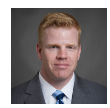
Asset Allocation Insights

Ten Key Insights From 2021

January 2022



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KEY INSIGHTS

- Although macroeconomic events may have dominated financial markets during the pandemic, earnings and fundamentals still matter.
- Easing supply bottlenecks could mitigate inflationary pressures, but durable increases in housing costs and wages could mean higher inflation for longer.

While we bid farewell to an eventful 2021, it is worth taking a moment to reflect on the past 12 months. I would like to share these 10 insights that I believe will continue to impact financial markets in the new year.

1. Earnings matter.

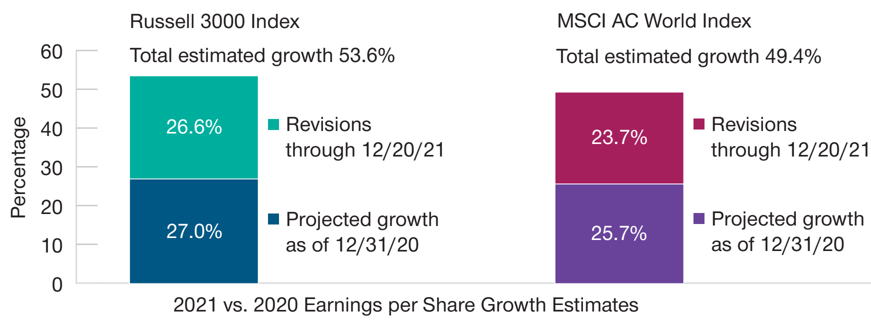
Monetary and fiscal stimulus faded sharply in 2021, as did the pace of economic growth. In spite of these headwinds, stock markets continued to notch record highs boosted by strong earnings growth (Figure 1), which not only met but exceeded lofty expectations.

2. Fed hikes expected to be limited.

Despite the recent hawkish pivot, aggressive tightening could upend

Strong Earnings Drove Equity Markets in 2021

(Fig. 1) Earnings growth estimates for the Russell 3000 and MSCI All Country World Indexes exceeded expectations in 2021



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the economy, and the futures market expects the Federal Reserve (Fed) to pause or even reverse course well before reaching its targeted hiking projection of above 2%. However, if the economy is still strong and inflation remains untamed by the end of 2022, these expectations may need to be reassessed.

3. Chinese regulatory policy is a big deal.

In recent years, there has been a lot of chatter in the U.S. about regulating big tech, but real actions have mainly come from China. In 2021, Chinese regulatory policy was the biggest driver of returns for emerging markets and will continue to be a key factor going forward.

4. Is elevated inflation structural?

The spike in inflation has mostly been driven by COVID-related shocks given the faster recovery in demand than supply. While this mismatch could ease considerably in the next few years, the tight housing and labor markets are likely to result in higher sustained inflation.

5. Growth versus value.

The growth and value valuation gap has reached levels only exceeded during the tech bubble. In this cycle, however, solid fundamentals and secular tailwinds underpin higher growth stock valuations. Although it is difficult to predict whether growth or value will perform better in 2022, the potential upside for growth stocks appears more limited.

6. Investors are clamoring for alternatives.

Given extended valuations relative to history and the diminished hedging qualities of bonds amid low yields, investors are seeking potential alternatives to stocks and bonds. Previously obscure segments, such as special purpose acquisition companies (SPACs) and cryptocurrency, have seen massive inflows, quickly becoming crowded.

7. U.S. politics, all sound but no fury.

After the Democratic sweep, regulations on infrastructure, tax reform, carbon emissions, and big tech were expected to meaningfully impact financial markets. However, despite the noisy headlines, progress on these initiatives has been uneventful, and new potential regulation is likely to be heavily watered down relative to original expectations.

8. Stock selection is important.

Since the pandemic, macro factors have often trumped company-specific fundamentals. However, stock selection is beginning to matter again, and unless the emergence of a new variant results in another full-scale global lockdown, the impacts of the coronavirus and its extreme echo effects appear to be fading.

9. Credit market fundamentals are supportive.

Credit sectors offer modest yields, but their fundamentals look remarkably strong. While tight spreads are typically a headwind for U.S. high yield sectors, leverage, margins, and interest coverage ratios all look very healthy.

10. U.S. dollar strength.

The dollar faded sharply during the second half of 2020, and most investors went into 2021 expecting more of the same. Instead, the opposite has happened as U.S. economic growth outpaced other developed markets. The dollar is likely to strengthen further as the Fed shifts to a tightening bias while other major central banks remain firmly on hold.

As we welcome 2022, we will continue to monitor these market themes and provide updates accordingly.

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