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MARKET INSIGHT

JANUARY 2022

CITYWIRE SWITZERLAND

TOP 50

INDEPENDENT ASSET MANAGERS 2021

Market analysis

January 2022

2022: equities are still preferable to bonds.

We've gone into the New Year with COVID-19 hanging over us, pretty much as it was last year. However, the latest news about Omicron seems fairly encouraging, even if the variant looks more contagious with every passing day.

In general, the pandemic dominated the markets in the fourth quarter of 2021, triggering erratic movements in all financial assets. Economic conditions – especially the Federal Reserve's decision to accelerate the change of monetary policy direction to regain control of inflation – also fuelled stock market and interest rate volatility.

The possibility of central bankers committing a "fatal" error for the economic cycle in their management of monetary policy understandably prompted knee-jerk reactions from investors.

We still think these are excessive given that economic growth should hold firm in 2022, even if it will probably be slower than in the last 18 months.

Similarly, while the inflation spike was surprisingly sharp in the latter half of 2021, we are sticking to a scenario of inflation normalisation in Q2 2022; in the United States it should return to between 3% and 3.5% over the next 12 months.

In such circumstances, it is quite natural that the Federal Reserve would tighten its monetary policy over the coming quarters. Considering two rate increases in the second half of the year seems obvious. The probability of a third hike is uncertain given the US Congress's prevarication over approving the latest recovery plan (Build Back Better), the scope of which will be much more limited than the Biden administration had wanted.

All of this suggests that economic conditions will probably cause bond yields to rise further over the next 12 months. While the emergence of the Omicron wave and related uncertainty had led us to moderate our US 10-year yield forecasts, recent developments have prompted a rethink; the 2.25-2.50% range could well be reached in 2022. Such a level is compatible with satisfactory economic growth as it implies that real long rates should remain negative throughout the coming year.

Basically, if we look beyond short-term variations in growth, which should be affected by the wave of Omicron in terms of the volatility of some quarterly GDP figures, a trend of continued expansion lies at the heart of our economic scenario.

"We are still reasonably optimistic for equity markets in 2022."

FRANÇOIS SAVARY, CHIEF INVESTMENT OFFICER, PRIME PARTNERS

In the same way, on a medium-term horizon we still think that deflation fears are unlikely to return in the coming years. Quite the opposite – inflation will probably be stronger as governments run with their various plans for kick-starting investment. Monetary authorities' more accommodative approach to inflation, as required by fiscal dominance, also points in this direction.

As John Maynard Keynes famously said: "in the long run we are all dead". In our case this means that, for now, we should concentrate on steering a path through the next 12 months when establishing our investment policy.

The above considerations have led us to understand that we should take a measured approach to bonds, as overall conditions are not favourable to them.

The monetary tightening that we foresee, at a time of undoubted economic growth, encourages us to underweight fixed income assets in a diversified portfolio. A strategy that emphasises more limited duration is also appropriate, at least until US government bond

yields reach 2.00%-2.25%. Sovereign debt is therefore largely absent from our bond portfolios.

Given the narrowing of spreads over the last 18 months, greater caution is now required for credit, especially the best-rated issues. The carry available on high yield debt can justify keeping some exposure, provided that we don't invest in excessively long maturities.

Inflation-linked bonds had a good year in 2021. While they may be held in the short term (3 months), we no longer advise buying at current levels, especially in the United States. This recommendation reflects our scenario of US inflation gradually returning to normal from the second quarter of 2022.

Convertible bonds were highly disappointing, weighing on the performance of our allocations in 2021. Admittedly, the previous year had been particularly kind to these assets. We think that, at a time when equities are likely to perform and credit risks are relatively limited, convertible bonds deserve their place in a diversified portfolio in 2022.

Investors who are underexposed to this asset class may wish to consider buying.

2021 was a good year for equities, although we should not ignore the fact that different sectors posted very different performances. Some of our strategies, especially on cyclical and value stocks, were disappointing. We are perfectly aware of this. Our preference for small and mid caps didn't have the intended effect either.

One can regret the past but there's little point. The question now is whether we should stick to our guns or reconsider.

Given our overall predictions, which include sustained earnings growth of around 10% in 2022, it still seems appropriate to be overweighting equities in a diversified portfolio. So if the movement in interest rates that we are expecting weighs on multiples over the coming months, an increase in the indices in line with profits is entirely possible.

Equally, if the economy continues to expand, then after a relatively drab showing in 2021, the most cyclical sectors should be able to outperform in 2022. We are therefore remaining exposed to financials, commodity stocks, and companies that will benefit from a resumption of consumer spending.

Periods of monetary policy change traditionally bring volatility back to stock markets. So it is also important to keep some "solid" equities with good visibility in the portfolio.

Greater care with strong growth stocks is required given the interest rate situation that we predict for the coming months, and the dizzying heights that some prices have reached.

In regional terms, European stocks are still slightly overweighted relative to US stocks. We made this decision because Europe has more of its recovery to come, and because its valuations are more attractive than those in the United States.

2021 was a bad year for emerging market assets, not just because of COVID-19 but also because of China's influence, which kept weighing on them – equities in particular. With relative valuations looking interesting, from both historical and regional perspectives, we recommend keeping exposure at least similar to that of global indices.

The prospect of better COVID-19 management, the moderation of EPS forecasts, and the improvement in global growth should help stock market performance, especially in Asia. China presents some opportunities, while investments in markets exposed to commodity prices may be considered.

As regards liquid alternatives, some of which performed disappointingly in 2021, we prefer tactical bond strategies and Long/Short equity strategies.

Elsewhere, we recently said goodbye to an investment based around macroeconomic trends as its performance failed to meet our expectations.

The US currency had an excellent H2 2021, overall and against the euro in particular. Does this cast doubt over our recommendation to diversify assets away from the dollar? We don't think so, at least not on a 12- or 24-month horizon.

The dollar is benefiting from its higher return and the United States' global lead in the cycle, so it's possible that it will approach the 1.10 mark in the coming months. However, because we think that the monetary tightening process has already been largely priced in, the greenback seems likely to depreciate on a one-year horizon. Our target for the EUR/USD by the end of 2022 is 1.18.

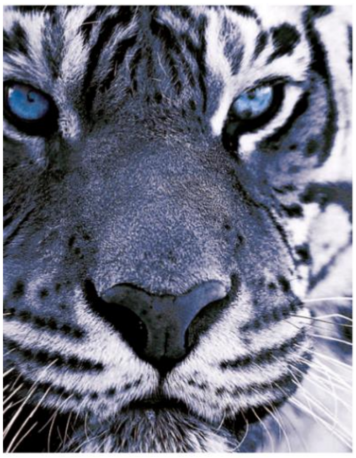
The Swiss franc has also performed well against the euro in recent months. It looks overbought, and the SNB will keep intervening to weaken the franc over the medium term. In light of this, it is unlikely that the Swiss central bank will contemplate raising its interest rates alongside the ECB. A return towards 1.10 vs the euro seems possible over the next 12 months.

To conclude, we are still reasonably optimistic for equity markets in 2022. Equities are a choice asset in a diversified portfolio. The progress that we can expect will obviously be much smaller than in the last 18 months, if only because we have entered a new period for macroeconomic policy.

Besides, the liquidity squeeze and ongoing change of monetary policy hint at increased volatility over the quarters ahead. Equities' ascent will probably not be in a straight line. However, we shouldn't forget that economic conditions and a "caring" approach from both governments (fiscal policy) and central banks are not good reasons to abandon equity markets!

We wish you a happy and prosperous 2022.

Geneva, 5 January 2022



Prime Partners SA
Rue des Alpes 15
P.O. Box 1987
1211 Geneva 1

www.prime-partners.com

CONTACTS

François Savary
Chief Investment Officer

Jérome Schupp
Equity Analyst

Julien Serbit
Senior Investment Advisor

Tel +41 22 595 09 97
fsavary@prime-partners.com
jserbit@prime-partners.com