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in the moment

# Financial market outlook for 2022: Policy progression pertinent

## Highlights

- As more and more countries move away from a zero-tolerance stance towards COVID-19, the negative growth impact of each new COVID mutation wave is likely to become less severe going forward, unless vaccines become less effective against new virus variants or new mutations more fatal.
- Financial asset prices have been hugely supported by abundant policy stimulus in 2020/21. The transition in the policy environment in 2022 from less stimulus to eventual policy tightening, should culminate in a less conducive backdrop for asset class returns and could lead to periodic drawdowns in riskier asset classes.
- While the anticipated slowdown in profit momentum associated with lower global growth also points to a lower global equity return outlook in 2022, the magnitude and longevity of any potential equity sell-offs will be limited as long as the global economic recovery remains intact. What would be problematic for equities is a spike in bond yields, if the bond market perceives the US Federal Reserve (Fed) to be behind the curve on fighting inflation.
- The expected turnaround in the quantitative easing (QE) cycle going forward should be a negative fundamental demand factor for global bonds. In conjunction with inflation that is proving to be more persistent than previously thought, this points to higher bond yields going forward.
- Although global equities look cheaper than cash or bonds in relative valuation terms, widespread expensive absolute valuations across asset classes put a major constraint on the future returns that can be expected from each of global equities, bonds and cash in 2022. Furthermore, should the rand appreciate from current undervalued levels as we anticipate, this would erode the local currency returns from global assets for South African (SA) investors.
- If US real bond yields rise in anticipation of tighter monetary policy as we expect, this should benefit the rest of the world's (RoW) equity markets over the US with its long-duration growth characteristics and high valuation premium.
- Pressure on SA equity market profits in 2022 is expected from a slowing in global and SA economic momentum on top of the high profit base created in 2021. As such, returns will have to come from a rerating in market valuations. Fortunately, the SA equity market valuation picture looks quite favourable.
- Not only are SA real bond yields currently attractive versus developed market (DM) and emerging market (EM) yields, but SA's real yield premium is also high against historical averages. Relative to SA equities and cash, nominal bonds have consistently been the cheapest asset class since 2013. In the inflation-linked bond (ILB) space, there should be some scope for further break-even widening in the interim, with inflation expected to peak in the first quarter of 2022. After the recent rate hike by the SA Reserve Bank (SARB), the prospective SA real cash yield has risen to above zero.
- We think a large part of the negative fundamental backdrop for SA listed property has already been discounted.

## Learning to live with COVID-19

It unfortunately seems to be an inevitable reality that COVID-19 will remain a part of the global milieu for some time to come. The unevenness of vaccine rollouts across the world provides fertile grounds for new COVID variants to cause sporadic disruptions in the global economy, impacting negatively on economic growth and financial market risk sentiment.

However, more and more countries have started to move away from a zero-tolerance stance towards COVID-19, realising that the severe economic hardships caused by the strict lockdowns required by such a stance are mostly ineffective in containing the virus and counterproductive for the general well-being of their populations. Even more so if rising vaccination rates minimise mortality rates and severe illness among residents, or if new virus mutations become less lethal.

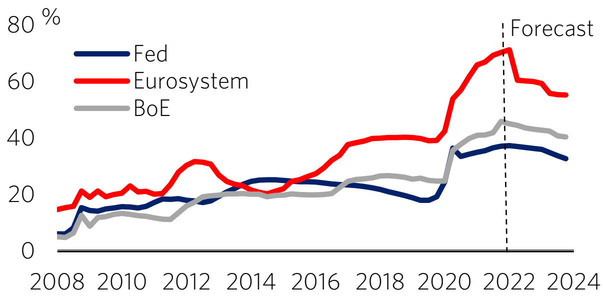
As such, the negative growth impact of each new COVID mutation wave is likely to become less severe going forward, unless vaccines become less effective against new virus variants or new mutations more fatal, leading to renewed spikes in hospitalisation and mortality rates.

## Navigating the global policy transition from massive stimulus to eventual tightening

An exaggerated cyclical global growth recovery in 2021 from the pandemic doldrums of 2020 was almost inevitable after the massive monetary fiscal and monetary stimulus dished out by policy makers around the world in response to the COVID-19 crisis and the improved mobility experienced in 2021 versus the lockdown conditions of 2020. In the same vein, a global growth slowdown in 2022 from the heady heights of 2021 looks a mathematical certainty, particularly against the backdrop of peaking policy stimulus.

In this regard, Bank of America projects that the central bank balance sheet of the UK is likely to already have peaked in the fourth quarter of 2021, both in absolute terms and as a percentage of GDP. Both the US and European central bank balance sheets are expected to peak in the first quarter of 2022 as a percentage of GDP (see chart 1), with the level of US QE likely to peak in the second quarter of 2022 and the European central bank balance sheet probably only peaking in 2023 in absolute terms.

Chart 1: Central bank balance sheet to GDP ratio

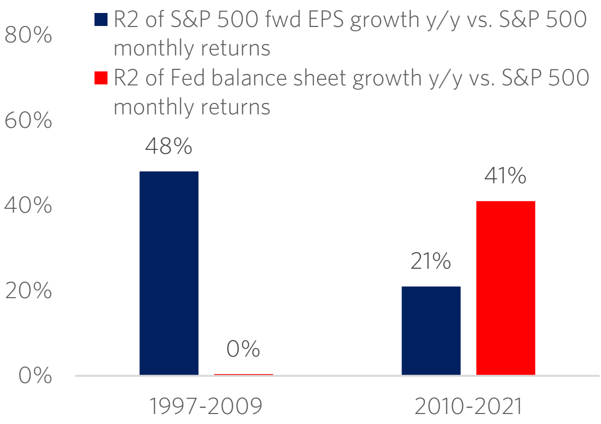



*Source: BofA*

The end of QE in the UK and the US is expected to soon be followed by interest rate increases, with the first rate hikes likely in the first quarter of 2022 in the UK and the second quarter in the US. However, a meaningful decline in the UK and US balance sheets levels associated with quantitative tightening at this stage looks unlikely before 2023.

Financial asset prices have been hugely supported by the abundant stimulus in 2020/21. The transition in the policy environment in 2022 (led by the US and UK) from previous massive stimulus to less stimulus, then to no additional stimulus, and eventually to policy tightening, should culminate in a less conducive backdrop for asset class returns and could lead to periodic drawdowns in riskier asset classes. How important QE had become for equity returns is aptly illustrated by research from Bank of America showing that since the global financial crisis (GFC), QE has become twice as important as a driver for US equity returns than profits (see chart 2).

Chart 2: Drivers of US equity market returns

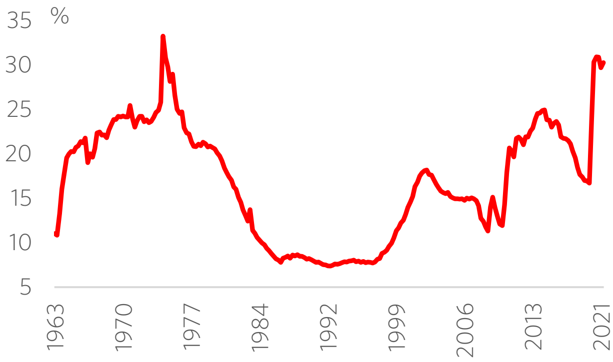



*Source: BofA*

While the anticipated slowdown in profit momentum associated with lower global growth also points to a lower global equity return outlook in 2022, the magnitude and longevity of any potential equity sell-offs will be limited as long as the global economic recovery remains intact and broad based, as is currently still the case. At least the anticipated growth slowdown around the world should be mild enough to keep growth rates well above trend levels in 2022, in our view.

The expected turnaround in the QE cycle going forward should be a negative fundamental demand factor for global bond yields. In the US, the Fed has been a major demand source for Treasury issuance since the GFC and again since the COVID crisis, so much so that the Fed now owns around 30% of all outstanding US Treasury securities (see chart 3). But this Fed demand will recede as QE is tapered and then ends, at a time when Treasury issuance will rise further to fund huge fiscal programmes in the US. The supply-demand dynamics for the US bond market is hence likely to deteriorate markedly in 2022. In conjunction with inflation that is proving to be more persistent than previously thought, this points to higher bond yields going forward.

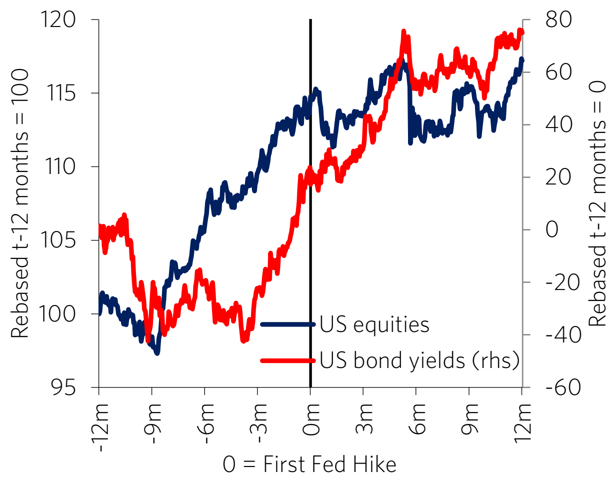
Chart 3: Fed % holdings of outstanding US Treasuries




*Source: MRB*

That caution is also warranted on global bonds as rising policy rates loom, is evident from a Citi analysis of US asset class behaviour at the start of previous rate hiking cycles. While US equities typically rally approaching the first Fed hike, bond yields rise in both the run up to the first hike and during the first year of the hiking cycle (see chart 4).

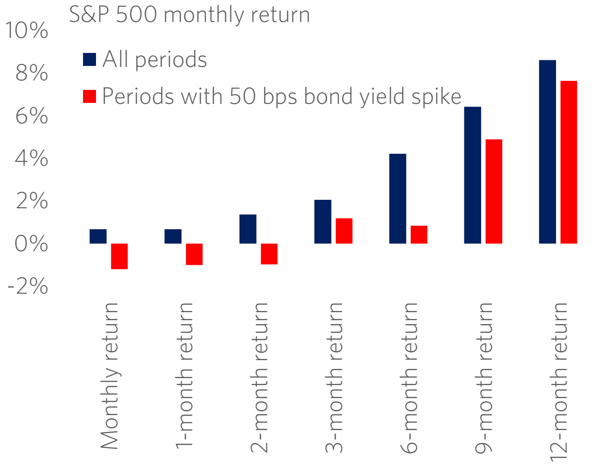
Chart 4: Historical US equity and bond performance around first Fed rate hike




*Source: Citi*

What would be more problematic for equities is a spike in bond yields, for instance if the bond market perceives the Fed to be behind the curve on fighting inflation. Research from Bank of America shows that when US bond yields historically rose by 50 basis points in a month, returns for the US equity market were negative in the immediate aftermath of the spike, while returns up to a year after the spike were weaker than normal (see chart 5).

Chart 5: US equity returns after a spike in bond yields

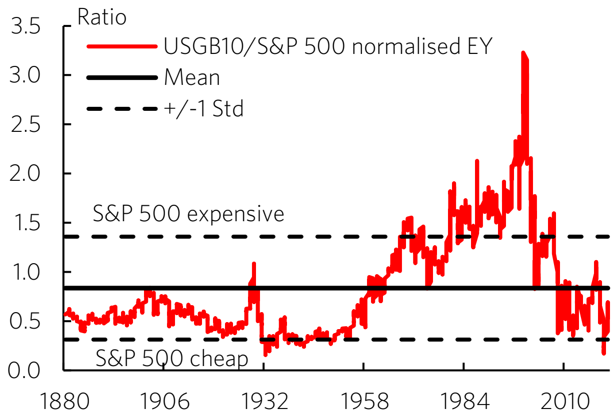



*Source: BofA*

It would be difficult to argue that any of global equities, bonds or cash are currently exhibiting great value in isolation, with the US equity forward earnings yield around 4.5% at the time of writing, the yield on 10-year US treasuries around 1.5%, Japanese bond yields scarcely above 0%, German yields almost -0.4%, one-year US cash yields less than 0.5%, Japanese cash yielding just above 0% and European cash -0.5%. These expensive valuations put a major constraint on the future returns that can be expected from each of these global asset classes in 2022 and beyond. Furthermore, if the rand appreciates from current undervalued levels as we anticipate, this would erode the local currency returns from global assets for SA investors.

In terms of relative valuations though, global equities look cheaper than cash or bonds. On a normalised earnings yield gap basis (using earnings over the past decade), US equities are currently more than one standard deviation cheap versus bonds on long-term averages (see chart 6). At the current through-the-cycle earnings yield, US 10-year bond yields would have to rise closer to 2% to erase the equity valuation discount. Conversely, at current bond yields, US equities would have to rise by more than 30% to close the valuation gap.

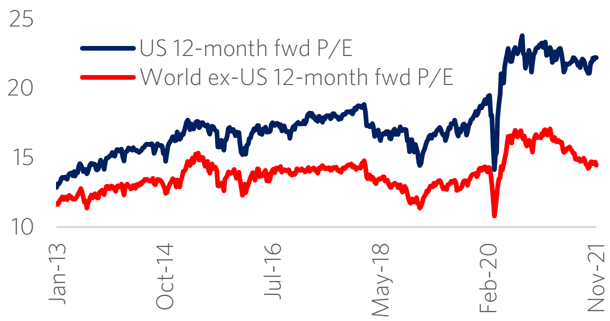
Chart 6: Relative US equity/bond valuations




*Source: Iress, Momentum Investments*

If US real bond yields rise in anticipation of tighter monetary policy as we expect, this should benefit the RoW's equity markets over the US market with its long-duration growth characteristics. In addition, as the US equity market has recently outperformed the RoW despite an inferior profit performance, this has opened up a record US forward P/E premium (see chart 7).

Chart 7: US and RoW forward P/Es




*Source: Morgan Stanley*

## Global and local risks in 2022

There is a risk that the pandemic could take a turn for the worse if vaccine rollouts falter due to unequal supply or hesitant demand, or if vaccines become less effective against rampant new virus strains. This could again cause more widespread and lengthy lockdowns around the world, resulting not only in a moderate slowdown in global economic growth as we expect in our base case, but a much more severe downturn, or even recession.

Should global central banks be forced to take a more aggressive policy normalisation path in an effort to contain more severe inflationary pressures, this could destabilise financial markets that have become accustomed to historically low interest rates and are priced for a very slow and gradual path to eventual monetary policy tightening.

Financial markets would also be roiled in case of increased geopolitical tensions between the US and China (whether on the Taiwan issue, military tension in the South China Sea or altercations on the trade front), or between Russia and NATO should there be a threat of an invasion of Ukraine.

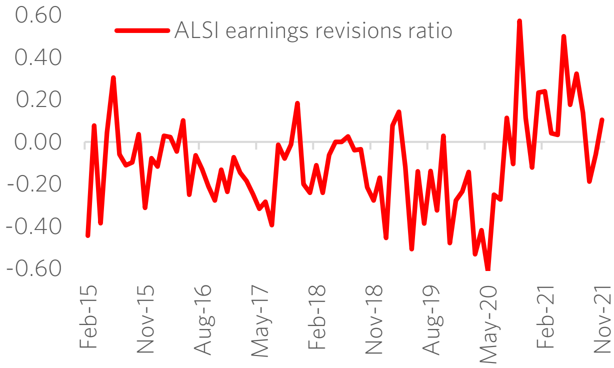
Adverse economic and regulatory developments in China would have negative repercussions for global and SA financial markets in 2022. Should economic growth in China turn out much lower than expected on the back of stringent pandemic-related lockdowns or policy shifts, it would have a direct negative bearing on the risk appetite in global markets. SA's heavy reliance on China's commodity demand and the fortunes of Tencent would leave local markets at risk from a China growth shock or further aggressive step-ups in the Chinese regulatory framework.

Within SA, any market-unfriendly political outcomes from the ANC elective conference in 2022 would be quickly reflected in lower local asset prices. Also, risks to SA economic growth from elevated frequencies of Eskom loadshedding in the coming year or disappointing progress on economic reforms, would result in an increase in SA's risk premium as an investment destination.

## Rerating the likely return driver for the SA equity market going forward

SA corporate profits benefited profoundly in the first half of 2021 from the stimulus-driven sharp rebound in global and economic momentum and the low earnings base of 2020. Continual earnings upgrades became the norm throughout this period. Unfortunately, this trend reversed in the second half of 2021 with the manifestation of a slowdown in global growth related to the appearance of the Delta COVID variant around the world. Apart from this global trend, local growth also buckled in the third quarter under the impact of civil unrest and more restrictive lockdowns. In response to these global and local growth trends, the SA industrial sector saw a downward slide in earnings revisions from mid-2021. Furthermore, SA resource companies also saw a peak in earnings revisions in the second quarter of 2021, which coincided with a peak in commodity prices driven by global supply and demand factors. This resulted in a less favourable earnings revisions trend for the overall SA equity market during the second half of 2021 (see chart 8).

Chart 8: ALSI earnings revisions

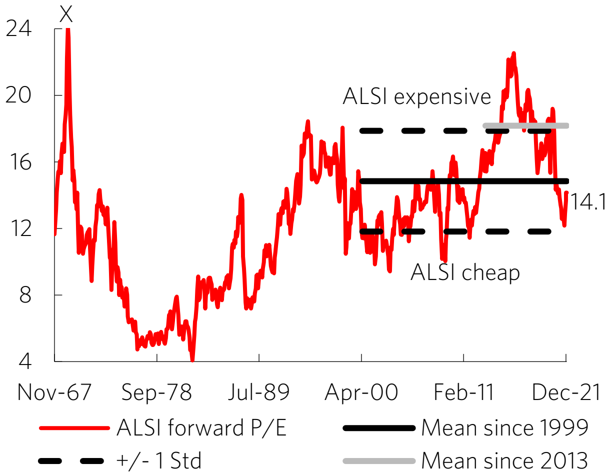



*Source: SBG Securities*

Whereas SA equity market returns in 2021 were derived from a strong profit rebound that overshadowed a valuation derating, this is likely to reverse in 2022, with pressure on profits expected from a slowing in global and SA economic momentum on top gof the high profit base created in 2021. As such, returns will have to come from a rerating in market valuations. Fortunately, the SA equity market valuation picture looks quite favourable. Even assuming -15% earnings growth in the next year, the SA equity market is now one quarter of a standard deviation cheap against the average since 1999 (see chart 9). Also, SA equities still trade at huge valuation discounts to the

RoW, with SA equities cheap versus EM equities (more than one standard deviation below long-term averages) and even more so versus DM equities (around two standard deviations below long-term averages).

Chart 9: ALSI forward P/E




*Source: Iress, Momentum Investments*

## SA bonds compelling versus RoW and against other asset classes

The global spike in inflation has further eroded the real government bond yields available in the developed world, with most developed countries' real bond yields in negative territory. Although SA's inflation rate has also risen from a low of 2.1% in May 2020 to the current 5%, the high real yield still available on SA bonds is in stark contrast to those in the developed world and even among EM peers (see table 1). It stands to reason that these high SA real bond yields already discount a high fiscal and country risk premium. Not only are SA real bond yields currently attractive versus DM and EM yields, but SA's real yield premium is also high against historical averages. Finally, SA's real yield is also almost one standard deviation higher than its own historical average.

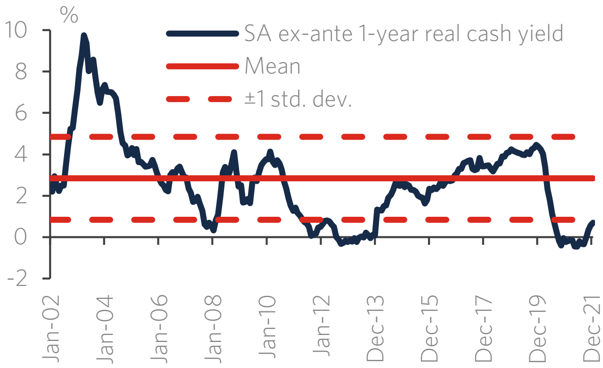
Table 1: Real ex-post 10-year government bond yields

| | |
|---|---|
| *DM* | |
| Japan | 0.0% |
| UK | -3.5% |
| US | -4.8% |
| Europe | -5.2% |
| *EM* | |
| South Africa | 4.9% |
| Mexico | 1.2% |
| Brazil | 0.4% |
| Russia | 0.3% |
| Turkey | -1.1% |

*Source: Iress, Momentum Investments*

In the ILB space, there should be some scope for further break-even widening in the interim, with inflation expected to peak in the first quarter of 2022. However, smaller monthly inflation accruals should provide less fundamental support for the asset class until the second quarter of 2022. After the recent rate hike by the SARB, the prospective SA real cash yield has risen to above zero, which is still more than one standard deviation below its historical average (see chart 10).

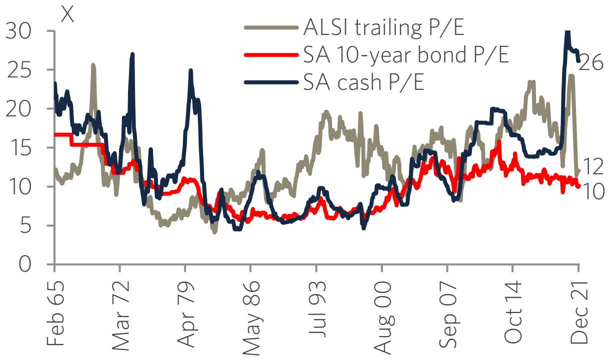
Chart 10: Prospective SA real cash yield




*Source: Iress, Momentum Investments*

Relative to SA equities and cash, SA nominal bonds have consistently been the cheapest asset class since 2013 (see chart 11). Aggressive COVID-related SARB rate cuts have made cash the most expensive asset class since 2020, while sharp profit upgrades in 2021 have pushed SA equity valuations sharply down.

Chart 11: SA asset class valuations




*Source: Iress, Momentum Investments*

## A lot of the negative listed property fundamentals looks to have been discounted

Sector fundamentals in the listed property sector remain negative, with rising vacancies; falling escalations; negative rental reversions with a focus on tenant retention and sharp rises in operating costs the order of the day. The negative structural factors of work-from-home (WFH) and desk sharing also impact the office sub-sector. In the retail sector, too high rental costs to sales and e-commerce are additional threats, while the industrial sector faces weak capacity utilisation rates and electricity supply issues.

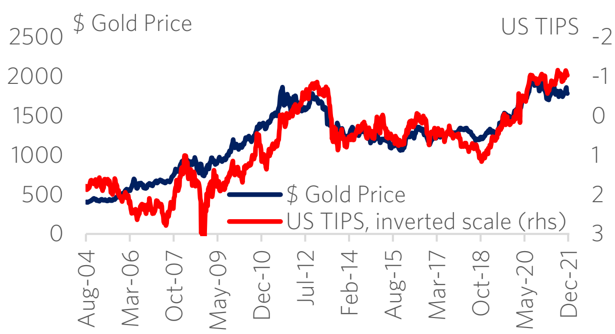
Our expectation is that listed property values will have to decline by 10%-15% peak-to-trough to account for these negative fundamentals. However, as values have already declined by 9.6%, we think a large part of the negative fundamental backdrop has already been discounted. In essence, decent potential property returns from here need to be weighed against the fundamental risks and uncertainties in the sector.

At current trough distribution levels, the relative expensiveness of property versus bonds looks exaggerated. Assuming an exit SA bond yield of 9.5%, that dividends in the next year retrace halfway towards their 2019 level and that listed property returns are in line with our 8% base case, relative listed property valuations would be 9% cheaper than the historical average.

## Gold price currently underperforming US real rates

With the fundamental driver for the gold price being the opportunity cost of holding a non-interest-bearing asset, it is unsurprising that US real interest rates have been the dominant determinant for the US dollar gold price in the last two decades (see chart 12). More surprising has been that movements in the US dollar no longer provide additional explanatory power for the behaviour of the dollar gold price.

Chart 12: US real rates and the gold price




*Source: Iress, Momentum Investments*

Based on the current level of US real interest rates, the predicted value of the dollar gold price is about 6% above the current actual spot level, providing a positive tactical signal for gold exposure. In addition, we maintain that there is always a strategic rationale for gold as a portfolio risk diversifier due to its safe-haven characteristics during risk-off global bouts, as well as its limited correlation with other asset classes in a portfolio.