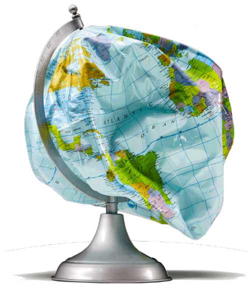
Review & Outlook

January 2022



"*Although our intellect always longs for clarity and certainty, our nature often finds uncertainty fascinating.*"
Carl von Clausewitz (1780 -1831), Prussian general and military theorist.

A year of déjà vu …

As yet another pandemic year comes to a close, one can't help but wonder if such a momentous disruption in our lives will ever come to an end, and even if the "before time[1]" is now firmly a thing of the past. It is that precious sense of normalcy that everyone is so desperately yearning for. Things did appear to be on the mend, if only for a moment during the first half of the year, as warmer weather and a ramp up in vaccinations appeared to be having a deleterious effect on the virus, such that governments began to reverse the burdening restrictions from earlier on. For a while it felt like "business as usual" was back, the services sectors that had been brutally battered as a result of the extended lockdowns and just a general fear of catching Covid, jumpstarted back to life and began scrambling to make up for all the lost time.

Covid did act as a powerful accelerant on multiple fronts, however. Lockdowns and confinements led to a profound reorganization of work dynamics, as a growing percentage of employees began to perform most of their job-related tasks from home. This in turn triggered an explosion in demand for technology goods, as firms and households began to consolidate to this "new normal" condition, further enhancing the already dominant position of big tech firms. If technological progress was already happening at an exponential pace before the pandemic, the last two years were like warp speed, resulting in an acceleration unlike anything seen prior. The fact that economies could continue functioning despite crippling lockdowns was a testament to how much progress we had achieved, allowing output of essential goods and services to continue almost unhindered.

As the year pressed along, however, dark clouds began to form on the horizon. Nobody really knew the sort of damage that a protracted period of global scale disruptions in such a highly interconnected world as ours would engender. Sure, we had the Spanish flu experience to lean on, but that was in a distant past and the world had changed so dramatically since, that it was doubtful anything of significance could be gained from it. The first major signs of trouble came in March when a giant container ship, the Ever Green, got stuck in the Suez Canal, blocking 369 other ships for more than a week, just as a major fire destroyed a crucial chip fabrication plant in Japan[2]. Coincidences that highlighted the inherent vulnerabilities of outsourcing and globalization, although the timing could not have been worse, just as demand for goods were ramping up, causing major bottlenecks along the supply chains.

A protracted period of lockdowns had led to material changes in the economic fabric (layoffs, bankruptcies, lost opportunities), causing significant delays in restoring conditions to where they were before the pandemic struck. With too much demand chasing too little supply, it was only a matter of time before inflation, after many years of being absent, would re-emerge all across the globe. Demand that for a time was almost entirely concentrated on goods began spilling over into services, as restrictions were eased and

[1] https://mashable.com/article/coronavirus-pandemic-one-year-scars-march-11
[2] https://arstechnica.com/tech-policy/2021/03/taiwan-drought-japanese-fab-fires-snarl-semiconductor-supply-chain/

as data pointed towards a sharp drop in Covid infection rates across the globe[3]. Not only did households have ample disposable income to continue spending unhindered (the U.S. government made huge cash transfers in March 2020 and 2021), but the Fed and other major central banks kept the monetary levers at full throttle throughout most of the year, further contributing to the asset bubble formations from earlier on[4].

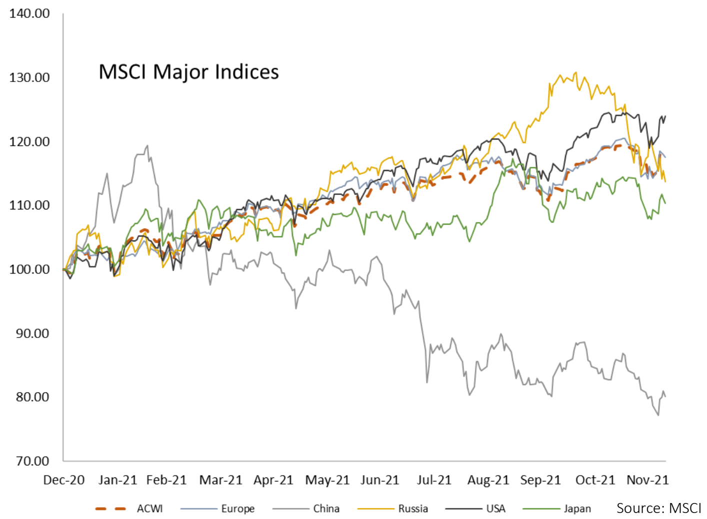


Figure 1: The majority of indices posted strong results throughout most of the year, but there were moments like in the second half where it felt as if the markets were entering a sharp correction, like the one in 2020. There were also a few major disappointments such as with China, where markets had been roiled by authorities reigning in on speculation and dissent and locking down entire regions in light of the new pandemic wave.

It was another record-breaking year for developed market equities, stretching multiples well beyond their historic averages. The pent-up demand for goods and services bolstered corporate earnings substantially, even as inflation began to seep into margins before being passed on to consumers. Thanks to the additional savings from protracted lockdowns, generous government handouts and sentiment that became more hopeful, consumption was little deterred by the steady rise in prices. The scale of the recovery beat most projections which at the end of 2020 were for a 22% increase in earnings per share on the S&P 500 for 2021. It now appears that earnings will be 45% higher than the last one, surpassing even the 40% rise in 2010 that followed the subprime global financial crisis.

Emerging market equity performances were more of a mixed bag, however, with inflation and an anticipated widening of interest rate differentials putting increasing pressure on dollar exposed economies. Turkey suffered a major currency crisis in the second half, as confidence in the government's ability to steer the economy took a nosedive, whilst China's aggressive regulatory crackdowns[5] and short notice, large scale lockdowns sent its markets into a tailspin. The sharp rise in oil and other commodities (contributing to the surge in inflation) as the global recovery shifted into higher gear, benefited a handful of nations such as Russia, with its significant natural gas resources, and although they performed similarly to those of developed markets, it wasn't all smooth sailing.

Sharp differences in access to vaccines between rich and poor nations was a stark reminder of continuing global imbalances, which also likely caused the emergence of Omicron, a less dangerous but more virulent form of the virus, spreading like wildfire in the second half of the year, just as economies were gearing up for the busy holiday season. This fifth wave put a substantial dent on the recovery, exposing the ailing services industries to yet another round of sharp drops in demand. 2021 was also marked by a continuation of the public strife between rich and poor, left and right and pro and anti-vaxxers. A worsening migration crisis didn't

[3] In all, spending on durable goods rose by 34% in America since the beginning of 2020, compared with an increase of nearer 4% on services.
[4] The current bout of inflation came on suddenly. Early this year inflation was still low; as recently as March, members of the Fed's Open Market Committee, which sets monetary policy, expected their preferred price measure (which usually runs a bit below the Consumer Price Index) to rise only 2.4 percent this year. Even once the inflation numbers shot up, many economists argued that the surge was likely to prove transitory. By November the CPI was 6.8 percent higher than it had been a year earlier. Much of this rise was due to huge price increases in a few sectors: Gasoline prices were up 58 percent, used cars and hotel rooms up 31 percent and 26 percent, respectively.
[5] Evergrande, a huge property developer, had long been the most extreme symbol of China's heavily leveraged real-estate sector. In 2021 it at last defaulted, in the face of a government effort to throttle borrowing by developers. The internet giant Alibaba's CEO disappeared from the public eye for a couple of months after having criticized regulators.

help either, reviving populism currents especially in Europe, creating tensions between members that blamed one another for not doing enough to stem the flow.

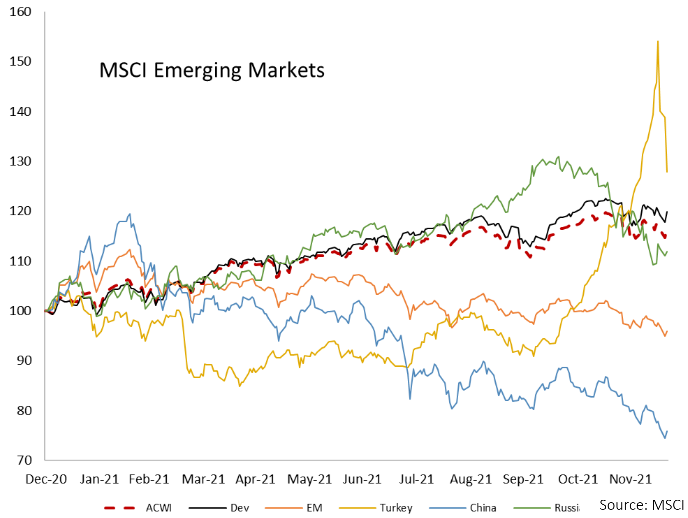


Figure 2: Unlike the previous year, emerging market equity performances were more of a mixed bag, with countries like Russia doing relatively well thanks to their exposure to natural resources, and others such as China due to a more forceful clampdown against speculation and dissent and Turkey roiled by inflation mishandling of the economy.

The same ugly divisiveness that has been sweeping the world since before the pandemic continued. Confirmation biases were pushed to the extremes thanks to the social media platforms and other mass broadcasting technologies that enabled individuals, some with cynical intentions or agendas aiming to stir confusion and sow discord amongst people. This went on throughout the year, culminating with the input of certain mega influencers, polarizing opinions even further[6]. A certain fringe of society (roughly a sixth of the population) became increasingly resistant to being vaccinated, unconcerned about the risks that they were causing to the collective and unimpressed by the overwhelming evidence of its benefits.

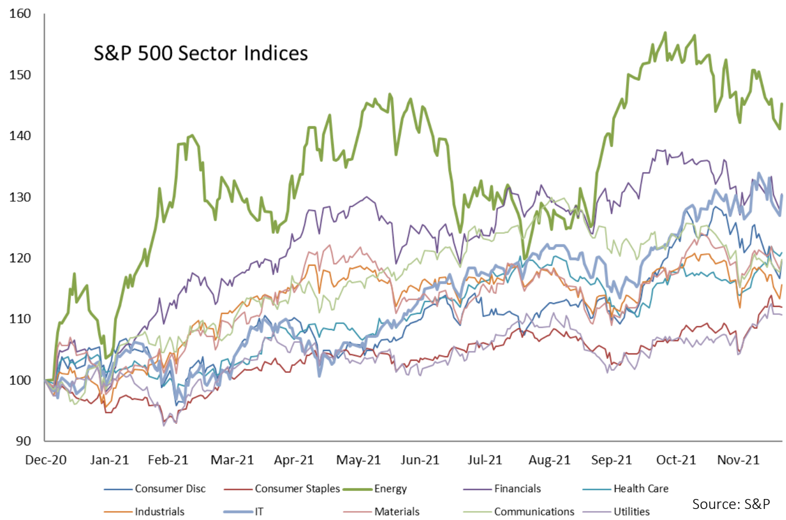


Figure 3: Although almost all sectors ended the year positive, there were significant disparities between them. Energy experienced substantial volatility, but ended the year amongst the best performers, reflecting the sharp pickup in the global recovery. Both financials and IT were also great performers, the former benefitting from increasing activity and anticipation for rising interest rates, and the latter from continued strong demand, as business and households recalibrated their work environments. Utilities and consumer staples were the main laggards, posting the least impressive returns over the year.

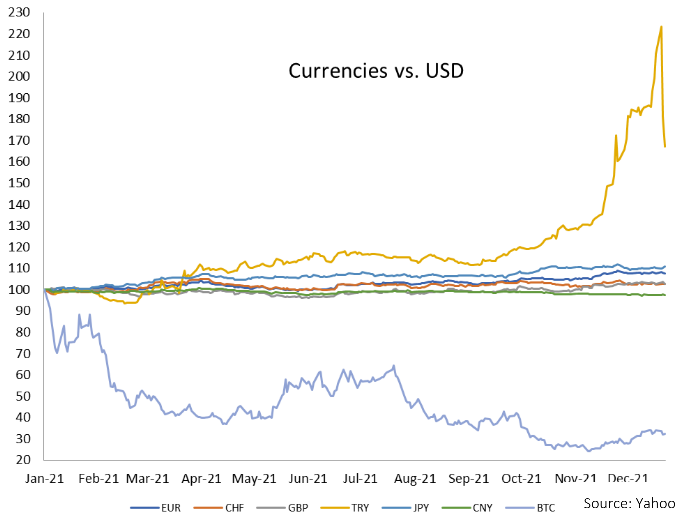
The Trump administration in its four years of tumultuous leadership set off a series of dynamics that are causing much headache for the Biden presidency. The chaotic transfer of power in January was a watershed moment that highlighted the extent of divisiveness in a deeply fractured society, whilst democratic principles and processes continued to further erode[7]. If China was bound towards a collision course with the west, the Trump administration accelerated that process significantly, emboldening them to be more overt

[6] https://www.ft.com/content/00a737e1-02b2-4e1c-848f-56f5358084de

[7] The world we live in today is one that is increasingly fractured. It's all division, driven by identity politics, race, gender and class. In the U.S., a rising generation of voters who were children when 9/11 happened and who grew up observing the imperfections, mistakes and damages of their own country are unfamiliar to the abuses of other regimes, of how damaging extreme socialism and communism can be and are questioning and challenging the very institutions that safeguard their rights. The longer-term consequences of these actions are clearly dire.

and assertive with their intentions. The Chinese took advantage of a pandemic in full swing to further consolidate their power, flexing their muscles both internally and regionally, tightening the screws of control and in the process rattling a delicate geopolitical balance that has kept the peace over decades.

2021 was also a year in which the awareness on climate change related matters gained prominence, as people become alarmed by the increasing frequency and growing damage of freak weather conditions. It has been estimated that the 10 worst climate-change related disasters over the year had caused damage worth $170 billion, a figure that appears to be on the increase[8]. Even if the Cop26 climate change summit in Glasgow didn't accomplish much, there was a sense that governments and businesses were starting to feel the pressure. It is telling that investment in climate-tech startups reached a record $60billion in the first half of 2021, more than triple the amount in the same period of last year. There was a huge surge of investor interest in electric-vehicle firms such as Tesla, which passed the $1 trillion market capitalization mark for the first time.



Source: Yahoo Finance

Figure 4: With inflationary pressure increasing as the year progressed, pundits were debating on how long it would last, as the Fed began to taper and signal a willingness to tighten, if conditions did not improve significantly in coming months. With the U.S. economy ahead in the cycle and the specter of tightening on the horizon, the dollar maintained its strength against most other major currencies. Bitcoin saw wide gyrations, reflecting its inherent uncertainties, whilst the Turkish Lira at one point depreciated more than 40% against the dollar, as confidence in the government's handling of the economy through inflationary turbulences eroded.

The wild bitcoin market gyrations reflected an ongoing tug of war between opposing forces, as blockchain continued to assert itself as a compelling "substitute" to fiat money for some, attracting the attention of the public and the investment bigwigs that saw huge potential behind the disruptions. It also drew government scrutiny, some such as China and the U.S. that were less favorable, as they perceived blockchain currencies a direct threat to their control over their respective economies, whilst others like El Salvador where much more open to the idea, going as far as adopting bitcoin as a currency[9].

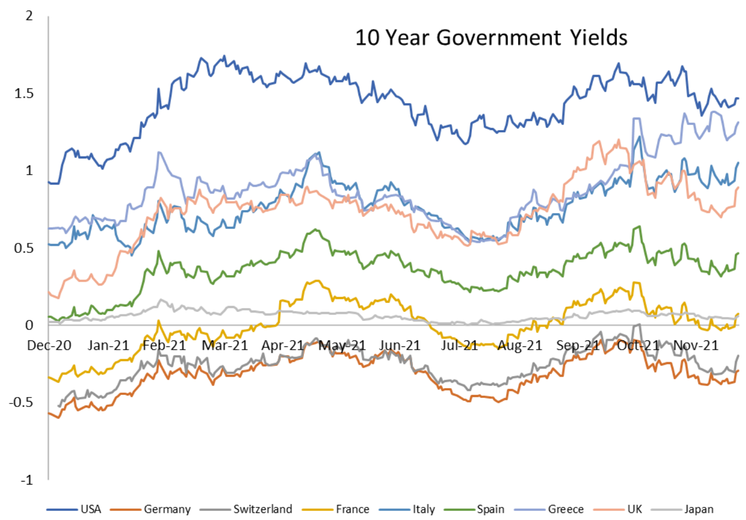


Figure 5: 10-year government bond yields were mostly influenced by the sharp rise in inflation. U.S. yields went above 1% in early January and remained there for the rest of the year. French yields kept switching from negative to positive and back, whilst both German and Swiss bonds remained negative throughout. Spreads were overall maintained with the exception of Greece and Italy to a lesser extent that saw a widening versus the German bund as the year came to a close.

[8] https://www.marketwatch.com/story/the-10-most-expensive-climate-change-disasters-of-2021-cost-170-billion-and-this-u-s-storm-was-no-1-11640631670

[9] https://www.weforum.org/agenda/2021/09/el-salvador-officially-adopts-bitcoin-as-legal-tender-but-will-other-countries-follow/

2021 also saw the emergence of “meme” stocks, driven mainly by young and inexperienced “investors” following the advice of social media influencers, causing large gyrations in the prices of the stocks, such as GameStop Corp and AMC Entertainment that they targeted[10]. It was like the financial markets equivalent of the populism waves that have been spreading across the globe. We also got a “taste” of the future, as emerging technologies such as blockchain became more prevalent : digital art auctions fetched mind boggling prices with the advent of NFTs, Bitcoin’s stock value went through the roof and huge amounts of money were being poured into the “metaverse”, a digital universe marked as the “new frontier”. Covid also triggered a strong demand of a certain category of physical goods, from real estate to watches and art pieces that fetched record prices at auction houses.

As the new variant of the virus began to spread in the second half of the year, prompting new confinement measures and the cancellation of events, and as the number of infected and hospitalized persons reached levels last seen a year earlier, one couldn’t help but feel a sense of déjà vu. Clearly we weren’t out of the woods yet, but we seemed to be more confident with regards to the future, a sense that we were more in control of our destinies than when it had all begun. Still something didn’t feel quite right, the world had become more divided in the meantime and even if we appeared closer than ever to vanquishing the pandemic, a far bigger battle seemed to be looming on the horizon.

Is the end nigh? …

The world entered the new year with a dizzying array of challenges on the horizon: a resurgent pandemic, inflation and asset price pressures, a growing sense of urgency on climate change matters, a more conflict prone world, a simmering humanitarian crisis and ongoing mass migrations. Geopolitical risks in 2022 will arise mostly from the historic struggles between democracies[11] and authoritarian regimes, the two major competing forms of governance that are pushing the world into the brink of a new cold war[12]. The west will have to contend with antagonists emboldened by America’s partial-retreat from the global scene. China is flexing its muscles as can be seen in its behavior and actions, in the more aggressive way it is handling Taiwan or dissent within its borders. Even if we won’t be seeing military conflict in the near term, the longer run remains much less certain.

Elsewhere it is with Russia that problems could rapidly deteriorate in the short run, especially as it continues to amass troops (estimated in the hundreds of thousands) across its border with the Ukraine, preparing for a possible invasion in response to the NATO-driven threats it perceives in the region. With U.S. presence in the Middle East significantly diminished, Russia will try to do the same in Europe, whilst China attempts to undermine U.S. influence in the Pacific, which means that the conflicts in coming years will likely be increasingly focused on “Eurasia”. With China and Russia’s strategic interests appearing more aligned, the world may be entering a more geopolitically perilous period, especially as the west continues to signal a certain reluctance to engage itself more overtly.

[10] A meme stock refers to the shares of a company that has gained a cult-like following online and through social media platforms. These online communities can go on to build hype around a stock through narratives and conversations elaborated in discussion threads on websites like Reddit and posts to followers on platforms like Twitter and Facebook. GameStop is widely regarded as the first meme stock, whose price rose as much as 100× over the course of several months, as members of its meme community crafted a spectacular short squeeze.

[11] The emergence of populism across the globe has actively weakened the standing of democratic institutions that have also become increasingly withdrawn from the international stage. The U.S. pullout from Afghanistan is just the latest example of this process, emboldening autocratic regimes to fill in the vacuum and broaden their spheres of influence, creating a more dangerous geopolitical environment that is prone to larger scale conflicts.

[12] https://www.nytimes.com/2021/10/17/us/politics/china-new-cold-war.html

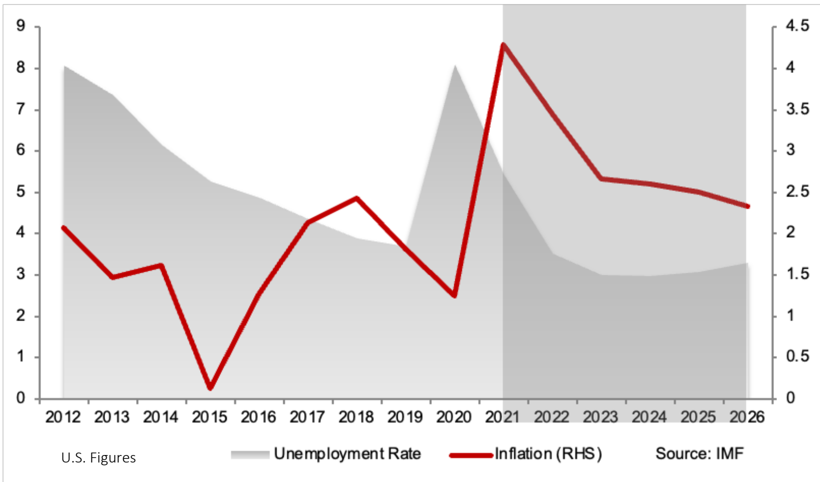


Figure 6: U.S. unemployment rate dropped sharply in 2021 after reaching a record 14.8% in April of the year before. The unemployment rate is expected to continue dropping, especially as the large savings that had been accumulated over the earlier phase of the pandemic continue to diminish, forcing a larger percentage of the labor pool to seek jobs. Inflation is also expected to level off in 2022 before dropping.

There are also the stalled Iran nuclear talks, opening the door to more confrontations between Israel and Iran, which always carries a risk of a wider regional conflict. The middle east with the ongoing war in Syria and tensions in Libya will remain a potent source of instability, whilst growing concern with Afghanistan and emerging signs of trouble in Kazakhstan and Bosnia-Herzegovina, not to mention emerging conflicts in parts of Africa suggest that 2022 will continue to be a year fraught with dangers on the geopolitical front. These various “trigger points” are bound to intensify, especially if the U.S. continues to shy away from its responsibilities and historical leadership role in the global arena, maintaining a vacuum that a weak and fractured Europe is unlikely to fill.

China’s resounding success in growing its economy and creating massive amounts of wealth over a relatively short time span is putting increasing pressure on the liberal, democratically driven models by exposing their many shortcomings as they confront a cluster of significant challenges. The protracted effects of the pandemic, growing wealth disparities, ageing demographics, worsening effects of climate change and the continued influx of migrants are fueling the type of populism that is weakening the traditionally liberal order of the west.

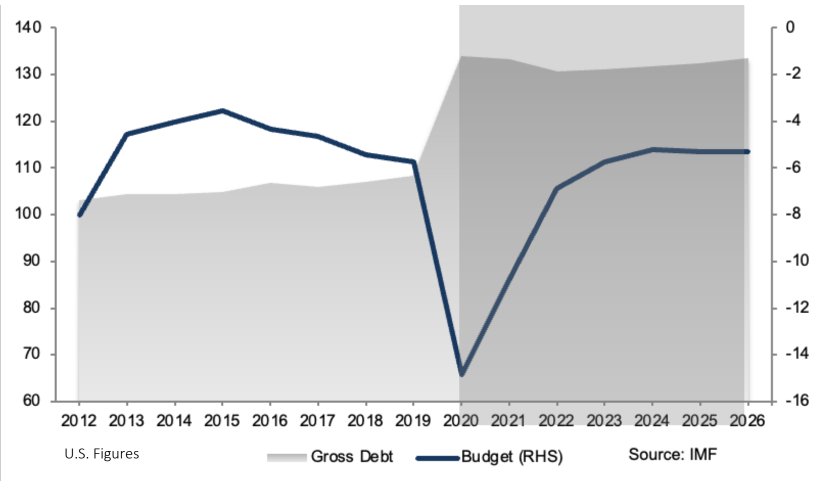


Figure 7: The U.S. budget deficit should start dropping with the sharp pickup in the recovery, as more workers find jobs and as large government outlays become a thing of the past. Debt should also level off after increasing sharply, especially if the strong recovery is sustained over an extended period. These trends should continue over time, especially if the pandemic’s effects continue to diminish with each new iteration.

Europe will continue to struggle in 2022, as the EU and national leaders grapple with a host of problems, both internally and with its neighbors, the social and economic fallouts from a protracted pandemic, an ongoing migration crisis and the many challenges of succeeding in its net zero emissions targets. The tone for the rest of the year and beyond are likely to be set in the first half with the outcomes of the spring elections in both France and Hungary, where rightwing populist forces continue to create uncertainties through their toxic agendas[13].

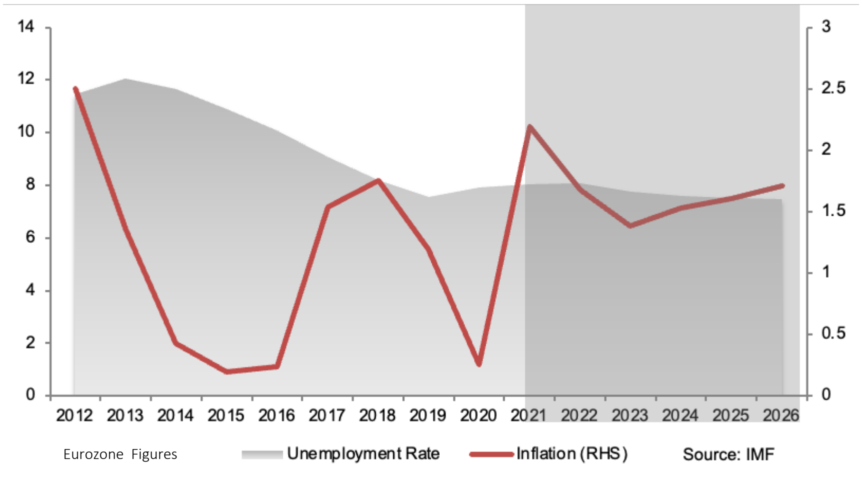


Figure 8: The Eurozone's unemployment rate saw improvements with the strong pickup in the recovery, although the effects were far less pronounced than in the U.S. thanks to its more robust social security coverage. Inflation also rose sharply as the combined result of strong demand and tight supplies. Inflation is expected to start dropping gradually whilst the unemployment rate continues to steadily diminish.

A populist setback would create a tremendous opportunity for much needed unity, providing the region with the drive to make progress on a range of matters that have been stalling at a critical juncture in time. The opposite would be a significant blow for the region, exposing it even further to existential dangers by dramatically weakening its resolve and effectiveness in fending off the many outside sources of instability[14].The true economic cost of Brexit will also become more apparent (the British economy is expected to shrink 4 percent according to the Office for Budget Responsibility) in 2022 especially as the effects of the pandemic continue to recede.

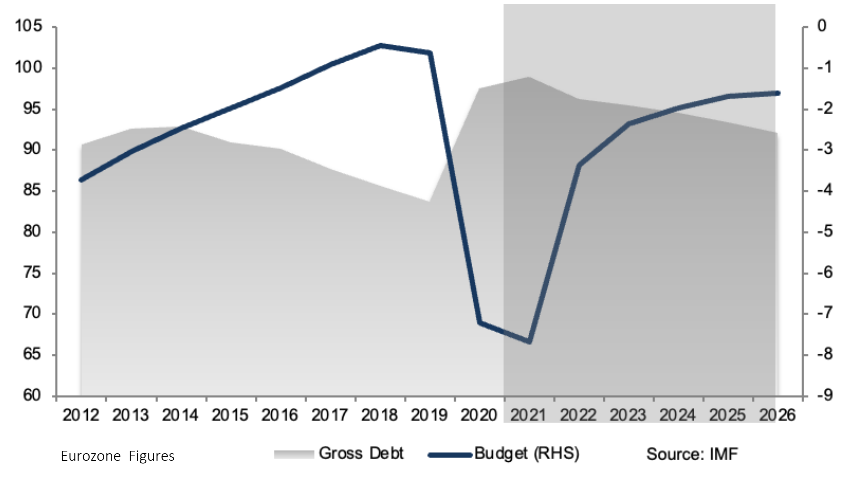


Figure 9: The sharp drop in economic activity in 2021, lowered tax incomes and boosted outlays leading to the deficit rising sharply, whilst debt levels continued to inflate as governments across the region came to the rescue of businesses, leading to a much less sharp increase in unemployment than in other regions. Deficits should continue to lessen with the sharp recovery, which also means that debt should diminish going forward.

The UK will likely continue to struggle with labor and goods shortages well into the year as it navigates through a protracted adjustment phase[15]. With an isolated, increasingly impoverished UK, Brexit buyers' remorse looks likely to become more pronounced. The U.S. will continue to face similar internal strife as it did in 2021, which risks being accentuated by Biden's many cock-ups and mistakes, as his popularity slides further. A worsening pandemic will dent the recovery whilst persistently high inflation may force the hand of the Fed to tighten, risking stagflation. The U.S. could also get sucked into another "endless" war which would damage

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[13] Emmanuel Macron will ask French voters for a second term in preference to his avowedly racist, Islamophobic rivals, Marine Le Pen and Éric Zemmour. Polls put him ahead, although he also faces what could be a strong challenge from the center-right Republicans. The authoritarian Hungarian leader who has made a mockery of the EU overrule of law, democracy, and free speech issues, will face a united opposition for the first time. His fate will be watched closely in Poland, the Czech Republic, Slovenia and other EU member states where reactionary far-right parties flourish.

[14] https://www.atlanticcouncil.org/blogs/ukrainealert/russia-is-the-worlds-leading-exporter-of-instability/

[15] Britain chose to delay implementing the full checks on imports from the EU for most of 2021, but they will begin to bite in 2022. Some European small and medium-sized businesses have already decided that exporting to Britain is not worth the hassle. British retailers reckon that supply shortages could last well into the second half of 2022.

the standing of democrats, leading to potentially significant setbacks in the November midterms and risking paving the way for a second Trump presidency.

The pandemic is unlikely to ever be fully eradicated, instead we will see a continued waxing and waning of its effects, although its impact will likely lessen with each iteration. Its threat to the global recovery will continue in the near term, as emerging markets in particular remain most exposed and vulnerable to its effects. With all the additional infections bringing us a step closer to achieving the so-called herd immunity threshold, broader access to vaccinations, the recent introduction of powerful antivirals and better overall preparedness by hospitals and the public in handling the pandemic suggest that we may be finally nearing the end of this calamity.

The Fed's increasingly hawkish stance will continue to create volatility in countries with large dollar borrowings. Rapidly deteriorating economic conditions such as in Turkey with its substantial currency slides could push the country into hyperinflation territory, which risks triggering a global contagion, creating wide scale economic and market crises that will be more difficult to contain once it has taken hold.

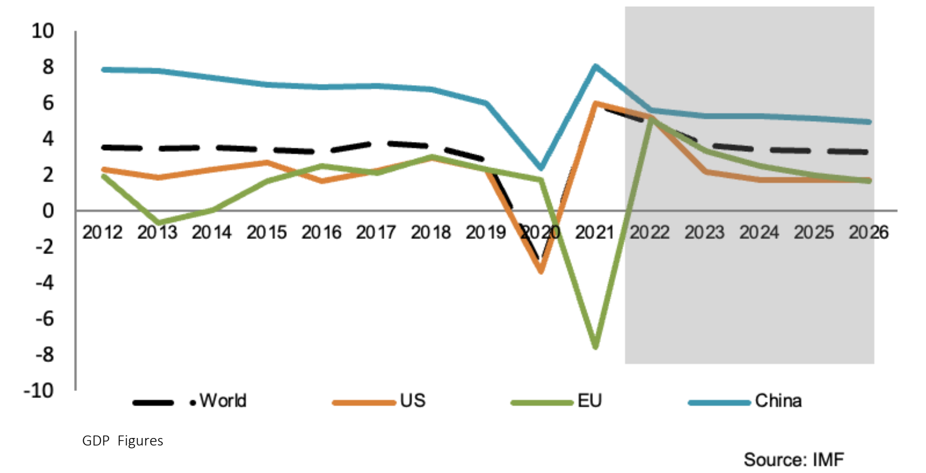
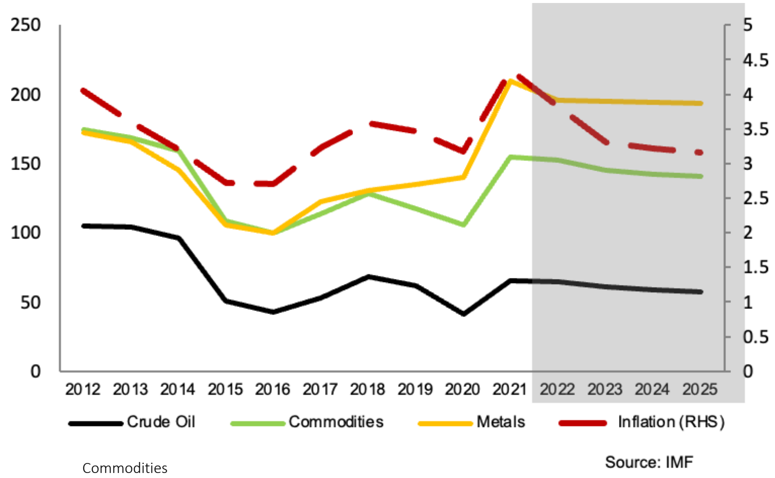


Figure 10: Even though the recovery has been relatively swift across the globe, it is the rate of inflation that is going to determine what happens next. If inflation remains persistently high in the U.S., it could prompt the Fed to start tightening, which risks drawing the economy into a stagflationary spiral that could drag along for a while to come. It is also possible that the inflation problem is fixed as supply bottlenecks are resolved and demand drops to a more "normal" rate, in which case the recovery should settle at a more moderate pace.

Climate change will continue to draw attention as extreme weather conditions like those of 2021 – fires, droughts, floods, storms and record temperatures – will repeat themselves and likely get worse, further inflating the total bill from the damage. This will cause alarm and more anger directed towards governments and businesses perceived as doing too little, too late. All eyes will be focused on the COP 27 summit scheduled in November, especially in light of the COP26 disappointments[16] of the previous year. Even if we may be heading in the right direction, however, the amount of effort necessary to produce a significant enough impact to reverse course is such that it is unlikely to be met.

The "great unknown" will be what happens to the inflation. Supply chain bottlenecks are also likely to resolve themselves over the year as improved processes and new chip fabrication plants are able to increase capacity to match the demand, whilst demand for goods should also subside in return. Even though most pundits expect inflation to ease, especially if both demand and supply pressures are simultaneously relieved, its actual path will remain uncertain, depending to some extent on whether businesses and households will have integrated higher inflation expectations into their thinking. The danger with higher inflation expectations will again be that it triggers stagflation, especially if the Fed carries out with its intentions of tightening.

[16] Cop27 will provide progress reports on the Glasgow pledges to reduce carbon and methane emissions, halt deforestation, "phase down" coal production, cut fossil fuel subsidies and provide finance to mitigate the loss and damage suffered by poorer countries.



Commodities

Figure 11: A resumption in the global recovery, especially regarding manufacturing and transportation activities as the pandemic and its effects continue to recede, will mean that demand for commodities, including oil, should also improve.

We are unlikely to get a repeat of the spectacularly positive earnings surprises of last year and with the S&P 500 index still hovering at above 20 times expected earnings, it is a tall order for stocks to do a repeat of the stellar performances of last year. It is in the laggards where performances are likely to shine, whether it be the emerging markets or certain specific sectors of the economy. Bond yields may finally see a reversal in trend which will likely put further pressure on equities, and the emergent technologies of blockchain and the metaverse promise to change the economic landscape even further, creating new opportunities along the way.

Still, there are many uncertainties out there that carry the potential of derailing an even more moderate recovery from materializing. The pandemic came as an abrupt shock and we weren't really prepared for it, which isn't surprising considering the last one happened more than a century ago. What was more surprising, however, was our efficiency and effectiveness in countering and containing the pandemic, in keeping our economies relatively intact, a demonstration of our prowess, ingenuity and solidarity when confronted with such complex challenges. Its exit will be far more gradual, however, which means that in addition to leaving scars, the pandemic will have irreversibly changed our behavior and mindsets, which is probably why it is now that the "before time" resonates more than ever. The new normal is already here, get used to it!

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