A review of 2021 and Strategic Positioning for 2022

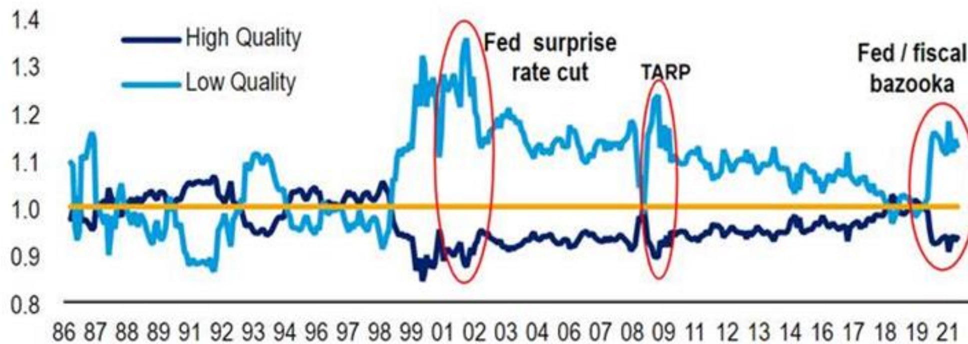
When we look back at 2021, one may well consider it as challenging even though the S&P 500 notched a total of 70 record highs over the year. Month after month, led by the U.S. markets, the MSCI World Index rose despite Chinese equities finishing the year down 22%, their worst year since 2008. However, low-quality investments performed well not only in equities but across all asset classes. For instance, in fixed income, U.S. junk bond spread over 10-year Treasuries currently stands near all-time lows indicating increased investor appetite for low-quality credit.

Source: Bloomberg, Barclays Capital US Corp High Yield Index minus 10 Year Spread

For a second calendar year, Covid-19 created volatility in financial markets with two major macro themes, which wavered throughout the year with varying enthusiasm: inflation and commodities price boom. After a 40-year pause, the commencement of persistent global inflation and the widespread distribution of vaccines helped combat the virus, restoring demand for goods and services. However, the pandemic also highlighted the fragility of global supply chains and resurgent global demand. Market participants' appetite for stocks meant that cash investments into equity funds in 2021 surpassed those of the past two decades combined.

Nevertheless, at the beginning of the year, concerns mounted on the vast amount of government spending and monetary stimulus that continued to flow worldwide as the first quarter drew on. Could this fuel more inflation? This would prove to be a theme that would continue throughout the rest of the year. The result was that in the first quarter, developed market bond yields experienced some of their biggest monthly jumps in over a decade, reflecting fears that central banks may tighten policy earlier than expected to suppress inflation. Despite solid GDP numbers from the U.S. and China in the early months of the year, May marked the start of significant inflation prints as the U.S. Consumer Price Inflation exceeded 5% for the first time since the Global Financial Crisis and continued to remain above this threshold for the rest of the year.

As a result, after months of holding their view that elevated price pressures would prove transitory, the Federal Reserve surprised many in June with hawkish rate projections, causing major sovereign yield curves to flatten. As we enter the Fed's tapering phase, we believe it is likely that we will see a gradual rotation into high-quality assets. For instance, high-quality equities specifically have recently traded at a 27% forward P/E discount to low-quality stocks following this unprecedented fiscal and monetary liquidity injection.



Source BAML, Relative fwd. Price Earnings Ratio of High Quality vs. Low Quality Stocks

For 2022 we have a preference for equities over government bonds and credit. Given the inflationary environment, the interest rate path has been shallower than in previous tightening cycles, supporting our overweight to inflation-linked bonds. The low interest rate environment supports an Equity overweight with a focus on Developed Markets and the U.S. in particular.

In comparison to other assets, Equity valuations remain reasonable from a cash flow generation perspective. Valuations are also supported by strong secular tailwinds (strong excess liquidity, balanced relative valuations, and continued strong corporate free cash flow generation), as well as, from a tactical standpoint, strong pent-up demand and low inventories.

Source: Bloomberg, S&P 500 Index, Price/Free-Cash-Flow Ratio since 1990

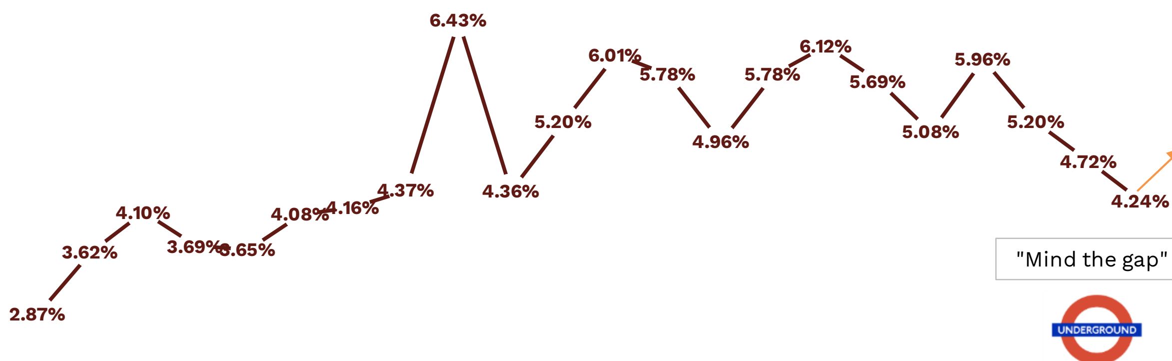
Moreover, the equity market is currently supported by a scarcity of compelling asset allocation alternatives. In particular, from a relative value standpoint, low interest rates continue to make stocks look attractive on a relative basis, as the spread between dividend yield and bond yield has recently been approximately 100-200 basis points above average.

	Dividend yield	10Y Bond yield	Dividend yield minus bond yield	Average since '00	Current vs Average (bp)
US	1.3%	1.3%	0.0%	-1.3%	134
Japan	2.1%	0.0%	2.0%	0.8%	125
Eurozone	2.1%	0.2%	1.9%	0.4%	150
UK	3.7%	0.7%	3.0%	0.6%	240

Source: JP Morgan, developed Market Yield Gap, June 2021

As a result, long-term investors will be rewarded for maintaining a high-quality bias in their stock selection over time, from both a return generation and risk mitigation standpoint. However, we cannot rule out the occasional rotations into the deep cyclical sectors such as Oil and Gas, which typically suffer from burdened balance sheets, low barriers to entry, and lumpy if not anemic free cash flow generation.

While the gap (premium) between S&P500 Earnings Yield and 10-year U.S. Treasury yield has been coming down, we think that higher earnings growth in 2020 will sustain a higher equity risk premium in 2022. However, we are very mindful of this "gap" and tracking it closely.



2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020 2021 2022

Source: Damodaran/NYU Stern, S&P500 Equity Risk Premium (ERP) or S&P500 earnings yield minus 10 Year treasury Yield

We balance our equity exposure with some bond duration but prefer inflation-linked bonds over nominal government bonds. This is because we see inflation persisting and nominal yields rising more than real yields.

How about the pandemic? While it is likely that Omicron is more transmissible, early reports suggest it may also be less deadly. Should these trends be confirmed in the coming month, we feel that the Omicron variant (abating) will ultimately prove to be a positive for risk markets in the sense that it could accelerate the end of the pandemic. If a less severe and more transmissible virus quickly crowds out more severe variants, the Omicron variant could be a catalyst to transform a deadly pandemic into something more similar to seasonal flu. Such development would fit with historical patterns of previous respiratory virus pandemics, especially given the broad availability of vaccines and new therapeutics expected to work on all known variants (Pfizer, Merck).

On the Emerging Markets front, China seems to be historically under-represented in Investors' allocation. We see significant positives stemming from the transformation in China's overall policy stance toward more state intervention and social objectives, even at the occasional expense of growth. The regulatory clampdown and tighter policy stance that rattled global investors in 2021 made that shift clear. However, we believe the low starting point of global investor allocations to Chinese assets is at odds with the economy's growing heft in the world. Blackrock estimates that current allocations in global portfolios point to an overly negative economic outlook in coming years - such as a long-lasting growth shock akin to Japan in the 1990s.

Source: Bloomberg, Chinese Equities vs. World Equities dramatically underperform

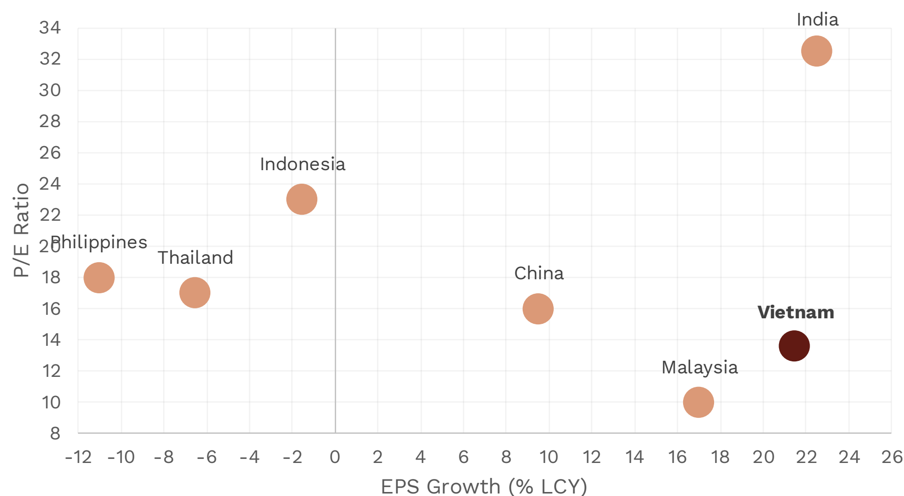
We expect stricter regulation in China to persist but think it is unlikely to intensify in the politically significant year of 2022, given slowing growth. We expect Beijing to gradually loosen monetary and fiscal policies – that remain very hawkish relative to DMs – to shore up growth. Policymakers have taken advantage of strong post-Covid growth to push through reforms. Yet risks to growth from new Covid-19 variants would further warrant more easing.

Within our Emerging Markets allocation, we recently included Vietnam that we think has a lot going for it on the macro front. To name a few:

- Political and Social Stability
- Youthful Demographics
- Emerging Middle Class Formation
- Low Foreign Debt
- External Account Surpluses
- Rapid Recovery in GDP Growth
- Moderate Inflation
- Private Sector Empowerment

As seen below, Vietnam is one of the cheapest equity markets in Southeast Asia.

In Vietnam, Infrastructure is planned as the key thrust of fiscal stimulus to fight COVID 19 and sustain growth. Whilst Infrastructure spending stalled by anti-corruption probes after 2017, following leadership reshuffle, the Government is now reinvigorating its pipeline of projects into a master plan that it estimates at $120bn in 2021-25.



Source: Dragon Capital, Bloomberg, 2021F PE Ratio vs. 2020 Earnings (EPS) Growth, September 2021

We are often asked whether inflation and the risk in real yields can derail stocks in 2022. We believe not; while even if real yields rise but from extremely complacent levels (i.e. -1%) to still accommodative levels of about -0.25%. Real yields will likely gradually revert to positive territory in the coming years and at a pace that risk assets should be able to handle and remain far from levels that can start challenging economic expansion. We think that the economy in 2022 will be defined by a full global recovery and an end of the global pandemic which we believe will produce a strong recovery, a return of global mobility, and a release of pent-up demand from consumers (e.g. travel, services) and corporates (inventory, capex and buyback recovery).

Tapering has happened before with equity markets rising in tandem. However, when real yields rise substantially over a short period of time and market depth is low (as is during the time of writing of this piece) VIX spiked and risk markets de-rated. Similar to the 2014-2017 rising real rates episode, for a short time, within Equities, Tech, Growth and Bond-proxies suffered the most, while Cyclicals/Value/Reflation outperformed.

In terms of Q4'21 inflation print of 5.9% which for many signals a sustained upward shift in inflation we believe that broadening of price pressures will remain but will normalize at the 3.5% area. In contrast to last year's COVID waves, it is unlikely that the Omicron wave derails the gradual relaxation of global supply constraints which is currently underway.

Balanced Mandate Matrix	Equities				Bonds	Alts. & Comms	Cash
	USA	EU	Japan	EM			
	OW	MW	MW	UW	UW	MW	UW
Q1'22	**42.5%**	**5.0%**	**2.5%**	**5.0%**	**20.0%**	**25.0%**	**0.0%**
Q1'21	**45.0%**	**5.0%**	**2.5%**	**5.0%**	**20.0%**	**22.5%**	**0.0%**

Beyond equities and bonds, we believe Private Markets and Alternative Investments will keep playing an important role in strategic allocations as private and institutional investors in Europe progressively leg into Private Equity and Venture capital due to the scarcity of alternative asset classes. We see private assets – from private equity and credit to infrastructure debt and real assets – as complementary to public markets for eligible investors and core holdings in their strategic asset allocations.

Equities

The stock market has risen steadily since its lows in March 2020 and has seen only a few phases of volatility since then. However, we consider equity risk premium still attractive and find fundamentals supportive. We are convinced the outlook for 2022 is again favorable for equities, but the expected returns will inevitably be lower than in 2021. Despite the further upside, company earnings growth will most likely weaken towards a more normalized historical average. The general forecasts are confirmed broadly stable despite the recent events and assume earnings growth of 8 to 10% for a payout growth of 4 to 9% year-on-year in most developed countries.

	Earnings per share		Dividends per share	
	2022	**2023**	**2022**	**2023**
[US] S&P 500	10.0%	10.2%	4.3%	3.7%
[US] Dow Jones	9.8%	7.9%	8.3%	1.7%
[EU] Euro Stoxx 50	8.1%	8.2%	8.0%	5.4%
[DE] Dax	8.9%	7.0%	7.5%	5.9%
[CH] SPI	8.7%	8.8%	5.9%	6.6%
[JP] Nikkei	8.6%	4.8%	9.5%	6.0%

Source: Bloomberg

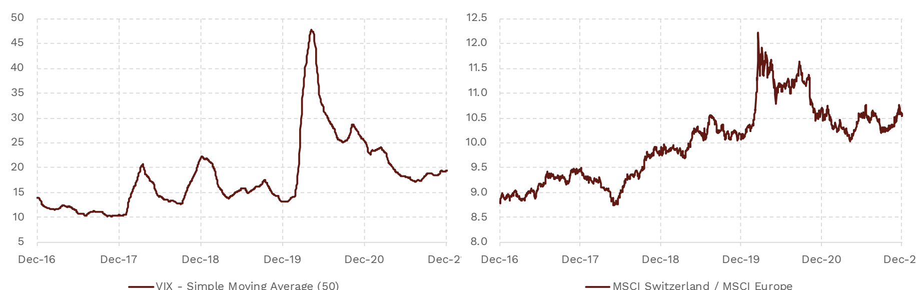
Our strong preference is for the U.S. and Switzerland. Into 2022, we are progressively and selectively constructive on Asia, namely Chinese secular trends and the recent Vietnamese disruption. In our view, other scenarios in Emerging Markets are not yet attractive enough from a risk/reward perspective.

Large-cap defensive growth is likely to benefit from perpetual uncertainties. In 2021 large caps have taken over leadership from the small and mid-cap universe, notably highly sensitive to actual economic conditions and shifts in expectations. The latter often suffered, while higher quality growth has taken over from speculative growth and reflation plays. The cyclical universe in developed markets has failed consistently to extend its outperformance relative to defensives. We now see further upside and downside risks to growth expectations, macro rates, and monetary policy, and we account for more volatility in store.

We believe larger defensive growth will be the principal beneficiary of the uncertainties across geographies, at least in the first part of 2022, on a risk-adjusted basis. However, higher risk value options will remain of interest, while we are convinced that short-term volatility would eventually provide attractive opportunities for the longer-term horizon, as happened historically. At this point of the cycle, remaining dynamic on the sector mix implies more resilient margins and valuations, but an active approach is more important than ever. Once the degree of inter-sector and intra-sector dispersion of performance and valuation by individual stocks will increase, we expect this to translate into a better alpha environment for active investors in the space.

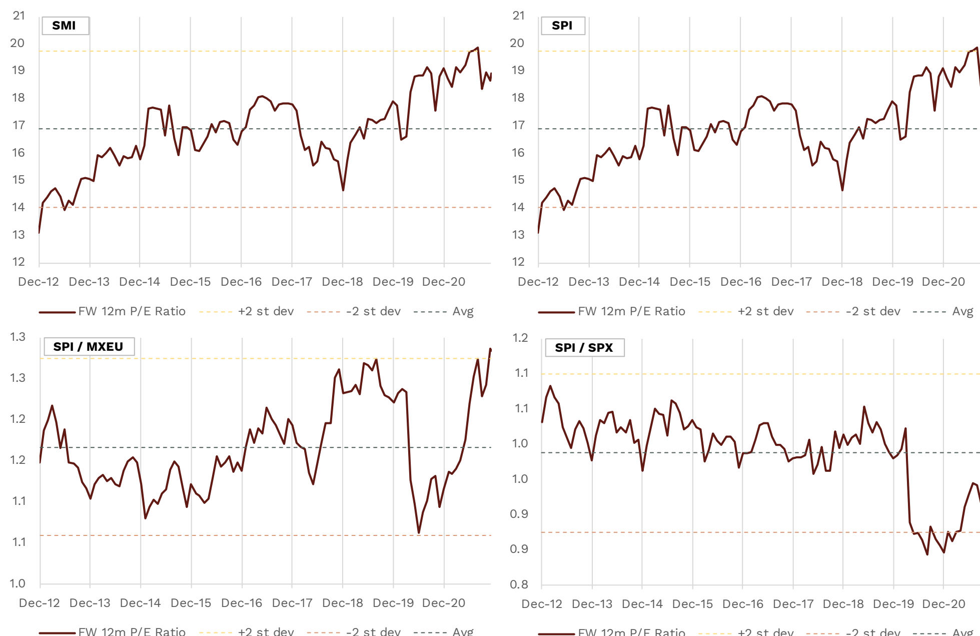
Source: Bloomberg

Switzerland is still the ideal value play in difficult times. The Swiss market has generated robust returns over the last decade. Further to that, Swiss equities have offered high yields and have been a near-perfect safe haven during times of market stress. The same happened again in 2020-21, as attractive diversification and superior risk/reward are core elements investors appreciated when in need of resilience over volatility. We expect such behavior to remain in 2022 and to consolidate further.



Source: Bloomberg

We are conscious that valuations may have little room to rise further and may be an obstacle for the index compared with other European major markets with similar earnings-growth prospects going forward. The Swiss market's valuation is near a decade high, both absolute and relative. The SPI was trading at more than 18x forward earnings at the end of 2021. This is more than 1.5 standard deviations above its 10-year average. More interestingly, the SMI's two-standard deviation discount, compared with the broader European market from early 2021, now has a similarly wide premium. Though the market is highly concentrated, its extended valuation is not simply a function of the multiples of a few super-weighted companies. The top three stocks combined, which aggregate to over 30% of the index weight, actually trade at a discount versus the SPI.



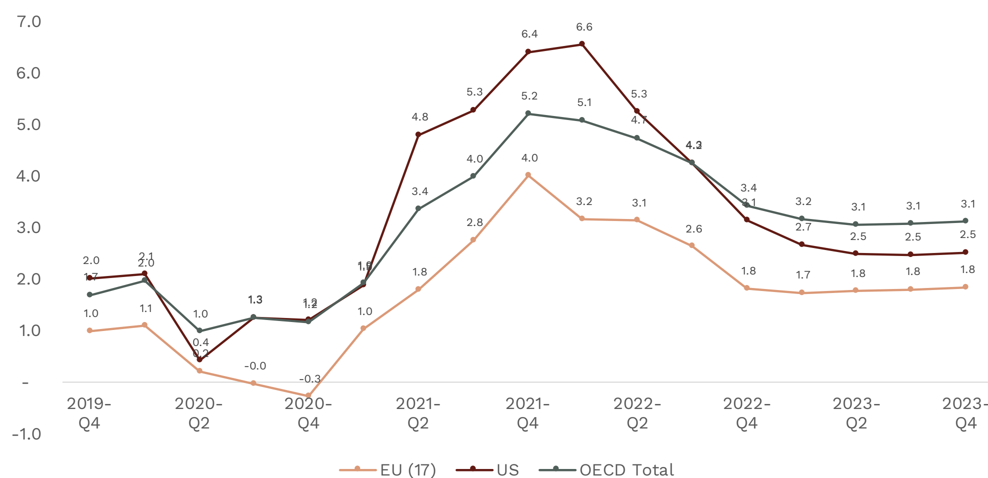
Source: Bloomberg

Instead, we find increasing potential in multiples of smaller companies, which combine value characteristics with quality growth economies. They are typically respected players that occupy leading market positions in promising niches and offer innovative, high-quality products. Small-mid caps have historically outperformed larger caps at lower volatility, but surprisingly the segment is still relatively under-covered by research analysts. The resulting information asymmetry combined with liquidity and price anomalies often lead to market inefficiencies that investors can actively benefit from. We thus see such increasing appeal to continue in 2022 for the segment despite some inflation headwinds, with actual superior earnings growth potential to explain the valuation premium to the broader region and to drive the outperformance against larger domestic companies at comparable enterprise risk.

Fixed Income

As mentioned earlier in this outlook, inflation in 2021 has been increasing from the very low levels observed in 2020. The production and supply chain bottlenecks that have been causing the soaring prices in 2021 are expected to ease later in the coming year, according to the inflation outlooks of the OECD.

Besides the easing of the shortages suffered in 2020 and 2021, the factors of the retreat of inflation in the U.S. will be the tapering of expansionary monetary policies and a decrease of commodity prices, according to the Chief U.S. Economist Ellen Zentner. The inflation experienced in the last year is not going to be transitory for all goods categories; some goods, such as housing, will have rising prices following the economic cycle.



Source: OECD. Inflation forecasts.

Monetary policy. Considering the global economy's recovery path, we expect the central banks to have tighter policies in 2022. The Federal Reserve announced on November 3rd that it would start slowing the pace of its asset purchase program and that it would end it by mid-2022. The inflation concerns and the decrease of the unemployment rate will play a role in the policy rate level. In 2022, as many as three rate hikes are expected, with an appropriate policy rate ranging between 0.6% and 0.9% in 2022.

In Europe, there are two contrasting monetary policies: the ECB will tighten its asset purchase program, but no interest rate hikes should happen as the inflation rate is expected to be lower than the target rate; unlike the ECB, the BoE has a clear path of policy rate increase.

Credit. The dovish monetary policy observed so far is set to change in 2022 and so is the credit space. From a general point of view, higher policy rates and the normalization of inflation rates are likely to flatten the yield curve.

Sovereign bond markets will be characterized by the fiscal aftermath of the pandemic. Public deficits are set to remain at pre-pandemic levels until 2023 for both developed and emerging countries. Despite some improvements coming from higher fiscal revenues brought by the economic recovery and the end of fiscal subsidies, the stock of debt that governments need to finance is expected to remain high.

Corporate debt has been benefiting from the low rate environment and from the low spreads of 2021. The increase of policy rates in the US poses a challenge to corporate issuers, which may face higher financing costs. Whether the low spread environment of 2021 will continue depends on the magnitude of improving business conditions, from supply chain issues to consumer spending.

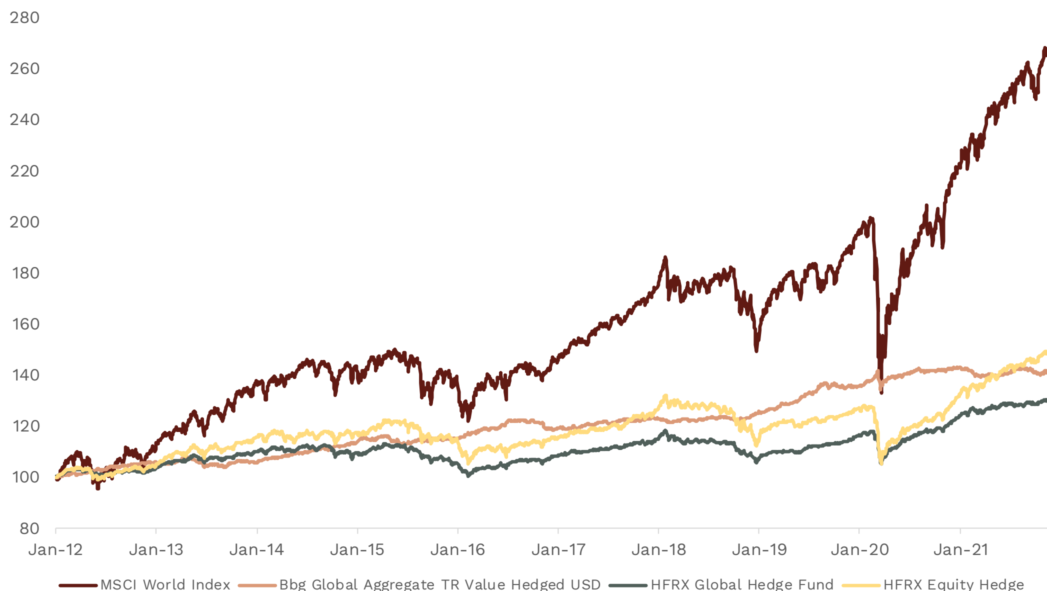
The economic recovery will improve the fundamentals of many corporations, therefore defaults are unlikely to play a major role in 2022.

Overall we remain very cautious on the outlook in the fixed income space: we are overweight and maintain a low duration exposure with a significant part of the portfolio protected from inflation risk through inflation-protected Treasuries and floating-rate notes.

Alternatives

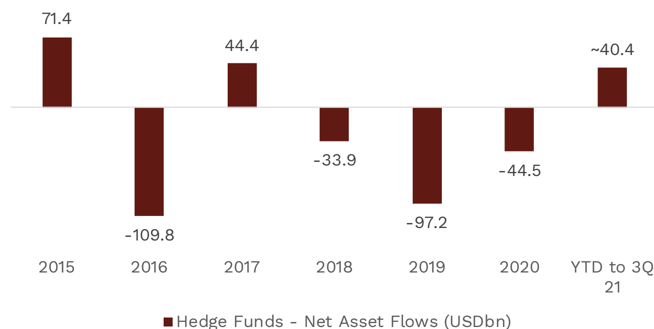
After more than a decade of exceptional returns for both equities and fixed income, investors are now finding themselves in an environment of equity valuation at or near all-time highs and bond yields at or near all-time lows. In this environment, alternatives can prove an excellent diversifier to the portfolio, with a broader range of actions and, therefore, the possibility to take advantage of the various potential outcomes.

Alternatives have been underperforming more traditional asset classes over the last decade.



Source: Bloomberg.

The reasons for this underperformance are various; among others the extraordinary central bank interventions, the crowdedness in the market trades that made it very difficult to generate alpha, and the heightened regulation, following the 2008 Global Financial Crisis. This, in turn, resulted in significant asset outflows for hedge funds over the last few years and in a few funds having to close down.



Source: Prequin, Reuters.

We believe that the factors that have played a significant role in the underperformance of alternative asset classes for the last decade are beginning to subside, and the trend seems to be accelerating in 2022. More specifically, as we discussed earlier in this outlook, Central Banks policies are expected to be tighter this year: the resulting volatility in equity markets will undoubtedly prove challenging for beta driven strategies. A lower net – lower beta equity long/short fund is much better positioned in this environment than a pure, long only, player.

The long/short nature of alternative funds and the trading techniques they use allow them to target and mitigate the overall risk of the portfolio, helping in periods of dispersion and volatility.

Equity Long Short

- Low net. Given the challenging beta environment, we are primarily interested in lower net, alpha driven strategies. We like managers who couple the fundamental bottom-up analysis on single names with a top-down macro analysis to manage the portfolio exposure. We feel these are positioned the best given the many moving parts in the current macro environment.
- Sector specialists. We find sector and country specialized managers complement well a portfolio of generalists and are invested in some of these managers. We are mainly looking at those sectors that can offer a good hedge against inflation, such as financials and utility/infrastructure.
- Small/Mid Cap specialists. Another area of interest is small and mid-cap specialists. This has become a focus in recent years, as crowding in the large-cap space has been increasing.

Event Driven. The outlook for the strategy remains very positive, with a continued record-setting pace of corporate activity both in the soft and in the hard catalysts space. Despite the higher valuations and the regulatory risk, deal spreads remain attractive.

Global Macro. As monetary and fiscal policies are turning in 2022 and uncertainty is present, we expect an expansion in the opportunity set for Global Macro managers. Once again, execution plays a big role and we expect diverging returns between managers.

Private Markets

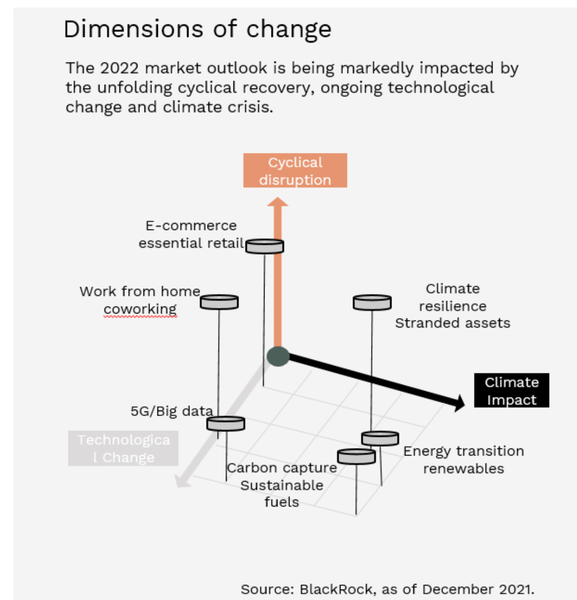
The year begins with the private equity market in good shape. Apart from hospitality and leisure – sectors that FAM has very limited exposure to – companies under private equity ownership have shown great resilience throughout the pandemic. Deployment is at an all-time high, and new businesses and opportunities, such as secondary investing, are growing. Investors continue to increase their allocations to most asset classes, and competition for assets is strong. High valuations were the norm throughout 2021, and we do not expect this to change in 2022. Long-term strategies are required to navigate potential bubbles. This makes differentiated sourcing more important than ever and sets the stage for greater dispersion in future returns. At the same time, we think that the best course is to diversify across asset classes and as well as across vintages as the future is unknown.

Mega Trends

Growth in Technology. The age of Covid has accelerated trends such as the use of technology across all businesses, changes in healthcare, new consumption, and living patterns. We see this in private equity and credit, but also in real estate sectors such as residential and logistics. Our view is that exposure to these trends is an important element

of future private market returns, particularly in a world where forward returns are more and more challenged.

Technology adoption — cloud services, artificial intelligence, and more — is accelerating everywhere, creating opportunities to finance both tech companies and the digitization of traditional firms. Businesses and rollup platforms need fast, flexible capital — both equity and debt — as the rapid pace of change creates winners and losers within industries. For infrastructure investors, digitization means potential long-term revenue streams from 5G cell towers, data centers, broadband buildouts, space communications, decentralized electrical grids, and smarter customer meters.



Source: BlackRock, as of December 2021.

Innovation is deeply linked with technology growth. Venture Capital returns have been strong in the past few years, with 2021 seeing a number of records in fundraising and deal volume, both of which more than doubled YoY. We believe this trend will continue, especially in underserved VC geographies such as Europe that are lagging behind the US venture ecosystem. Capital deployment needs caution, though, to avoid getting caught in the high valuation frenzy.

Growth in healthcare. Pre-Covid, we saw healthcare as an attractive sector. Today the tailwinds are as strong or stronger in healthcare technology, telemedicine, and beyond. In services, the aging population and rising income create further opportunities. We see considerable future demand for capital and a strong flow of opportunities across private equity and private credit.

Decarbonizing. Much has been said about the destination of net zero, but little is known about the pathway. We believe that forecasting this path — which requires a solid understanding of policy, innovation, cost, and resilience — will create opportunities in power, transportation, industry, and agriculture. Large CapEx infrastructure projects will be attractive, especially as there is expansive government support worldwide (e.g., EU Green Deal, US Infrastructure Bill). Emerging markets are also expected to take part in the transition, with significant capital flowing from developed to emerging markets.

The green transition will push technological breakthroughs. The importance of deep technology for solving hard problems such as climate change will be evident, with growth in the sectors of cleantech, foodtech, agritech being stronger than ever. Venture investment will profit from those trends, especially early stage funds that take advantage of lower valuations.

Changing life patterns. Where we work, play, shop, learn and educate is rapidly evolving, with significant consequences for real assets, in particular real estate. Logistics and residential are two high-performing areas, but we see demand for property evolving as tenants look for sustainably engineered buildings. While asset-specific factors will continue

to dominate and drive returns, looking across real assets, investors may also benefit from inflation-linked returns (albeit we expect inflation to remain within an acceptable range).

As private market investors, we observe this landscape from our long-term perspective. Our focus is on idiosyncratic situations within broad, long-term trends. When building our portfolios, the objective is to have a strong individual thesis and exposure to a powerful thematic jetstream. Our investment decisions should shape portfolios that contribute to a particular outcome, whether growth, income, diversification or a combination thereof.

Disclaimer

This document (the "Document") may not be distributed in whole or in part to any other persons. The Document is for general informational purposes only. Nothing contained in this Document constitutes legal, tax or investment advice. The information in this Document does not constitute an offer or solicitation to buy or to sell any securities or other financial instruments, or to engage in any other transaction involving securities or other financial instruments. This Document is not addressed to any person or entity in any jurisdiction where this may be or may be deemed to be unlawful. All Recipients take full and sole responsibility for compliance with applicable laws and regulations in relation to any use they make of the Document. The information in this Document may not be considered as a recommendation to buy or sell any securities or to adopt any investment strategy. The investments and strategies analyzed in this Document are not personalized and may therefore not be suitable for persons or entities to which this Document may have been delivered. Personalized and professional advice should be sought prior to taking any investment decisions. Any decision based on information contained in this Document lies in the sole responsibility of the Recipient. Although the Document is based on information that our research team considers to be reliable, it does not guarantee that the content is accurate, up-do-date or complete. The author may amend the Document partly or entirely at any time without prior notice. The author is not obliged to provide Recipients with an amended version of the Document. Recipients should not rely on it as a forecast of performance. The author provides no guarantee whatsoever pertaining to future performance of securities analyzed in the Document. The Document does not constitute an issuance prospectus. None of the securities described in the Document are recommended as an investment by the author. Their performance is not guaranteed to any extent. Past results are not a guarantee of future results and are for illustrative purposes only. The information provided is intended to highlight issues and not to be comprehensive or to provide advice. Risk factors you should consider before investing: The value of shares and income from them can go down as well as up and you may lose some or all of your initial investment. If the currency in which you invest strengthens against the currency in which the underlying investments of the fund are made, the value of your investment will decrease. Depending on the strategy, risks may be associated with investing in emerging markets and/or high-yield securities; emerging markets are volatile and may suffer from liquidity problems.