 12 months is the interplay between the growth-inflation mix and the conduct of monetary policy. At least over the first half of 2022, the tug of war between slowing growth and higher inflation is likely to influence the policy and the direction of financial markets. Based on this, we frame a base case scenario and a downside risk scenario for financial market assets during 2022. From a macro viewpoint, our base case scenario assumes a faster moving global economic cycle with most economies transitioning into a mid-cycle environment. However, such transitioning is likely to be asynchronous across the constituents. Inflation is likely to start moderating in Q1 and central bank policy will be appropriate for the growth-inflation mix. The downside risk scenario, which still has lower probability in our assessment, sees an unfavorable growth-inflation blend and an inappropriate central bank policy. On pages 2-3 we discuss our investment strategy around these scenarios, and on pages 4-5 we present our portfolio positioning.

Fixed income (pages 6-7): We maintain an underweight stance on fixed income. We believe that 2022 could prove to be another challenging year for the asset class. Inflation uncertainty could continue into 2022 with Omicron further delaying the normalisation of supply chain issues. However, the dominant drivers for the fixed income performance will be the central bank policy and its prospective impact on growth and inflation. With the Fed hitting brakes on loose monetary policies, we expect UST yields to rise across the curve in 2022. We maintain our short-duration overweight stance on US Treasuries.

Equities (pages 8-9): We are neutral equities. 2021 marked the third consecutive year of double-digit returns for global equities. Last year's returns were driven by earnings growth while valuation multiples contracted. In 2022, we estimate valuation multiples – driven by monetary tightening – to fall further but earnings growth to remain strong. We see clear upside to the I/B/E/S consensus 2022e earnings growth for MSCI ACWI (c7% currently). We discuss our base case scenario (of a higher single digit returns, with highest probability), downside risk scenario (of negative returns, with low probability) and an upside risk scenario (of double digit returns, with lowest probability).

Alternatives (pages 10-11): We stay neutral alternatives which offer a range of opportunities to diversify. Energy prices are likely to stay elevated as the market begins to balance into a new supply-demand regime. For oil prices, we see potential for some downside in Q1 2022, and upside beyond that for the following 12 months. For the longer-term, demand outlook remains uncertain given the energy transition. We discuss carbon credit as an opportunity to diversify and hedge some carbon risks to the portfolios. We reiterate our overweight on gold given the political and geopolitical risks on the horizon. Decoupling of gold prices from real rates in 2021 means any backup in rates is not a major risk.

Currencies (pages 12-13): We expect the differences in central bank policy action to drive currency markets in 2022. Decisive hawkishness of the US Fed has helped the USD thus far but persistent twin deficits and moderating growth outlook in the US could cause some weakness in the greenback. Whilst the GBP appreciated against the EUR during 2021, it stayed flat against the USD. This was mainly on account of market expectations of a shorter BoE rate hike cycle versus the Fed rate hike cycle that runs into 2023. Given the high uncertainty around the BoE's monetary policy outlook in 2022, the pound sterling could experience bouts of volatility over the year.

Kishore Muktinutalapati
Equity Strategist
Tel: +971 (0)2 696 2358
kishore.muktinutalapati@adcb.com

Prerana Seth
Fixed Income Strategist
Tel: +971 (0)2 696 2878
prerana.seth@adcb.com

Mohammed Al Hemeiri
Analyst
Tel: +971 (0)2 696 2236
mohammed.alhemeiri@adcb.com

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The one macroeconomic aspect that we would be monitoring closely over the course of next 12 months is the interplay between the growth-inflation mix and the conduct of the monetary policy. At least over the first half of 2022, the tug of war between slowing growth and higher inflation is likely to influence the policy and the direction of financial markets. Based on this, we frame a base-scenario and a downside risk scenario for financial market assets.

On the economic growth front, we have a good news and a bad news. The good news is that, in absence of any exogenous shock, the chance of a global recession during 2022 is relatively low. The bad news is that growth rates across the board are likely to moderate over the next few quarters from very strong growth rates of the past few quarters. Of course, this moderation will still leave the growth rates at strong levels – in many economies above their potential. Also, as we had highlighted in the past, in aggregate the global economy is moving from the early-cycle phase into a mid-cycle environment and arguably this cycle is moving faster than normal (see Quarterly Investment View: July 2021). However, market participants who believed that most major global economies would rebound from the slump in a lockstep, have been disappointed in 2021 (see Quarterly Investment View: October 2021). This asynchronous journey is likely to continue into 2022. So, the mid-cycle transition of this faster moving asynchronous cycle creates opportunities and risks for investors over the next year. Such transitions are usually associated with higher uncertainty and financial market volatility. However, as the cycle matures into a new normal, uncertainties should start to diminish and provide a reasonably clear path for financial markets.

Inflation has proved more persistent than initially expected thanks to lasting supply side bottlenecks. However, there are reasons to expect that inflation rates – which measure year-over-year change in consumer prices – will moderate in Q1 of 2022. Yet, the glide path of inflation – especially relative to growth – will be the key trend to watch. The risk here is that inflation could stay elevated for longer than expected creating a negative growth-inflation mix.

Speaking of risks, there are quite a few facing the global economy in 2022. These include:

- Persistent inflation
- Sharper slowdown in economic momentum
- New variants of the COVID-19 virus that escape vaccine efficacy
- Higher-than-expected fade in fiscal stimulus
- Increased tech regulation in the US
- Escalation in US-China trade tensions
- Higher corporate and personal income taxes in major developed markets
- Risks around political events like the US-midterms, 20th congress of the Chinese Communist Party, presidential elections in France and South Korea, Chief Executive Election in Hong Kong, and general elections in Brazil.
- Also, geo-political risks in certain geographies (US-China, US-Russia, US-Iran) are worth monitoring too
- However, in our view, the biggest risk is a potential policy misstep by the central banks.

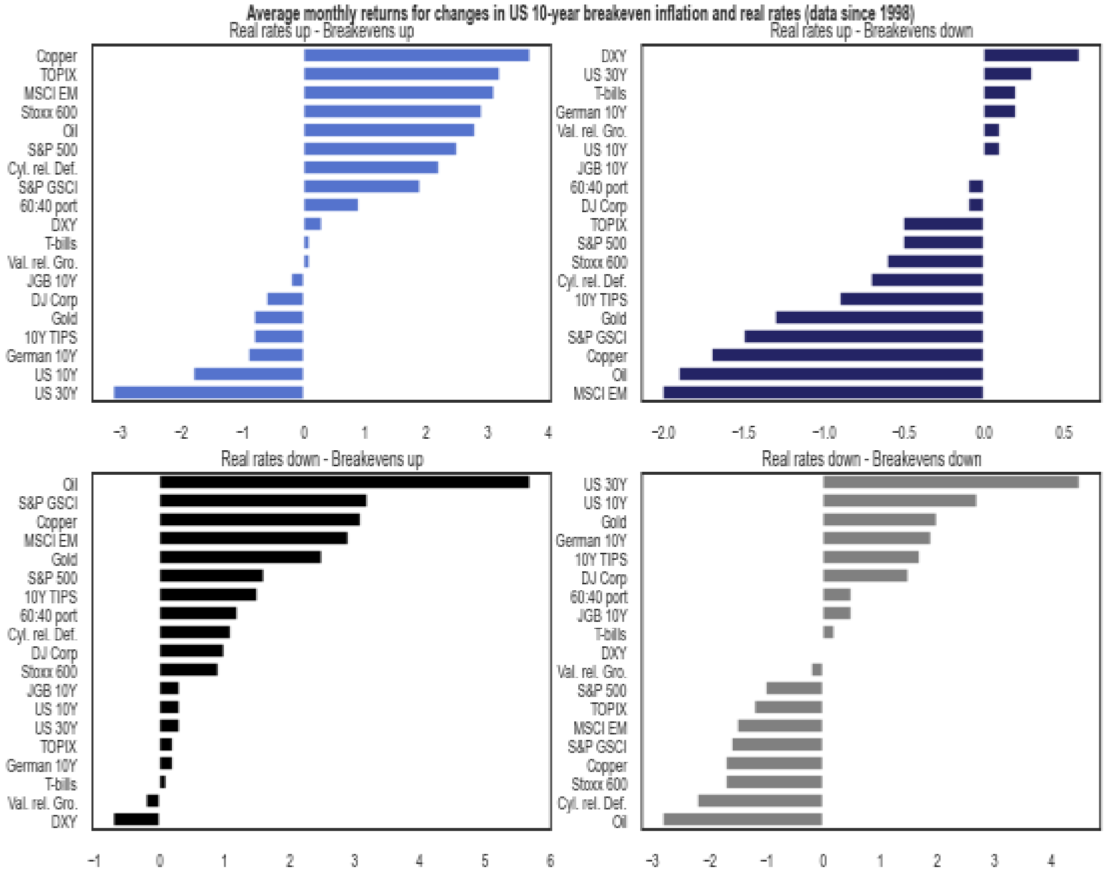
Base case scenario: Row, row, row your boat gently down the stream

In our base case, we have the US Federal Reserve treading its path of policy normalization very carefully. Even as the Fed embarks on the tightening, it maintains a balanced view of growth vs. inflation. As indicated in its recent statement, The Committee's assessments will consider a wide range of information, including readings on public health, labor market conditions, inflation pressures and inflation expectations, and financial and international developments. This scenario sees stable outlook for financial markets in absence of any major external shock.

Downside risk scenario: If you see a crocodile, don't forget to scream

This scenario, which has lower probability but is still possible, is one in which Fed focusses more on inflation and less on risks for growth. In our view, inflation is not only an economic issue but also incrementally becoming a political one. In this case, the Fed could end up giving a more hawkish signal about the persistence of inflation and this could push up the market assessment of the terminal rate (for discussion on terminal rate see equities section on pages 8-9). This scenario is likely to prove negative for most financial market assets. Indeed, any movement higher in the real terminal rates from the current depressed levels will likely be a negative for a broad range of risk assets. Should that be accompanied by a fall in breakeven rates, most assets are likely to struggle (see exhibit 1). Yet, given the low probability of a recession, any such dips in risk assets are buyable.

Exhibit 1: Performance of assets linked to movement in real rates and breakeven rates



Source: Goldman Sachs, S&P, MSCI, and ADCB Asset Management

Asset allocation implications

Bringing these two scenarios together and considering the strong performance of various assets over the past two years, we think a few points are worth bearing in mind through the course of this year.

- Investors should upfront expect lower returns during 2022. This doesn't mean negative returns or losses but returns lower compared to the extraordinary returns of the previous two years.
- Financial market volatility is likely to be higher over the next year as the pandemic-era policy accommodation is withdrawn. This calls for patience, discipline, and focus.
- In the downside risk scenario, some financial market segments could see sizable drawdowns, but any such dip in equities is buyable.
- Further, asynchronous transition into the mid-cycle phase creates opportunities and risks across countries. This is likely to drive relative performance of countries.
- Across major markets, expect a leadership rotation within the drivers of financial conditions and this will likely differentiate winners from losers across assets.
- As investors, continuing to have a disciplined participation in these financial markets is important as the chances of a recession in the next 12 months are relatively low.
- Perhaps adding some downside protection to the portfolios is prudent. This can be done in many ways including:
    - Simply diversifying across assets/geographies
    - Thinking long-term and thematically
    - Adding negatively correlated assets like volatility and gold
    - Preferring low volatility and quality across assets and segments
    - Holding some tactical cash
    - And for advanced investors, using stop-losses and derivatives

In terms of our asset allocation, **we stay neutral equities and alternatives, underweight fixed income, and hold a tactical overweight in cash and liquid assets**. Here, our conviction is that returns on fixed income are likely to be negative and therefore, we hold more cash tactically. However, **we would remain watchful of any opportunities to deploy this cash**.

Porftolio positioning

Exhibit 2: Recommended portfolio positioning

Asset Allocation	Underweight	Neutral	Overweight	Comments
Equities		■		A more diversified exposure warranted
Fixed income	■			Tighter central bank policy to present challenges
Alternatives		■		Prefer gold and market hedge strategies
Cash and liquidity			■	Dry powder looking for deployment opportunities
Equities*	**Underweight**	**Neutral**	**Overweight**	**Comments**
Regions				
US			■	Prefer equal weighted indices; focus on quality
Canada		■		Stick with the benchmark
Europe ex UK	■			Light on structural drivers of growth
UK			■	Prefer global large caps with quality-tilt
Japan			■	Near-term tailwinds from improving macro
Asia Pacific ex Japan			■	Prefer ASEAN (Singapore) and EM Asia
EM LatAm	■			Constrained by commodity-dependence, debt vulnerabilities, outflows and weak currencies
EM EMEA	■			Constrained by commodity-dependence, debt vulnerabilities, outflows and weak currencies
GCC		■		Stick with the benchmark
Global sectors				
Comm. Services			■	Diversified telecoms and Media
Consumer Discr.		■		Hotels, Rest. & Leisure
Consumer Staples		■		Food, Beverage & Tobacco
Energy		■		Capital discipline and makeover plays
Financials		■		Focus on growth opportunities in Asia; fintech
Health Care		■		Biotechnology and Health care technology
Industrials			■	Industrial automation and IoT; likely GICS change
IT			■	‘Moderate’ OW with focus on durable growth
Materials	■			Structural weakness on a shift to ‘new economy’
Real Estate		■		Real estate management & development
Utilities	■			Gas utilities and Renewable Electricity Prod.
Factors/styles/sizes				
Large cap			■	Strong balance sheet, earnings visibility
Mid cap		■		Likely to be market-performers
Small cap	■			Strained by leverage and peak-growth
Growth			■	Prefer non-cyclical growth
Value		■		Avoid value in sectors facing disruption
Dividend yield			■	Prefer quality dividends and dividend growth
Quality			■	Quality in the environment of low risk-tolerance
Momentum		■		Benefits from ‘new economy’ orientation
Legend	*New*	*Old*	*No change*	

Source: MSCI, Barclays, HFRI, Bloomberg, and ADCB Asset Management | Notes: *Positions recommended based on MSCI ACWI Standard/IMI benchmarks.

Exhibit 2: Recommended portfolio positioning (continued)

Fixed income**	Underweight	Neutral	Overweight	Comments
Duration	■			Short duration; Overweight on 5yr USTs
US Treasuries			■	Prefer US Treasuries acting as a hedge
US Credit				Preference for HQ corporates over HY corporates
- Investment Grade		■		AAA and AA; Energy, financials and capital goods
- HY (off benchmark)	■			BB; financials and communications
European Bunds		■		ECB to be less aggressive
European Credit				Preference for HQ corporates over HY corporates
- Investment Grade		■		QE program-CSPP to support
- HY (off benchmark)	■			Moderate growth outlook to weigh
UK Gilts			■	BoE unlikely to be as aggressive as priced in
EM USD Sovereign		■		
- Brazil			■	Hawkish Fed could weigh on various EMs, selectivity is key
- Russia			■	
- High quality GCC			■	
EM LC Sovereign	■			EM policy normalization
- India Govt. bonds			■	Preference for short-dated government bonds
EM Corporate	■			High leverage is concern, but opportunities in Asia
- EM Asia			■	Preference for Asia IG with spreads attractive

Alternatives	Underweight	Neutral	Overweight	Comments
Gold			■	Hedge against political and inflationary risks
Oil		■		Looking for a balanced market
Other commodities	■			Commodity super-cycle is difficult to realize
Hedge funds		■		Strategies that are less correlated to equities

Currencies	Negative	Neutral	Positive	Comments
USD			■	Fed's aggressiveness versus DM central banks
EUR	■			Path of short-term rates over long-term
JPY	■			Rising UST yields and opposite BoJ policy
GBP		■		Driven by the aggressiveness of BoE versus Fed
EM currencies		■		Driven by idiosyncratic developments

Legend *New* *Old* *No change*

Source: MSCI, Barclays, HFRI, Bloomberg, and ADCB Asset Management | Notes: **Positions recommended based on Bloomberg Barclays Global Aggregate (USD unhedged) Index benchmarks

Fixed income

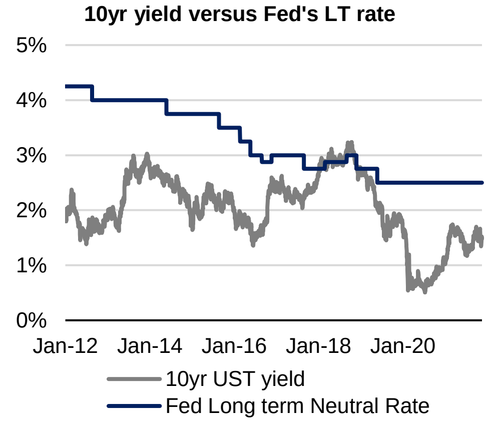
Ready for policy lift-off

2021 was a difficult year for fixed income assets with signs of inflation being persistent in nature forcing more aggressive stance by central banks. One common aspect was bond market volatility, which remained on the upward trajectory in 2021. Bloomberg Barclays Global Aggregate Bond Index lost almost 5% in 2021, registering the worst performance since 2005. The main culprit being the DM central bank bonds which suffered on account of inflation worries and finally the central bank pivot towards the end of 2021. US Treasuries recorded the worst annual performance since the 2013 taper tantrum year. The 10yr UST bond yields jumped in the first quarter to 1.7% on reflation trade, but later ended the year at 1.5%. On the other hand, the short-dated bond yields rose with markets pricing in aggressive rate hikes, leading to a flattening of the yield curve in 2021. On the credit side, Global HY recorded positive returns with US HY index rising by 5%. In emerging markets, EM USD Sovereign bonds underperformed the most.

We maintain our underweight stance on fixed income. We believe that 2022 could prove to be another challenging year for fixed income assets. Inflation uncertainty could continue into 2022 with the emergence of new COVID-19 variant likely to further delay the normalisation of supply chain issues. However, the main dominant drivers for the fixed income performance will be the central bank policy and its prospective impact on growth and inflation. The Fed has signalled a gradual exit from its ultra-loose monetary policies by ending its taper in end of March and pencilled in three rates hikes for 2022. With the Fed hitting brakes on loose monetary policies, we expect UST yields to rise across the curve in 2022. We maintain our short-duration overweight stance on US Treasuries.

In terms of the curve trends, we believe that 2022 could be a year of two halves. *In the first half*, signs of persistent inflation and improving employment trends could accelerate market expectations of rate hikes beyond 2024. In such a scenario- the belly to long-end could face more pressure compared to the short-end which is already fully pricing in the rate hikes indicated in the Fed's dot plot. The OIS curve is pricing in the first rate hike of 25bp in May 2022, second rate hike of 25bp in September 2022 and another 25bp rate hike in December 2022. The long-end bond yield remains compressed with the flat yield curve indicating a shallow Fed cycle. In fact, the 10-2yr UST yield spread is at the flattest level going into a Fed tightening cycle. At the same time, the spread between the 10yr UST bond yield and the Fed's long-term neutral rate (peak policy rate) is also at wide levels. In a situation where inflation pressures fail to ease, markets will begin to test the expectation of a shallow Fed hiking cycle. In such a scenario, the UST yield curve could bear steepen, albeit not significantly, as the 10yr UST yields still trade at an attractive spread versus the Europe and Japan peers. *Around second half of the year*, the Fed could start to raise policy rates – thus leading to bear flattening of the curve. If the Fed becomes aggressive, the yield curve could move close to inversion – especially if an over aggressive Fed strategy begins to threaten the growth outlook. We do not anticipate the yield curve to invert as the probability of recession remains low. However, if inflation levels remain elevated despite Fed rate hikes and at a time when growth is slowing (stagflation scenario) – this could put the central bank in a growth-inflation dilemma and pressure the financial conditions.

Exhibit 3: 10yr yield trades below Fed's LT rate



Source: Bloomberg, and ADCB Asset Management

Exhibit 4: US IG spread widening during excessive flattening

Source: Bloomberg, and ADCB Asset Management

Neutral on US and EU IG, Underweight on US and EU HY, Preference for high-quality bonds

DM corporate bonds performed relatively better compared to DM sovereign bonds in 2021. Global IG bonds suffered meagre losses, on account of their high duration characteristics. On the other hand, Global HY bonds posted positive returns, outperforming the IG bonds in 2021. US HY was the best performer, with the demand driven by search for carry and higher oil prices. As growth is likely to moderate in 2022, we believe there is further limited scope for spread compression in global credit. Central bank policy could also pose risks for global credit in 2022. An aggressive and surprise turn in Fed policy has historically impacted the performance of US credit. Low-rated bonds have been particularly vulnerable during periods of tight financial conditions. We expect that financial conditions could come under pressure if there is more than 1% jump in real rates (either led by significant decline in breakeven rates or alternatively by rise in long-term bond yields). However, until such a situation arises, higher carry should continue to attract investments into HY bonds but given the tight valuations of the HY index- return from further price appreciation looks challenging in 2022. Valuations also remain rich in US IG and 2022 performance will be dependent on the trend in UST yield curve. Typically spreads have widened in the event of sizeable flattening in the UST yield curve. As such, we remain neutral on US and EU IG bonds while remain underweight on US and EU HY bonds. Our neutral stance on US IG and underweight stance on US HY acts as a hedge against our short-duration call on USTs. With tight valuations- selectivity is key in the credit space. In terms of valuations according to the ratings- we favour to move up the rating spectrum. In US IG- we favour AAA and AA while in US HY we prefer BB over single Bs and CCCs. In terms of sector- low-duration sectors including energy, capital goods and financials are favoured in US IG. In US HY- energy sector will be the main driver but spreads look rich- relatively financials and communications are two sectors trading attractive.

Stay Neutral on EM USD sovereigns, Underweight on EM LCY bonds; Overweight on EM Asia credit

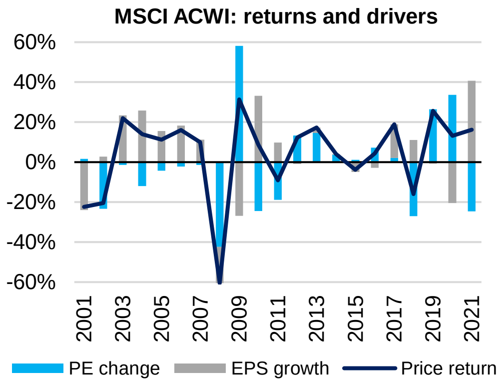
EM bonds suffered losses in 2021 with the exit from loose monetary policies, stronger dollar and slowdown in China growth weighing on the sentiment. Within EM- EM USD sovereign led the underperformance while EM corporate bonds- despite the China default concerns- outperformed both EM USD sovereign and EM local currency bonds. Declining EM growth differential relative to DM and increased UST volatility have negatively impacted the performance of EM USD sovereigns. However, in 2022- DM policy normalization could moderate the growth in the DM. On the other hand, emerging markets could witness a revival in economic activity- particularly in Asia where growth was subdued in 2021 due to the Covid-19 lockdown restrictions. We expect the growth baton to eventually move to emerging markets- which should play catch-up with their DM peers. An improvement in growth outlook versus DM- particularly the US- could also lead to downward pressure on the US dollar. Having said that, emergence of new Covid-19 variant and rampant spread of Omicron still pose short-term risks for growth outlook in the EM. In terms of our allocation—we remain neutral on EM USD sovereigns, but prefer over EM local currency bonds. EM USD sovereigns have underperformed- dragged by LatAm, Turkey and Egypt. Valuations have become more attractive versus EM local currency bonds. With EM central bank policy normalisation still underway- EM local currency remain vulnerable. EM Asia local currency bonds are an exception with relatively accommodative monetary policy stance led by China in the region. Even with our neutral stance on EM USD sovereigns, there are selective opportunities in Russia and Brazil and higher-quality GCC sovereigns. We express caution in adding new positions in the low-rated EM sovereigns as these could be come under pressure amidst Fed tightening risks.

In EM corporate, we retain our preference for Asia credit through our overweight stance on Asia IG bonds. Asia IG bonds outperformed US IG and EUR IG bonds- despite the China default concerns. While Asia IG spreads have returned to 2019 levels- they continue to trade attractive versus the US IG and EUR IG. China's credit impulse is expected to start rolling over in 2022- which should prove supportive for Asia IG. Asia HY - though trading at attractive levels - continues to remain vulnerable amidst the defaults of key Chinese real estate companies. However- the prospect of positive regulatory changes for the real estate sector could provide some support. In addition- surviving real estate companies will prioritize on leverage reduction. However- upcoming schedule of bond maturities mean China HY could continue to face volatility.

Equities

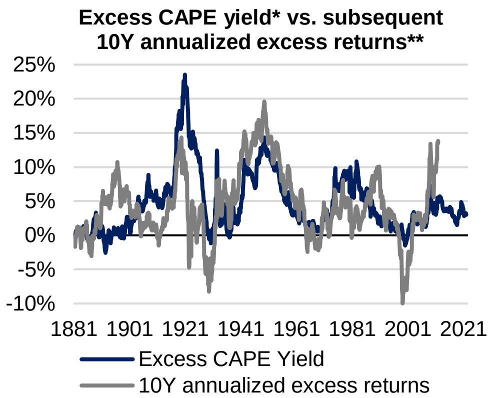
2021 marked the third consecutive year of double-digit return for global equities. However, drivers of returns were different across these three years (exhibit 5). Whilst both 2019 and 2020 saw huge valuation expansion, earnings were stable in the former and fell in the latter. 2021 was however driven by very high earnings growth while valuation multiples contracted. In 2022, we estimate valuation multiples to fall further but earnings growth to remain strong. At the time of writing this report, I/B/E/S consensus estimates for 2022 earnings growth stood at c7% (compared with estimated c53% earnings growth during 2021). We believe there is a significant upside for earnings growth estimates for this year. However, valuation changes are likely to induce volatility and influence the returns during the year. The key driver of equity valuations will be the conduct of monetary policy in the US. In relation to equity valuations, it is worth noting that while on an absolute basis they remain elevated, in relation to bonds, they look cheaper (exhibit 6).

Exhibit 5: 2021 returns driven by earnings



Source: MSCI, I/B/E/S, Refinitiv, and ADCB Asset Management

Exhibit 6: Relative valuation is still an attraction



Source: Stock Market Data Used in "Irrational Exuberance" Princeton University Press, 2000, 2005, 2015, updated (Robert J. Shiller Data), and ADCB Asset Management | Notes: *Inverse of 10Y CAPE, **Adjusted for inflation

Key influence: monetary policy in the US

FOMC's dot plot released in December indicated faster rises in interest rates compared with the projections made three months ago. The median projection for the Federal Funds rate for 2022 is 0.9% now compared with just 0.3% as projected in September. Similarly, forecast for 2023 increased from 1.0% to 1.6%. And for 2024, the projection now is for 2.1% compared with 1.8% predicted three months ago. However, the committee's expectation of the longer-run interest rate remained unchanged at 2.5%. In our view this longer-run rate which can be considered as the "terminal rate" is the most important aspect to monitor as the US Fed starts to tighten its policy. Terminal rate is the peak level of Fed funds rate in any cycle. All asset classes are linked to the terminal rate through discount mechanism. At the current juncture, market expectations of this terminal rate are rather low. This offers some explanation of why the US 10-year yield is low. Expectations of low terminal rates acted as a support to the equity market and the credit spreads too. All this meant easier monetary and financial conditions.

Over the past few cycles, terminal rate in the US has been falling. For the context, back in 2000, the Fed Funds target rate peaked at 6.5%. In 2007, the terminal rate hit 5.25% before it came down. In the latest cycle, the peak was below 2.5%. This lower terminal rate in each cycle is in line with the falling r* or the so-called natural rate of interest which tends to be more structural than the terminal rate itself which is more cyclical. In line with the long-term trends, market expectations for the terminal rate this cycle are less than 2% while projections from the US FOMC in their dot plot point to a 2.5% longer run interest rate. Looking ahead, especially over the next 12 to 18 months, changes in the expectations of the terminal rate in the US are likely to be the key driver of equity market returns.

Our base case and risk scenarios

Just in line with the framework laid out in the investment strategy section (pages 2-3) of this report, we are working with a base case scenario and a downside risk scenario for equities as an asset class too. However, we add an upside risk scenario here given our neutral allocation to equities.

- **Base case scenario:** Fed tightens its policy in line with the current market expectations and the conduct of monetary policy remains appropriate for the evolution of the growth inflation mix. Market estimates of the terminal rate remain well anchored, helping valuation multiples to remain stable. Earnings growth surprises to the upside by end of the year. In this scenario, which has the highest probability, global equities could post higher single digit returns.
- **Downside risk scenario:** Fed tightens too aggressively and its policy turns inappropriate for the growth inflation mix. Market estimates of terminal rate rise in response. In this scenario, despite the earnings growth remaining considerable, valuation multiples could contract and create a negative drag on the overall returns (similar to the episode of 2018). In our assessment, the chances of this scenario materializing are relatively low.
- **Upside risk scenario:** Fed surprises with easier policy in line with moderating growth and abating inflation. Market estimates of the terminal rate remain stable (or move marginally lower). Against this backdrop, helped by stable to higher valuations and strong earnings growth, equity markets could register strong performance. Compared to the other two, this scenario has the lowest probability.

In the context of this bigger picture assessment, we make the following points regarding equities:

- Expect lower returns compared to the prior three years and volatility to rise in 2022
- Returns are likely to be driven by reasonably strong earnings growth offsetting valuation contraction
    - When it comes to earnings, trust is a must – focus on high earnings visibility stories
- Given the strong performance over the past three years and the risks looking ahead (see page 2), maintaining a diversified portfolio of equity segments will be important
    - In terms of thinking about diversification, moving away from heavy concentration of indices could be prudent. For instance, in the US, preferring SPW over SPX.
    - Stock selection could be key. Last year saw a handful of stocks drive index returns while many stocks experienced a bear market beneath the surface.
- In our downside risk scenario, equities could see a drawdown of 10%-15% but any such dip is likely to be bought as TINA (There Is No Alternative) narrative remains.
- For opportunities in 2022, keep an eye on the laggards of 2021 for a potential rebound.
    - Asian markets – which we have moved to an overweight late last year (see The Equity Strategist: Looking to the East, September 13 2021)
    - Structural investment themes including health tech, ed tech, and clean energy
    - Consumer staples and healthcare sectors – we hold a neutral recommendation on both
    - For Q1 2022, the best opportunities are in reopening beneficiaries. Airlines, hotels restaurants & leisure, and consumer services are likely to do well as the Omicron related concerns fade.
- By geography, we maintain modest overweights in US, UK, and Japan; Europe ex UK and EMs outside Asia are our underweight positions.
- By sector, our overweights are in industrials, IT, and communication services; underweights are in materials, and utilities. However, we think the best opportunities are likely to be at stock level rather than at sector level.
- By style, value is likely to outperform in the first half of the year while large cap growth stocks are likely to do well over the long run. By size, we prefer large caps over mid and small caps. However, for those investors who are able to differentiate, large cap growth and mid-small cap value segments present best opportunities. Large cap dividend growers with earnings visibility are likely to outperform through 2022.
- Across segments, we would emphasize a focus on quality.
- Thematically, we still favour the following:
    - Three structural themes (comprising of 12 sub-themes) which could also potentially benefit from investments aiming to build back better, a post-COVID world (see The Equity Strategist: Global Equity Outlook 2021: The unabnormal, January 19 2021).
    - 17 industries/sub-industries (six cyclical, seven defensive and four financials) identified in our analysis The Equity Strategist: COVID-19 induced changes to market sensitivities present opportunities, September 21 2020 as ways to play the near-term opportunity of beta normalization associated with COVID-19 influences.

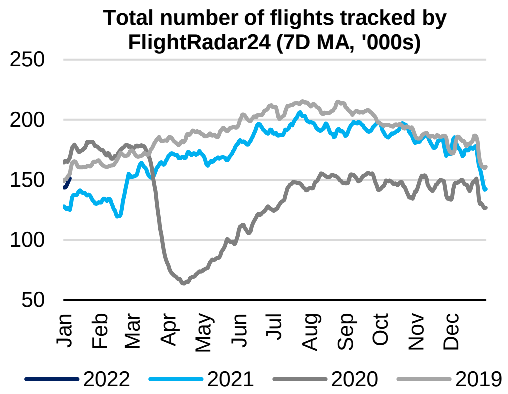
Alternatives

Energy

Energy prices are likely to stay elevated as the market begins to balance into a new supply-demand regime. Against this backdrop, oil prices are worth a close watch. In terms of demand for oil, as Omicron related fears subside, mobility is likely to improve and the demand for air travel is likely to return (exhibit 7). However, the demand outlook remains uncertain for 2022 – at least for Q1. This ambiguity is also reflected in the out-of-step demand projections by Organization of Petroleum Exporting Countries (OPEC), the US Energy Information Administration (EIA) and, the International Energy Agency (IEA). On the supply side of the equation, OPEC+'s disciplined approach to return supply to the market puts a floor under the oil prices. Whilst the US and conventional non-OPEC supply is expected to grow from rather depressed levels (exhibit 8), increasingly scarce spare capacity will likely influence the overall supply in the next 1-2 years. The underinvestment of the previous years is likely to have begun influencing the capacities at a time when appetite for investment remain still relatively low given the ESG concerns.

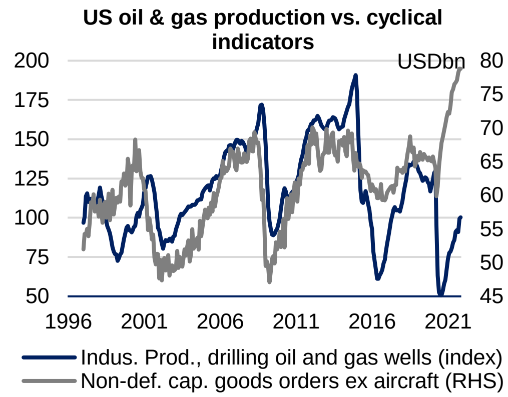
Given oil prices close to USD80/bbl at the time of writing this report, we think there is potential for some downside in Q1 2022, some upside beyond that for the following 12 months. For the longer-term, demand outlook remains uncertain given the energy transition. Also, mitigation as a climate strategy implies change in global energy mix entailing not only faster phasing out of fossil fuels but also accelerated deployment of renewables. Whilst this development means greater opportunities in the renewables space over the long-term, it also counter-intuitively means higher fossil fuel prices in the near-term. On the fossil fuels, the prices are likely to stay elevated in the near-term as the renewables are not yet widely available to meet the energy demand at the time when additional fossil fuel supplies are likely to remain contained. However, higher fossil fuel prices in the near-term should in turn accelerate the migration to renewables over the medium to long-term. Against this backdrop, the outperformance of oil & gas equities relative to clean energy segments during 2021 was already noteworthy.

Exhibit 7: 2022 demand is so far so good



Source: FlightRadar24, and ADCB Asset Management

Exhibit 8: US oil & gas production has picked up but is significantly lagging this cycle

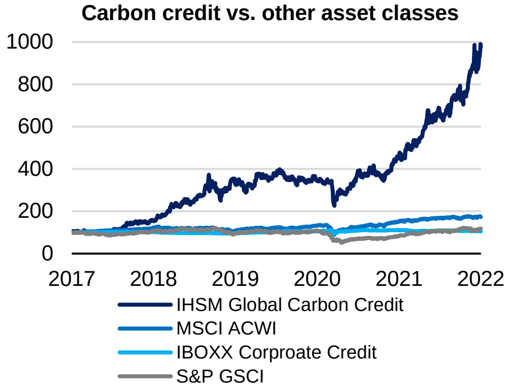


Source: Refinitiv, and ADCB Asset Management

Carbon credits

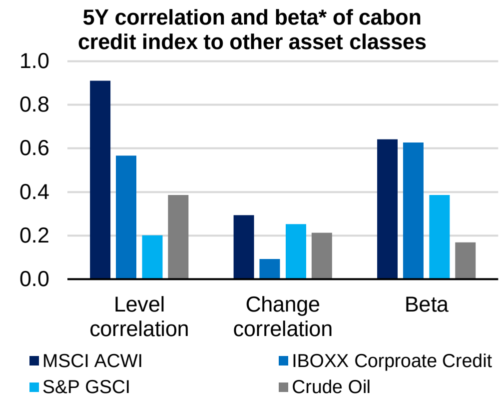
A carbon credit is a permit that allows the company that holds it to emit a certain amount of carbon dioxide or other greenhouse gases. One credit permits the emission of a mass equal to one ton of carbon dioxide. As concerns about the environment increased over the recent years, Governments/Regulators have tightened the restrictions on polluters thereby pushing up the carbon credit prices quite significantly (exhibit 9). Looking ahead, as the world moves towards the deadlines for the targets laid out for restricting the global warming, regulatory tightening is likely to pick up pace. Further, given the increased fossil fuel adoption of recent months (thanks to supply side bottlenecks on the clean energy front), the demand for carbon credits could rise. For investors, owning carbon credits supports responsible investing and can be considered under the ESG sleeve of one's investment portfolio. Carbon credits could act as diversifiers too and provide an additional route to ESG investments which have traditionally been in equities and bonds. Exhibit 10 shows the correlations and beta of carbon credits to various traditional assets and one can readily see the diversification opportunity there. Also, for investors holding carbon emitters in their portfolios, adding carbon credit acts as a hedge. Investors need to be mindful that most investment vehicles trade the carbon credit through futures contracts. Also regulatory changes have the potential to alter the investment thesis here rather quickly. However, we believe that regulatory changes present more upside (than downside) risks.

Exhibit 9: Carbon credit has significantly outperformed other assets over the past 5 years



Source: IHS Markit, MSCI, iBoxx, S&P, Datastream, and ADCB Asset Management

Exhibit 10: Carbon credit offers significant diversification opportunity



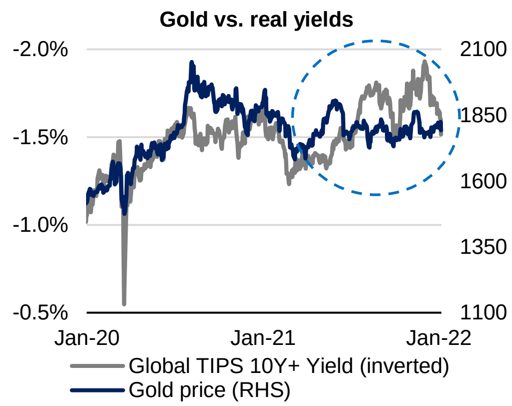
Source: IHS Markit, MSCI, iBoxx, S&P, Datastream, and ADCB Asset Management | Notes: *Based on daily data

Gold vs. new gold?

We keep an overweight position in gold which in our view remains a classic hedge against potential inflation and political risks. Historically, gold prices exhibited a strong negative correlation with US real bond yields. However, over the past 18 months or so, despite the real bond yields remaining near record lows, gold prices slumped (exhibit 11). This deviation from historical trend can be explained by the rise of cryptocurrencies as an alternative to gold. Jury is out on whether cryptocurrencies can eventually replace gold in portfolios. In the near term, however, we continue to see gold retaining its attraction as a strong hedge against risks that are negative for risk assets. While we are no experts in modelling cryptocurrencies, we would simply note that rapid rise in the number of cryptocurrencies (exhibit 12) itself makes them not so 'precious'. Granted, coins of a cryptocurrency are finite, but the number of cryptocurrencies itself has been increasing quite dramatically. Of course, when the adoption of cryptocurrencies picks up pace, and the supply gets to a steady state, supply-demand models could be deployed to understand the price movements better. In our view, we are not there yet. For the near-term we see risk of regulation for cryptocurrencies which in the long run could help increase the adoption of this new asset class into portfolios.

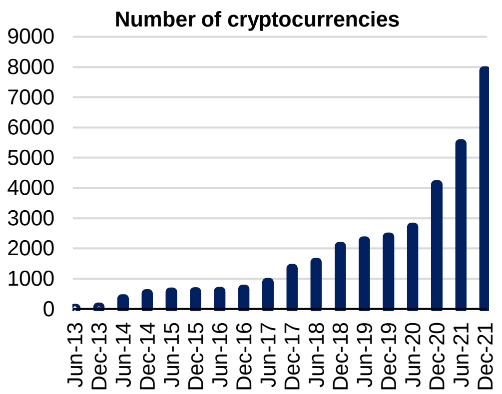
For gold, higher demand for coin, bar, and jewellery may be the offset for weakness in demand for ETFs. Central bank demand has revived in 2021. After record-high buying of in 2019, central banks slowed down their purchases of gold in 2020. However, 2021 saw central bank gold buying pick up quite strongly. In turn, higher gold prices could also help the global gold miner equities which have underperformed broader global equity benchmarks in 2021.

Exhibit 11: Gold decoupled from real yields



Source: Refinitiv, iBoxx, and ADCB Asset Management

Exhibit 12: Exponential rise of cryptocurrencies



Source: CoinMarketCap, and ADCB Asset Management

Currencies

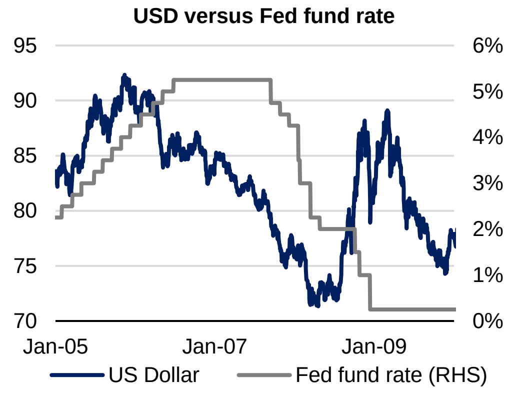
US Dollar – continue to shine?

The US dollar had a spectacular 2021 with US growth dominance and widening central bank differential proving to be tailwinds for the currency. US leading the global growth in the first half- sparked the dollar rally in the first half of 2021. This was later supported by indications of faster policy normalisations by the Fed- resulting in widening short-term interest rate differentials as other major DM central banks including the ECB and the BoJ continued to advocate loose monetary policy. Entering into 2022, the question remains-will the dollar rally phase-out? We still expect that the currency trends will continue to be driven by differences in central bank policy action. Moderating growth outlook in the US could also derail the strong dollar rally eventually.

One of the key factors for the continued strength in US dollar was the Fed's hawkish tilt. The greenback turned out to be the best performer during periods of hawkish Fed commentary. In the recent Fed meeting- despite the Fed signalling an aggressive rate hike projection- the US dollar failed to rally as much. While the Fed's hawkish outlook should keep the greenback strong versus the peers- with the Fed's rate hike projections matching market expectations- the likelihood of a repeat of 2021 rally is low. Unless the markets start getting more aggressive- which may now be possible only by higher expectations of the Fed's long-term neutral rate- the scope for a significant dollar rally remains limited. This does not mean that the greenback will begin to weaken but rather the rate at which the dollar was strengthening could start to decline. The US dollar trends have varied during the recent two rate hiking cycle. During the 2005 tightening period- where the Fed started to get more aggressive- the greenback continued to rally until the middle of the rate hike cycle and started to weaken in the second half of the rate hike cycle. Whereas in the more recent tightening period (2015-2019) - where the Fed was more patient- the dollar started to weaken after the first rate hike. As a result- the degree to which the dollar could strengthen during the Fed tightening cycle will ultimately depend on the shift in Fed bias during the tightening cycle.

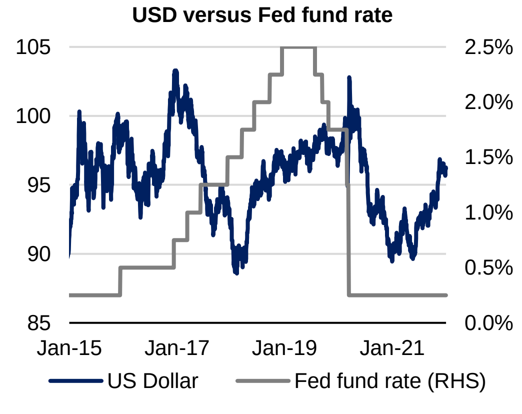
With the Fed's hawkishness largely priced in- what could possibly surprise the currency markets in 2022 is the sudden shift to less easy monetary policy bias by the ECB. Elevated inflation pressures- if sustained- could force the ECB to consider an exit strategy. So far, the ECB expects the rise in inflation pressures to be transient in nature and expects them to ease over the year. However, the spread of Omicron variant is posing threat to the supply bottlenecks. If inflation continues to surprise on the upside, then the market could start pricing in earlier than anticipated ECB policy normalisation. This should potentially lead to pause in the widening of the short-term interest rate differentials between the US and Europe. However, the likelihood of less easy signal by the ECB could potentially happen only in the second half of 2022.

Exhibit 13: An aggressive Fed hiking cycle..



Source: Bloomberg, and ADCB Asset Management

Exhibit 14: …versus a less aggressive one

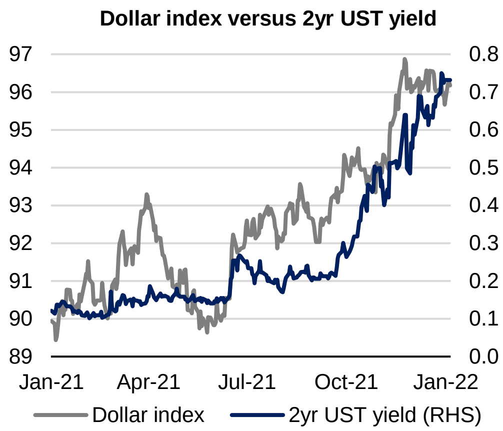


Source: Bloomberg, and ADCB Asset Management

Pound sterling: Short-term appreciation

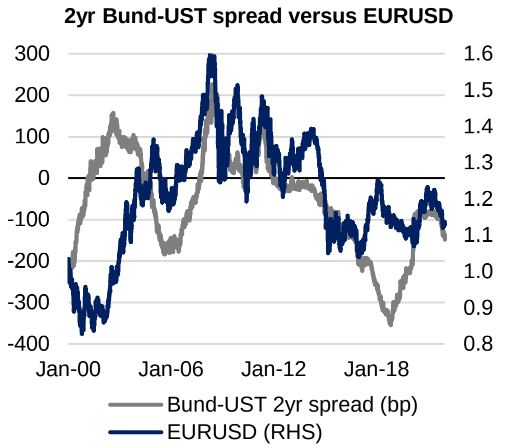
The Pound sterling ended the year unchanged versus the US dollar, but strengthened versus the Euro. Divergence in central bank policy was again at play here- after the BoE surprised with a hawkish tilt. However, the pound sterling failed to rally versus the US dollar in 2021. This was mainly on account of market expectations of a shorter BoE rate hike cycle versus the Fed rate hike cycle that runs into 2023. Given the high uncertainty around the BoE's monetary policy outlook in 2022, the pound sterling could experience bouts of volatility over the year. We expect that the pound sterling to remain flat versus the US dollar. However, the pound sterling is likely to remain strong versus the euro until there is a sudden hawkish tilt by the ECB.

Exhibit 15: Dollar strengthens with rise in 2yr yields



Source: Bloomberg, and ADCB Asset Management

Exhibit 16: Widening differential between UST and German bunds

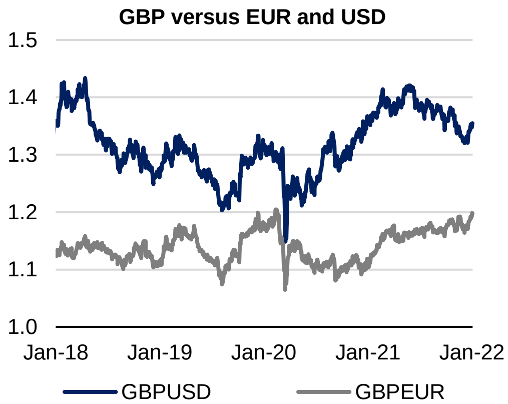


Source: Bloomberg, and ADCB Asset Management

Japanese Yen

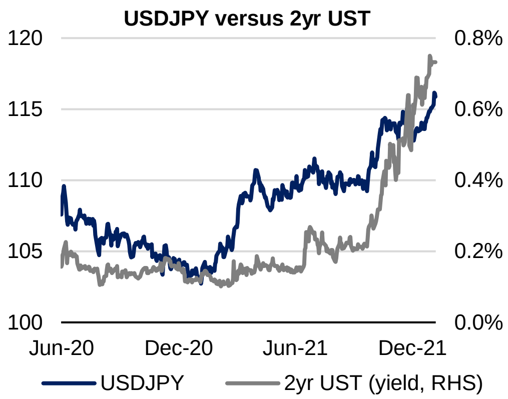
The Japanese yen significantly weakened versus the dollar in 2021, due to broad dollar strength and rising UST yields. We believe that the increasing divergence in monetary policy between the Fed and the BoJ will continue to put pressure on the Japanese yen. The differential between short-tern UST and JGB yields has widened. With markets pricing coinciding with the Fed rate projections- the magnitude of yen weakness may not be as significant in 2022 compared to 2021. However, the widening gap between short-term yields and volatility in UST rates will keep the yen vulnerable.

Exhibit 17: Pound sterling strong versus euro



Source :Bloomberg, and ADCB Asset Management

Exhibit 18: Yen weakened with the rise in UST yields



Source: Bloomberg, and ADCB Asset Management

Sources

All information in this report has been obtained from the following sources except where indicated otherwise:

1. Bloomberg
2. Wall Street Journal
3. RTT News
4. Reuters
5. Gulfbase
6. Zawya

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