ESCALA
PARTNERS

AGENDA 2022

Chief Investment Office

Welcome

Welcome to the third edition of our annual investment publication, Agenda 2022. This publication is compiled by our investment team headed by our Chief Investment Officer, Tracey McNaughton.

A climate of change is upon us and not just in an environmental sense. Most health professionals now agree the pandemic will become more endemic as 2022 progresses. At the same time, technology is becoming more disruptive and politics more polarised. We expect monetary policy to become more diverse and economic growth will become more infused with inflation uncertainty.

What doesn't change, indeed shouldn't change, is investors' approach to long term wealth creation. Setting an investment strategy and being disciplined in staying true to it is the keel that balances the boat when the tide turns. Keeping an eye on the horizon and a steady hand on the wheel is crucial.

In 2022, we will see the tide of cheap, easy money begin to run out. Interest rates have already begun to be lifted in several developed economies and in many emerging ones. We are expecting to see more of this in 2022 as central banks become more comfortable with the growth outlook and move away from emergency policy settings. Fiscal policy too will become more austere as governments seek to reign in the explosion in debt levels.

Unlike 2020–21, this will not be a time for taking tactical tilts in and out of markets. 2022 will be a time for laser-like focus on fund manager selection. It will be as much about risk management as it will be about return management. Being comfortable with the risks that are in the portfolio and trimming the ones we are not.

Our long-term themes remain firmly in place – lower for longer growth, inflation and interest rates; decarbonisation and tech disruption. The asset class that is best suited to prosecute these themes is alternatives and we are pleased to introduce you to the newest member of our CIO team, alternatives specialist Stephen Dickinson. Stephen brings extensive knowledge and expertise to the role and will be a key member of Tracey's team.

We are proud to be your trusted wealth adviser and feel privileged that you have entrusted us to help you navigate the path ahead. I hope you enjoy the thoughts and views of our investment team in the pages that follow. I, and the entire Escala team, look forward to our continued partnership in the year ahead.

Pep Perry
Chief Executive Officer

Escala Partners Pty Ltd

Melbourne
Level 19, 90 Collins Street
Melbourne VIC 3000 Australia
T 03 8651 2600

Sydney
Governor Macquarie Tower
Level 25, 1 Farrer Place
Sydney NSW 2000 Australia
T 02 9102 2600

Perth
2/328 Stirling Highway
Claremont WA 6010 Australia
T 08 6282 2600

information@escalapartners.com.au
escalapartners.com.au

Contents

Our Views in Brief

Global Growth

Growth will slow in 2022 but settle at an above-trend rate for the second consecutive year. We expect the US to outperform Europe and Japan where the fiscal drag is expected to be significant. Growth will also slow in emerging markets led by China and Brazil but offset somewhat by stronger growth out of India, projected to again be the fastest-growing major economy in 2022.

Inflation

The current inflation episode will fade in 2022 as the largest surge in demand since WWII eases while supply adjusts. Some inflation may linger through wages but this will be balanced by deflationary forces from an expected inventory overadjustment and technological disruption.

Interest Rates

Divergence in the outlook for monetary policy will feature in 2022 as some central banks (mainly in emerging markets) respond to inflation while others take a more patient approach (mainly in developed markets). Central banks can only step in to dampen demand. Supply problems need time to auto correct.

Fiscal Policy

The fiscal tailwind during the pandemic will turn into a headwind in 2022 as governments around the world pull money out of their economies. The turn to austerity is estimated to be five times larger than that experienced in the wake of the 2008 crisis and will mostly be a developed economy problem.

Bond Yields

Fixed rate bonds remain expensive and continue to offer little in the way of income, diversity or stability within a portfolio. Credit spreads are at historically tight levels, which leaves minimal room for error. Strong fundamentals, however, reduce the risk of default.

Equities

Corporate fundamentals are strong, funding costs are still relatively low and margins are holding up. Higher input costs are for the most part being passed onto consumers, insulating equity investors from the sting of inflation.

Currencies

As a starting point, our preference for Australian-domiciled investors is to be 100% unhedged on their international equity position. This serves as a cushion in the event of a sell-off in international equities where the US dollar tends to rise against the Australian dollar.

Alternatives

In general, alternatives offer the most attractive risk-adjusted returns for investors and will continue to do so in 2022.
In particular we like private debt for yield and private equity for growth. Unlisted infrastructure is benefitting from the acceleration of the renewables theme.

A Rising Tide Lifts All Chips and Ships

Tracey McNaughton
Chief Investment Officer

The tide of monetary and fiscal stimulus that has been responsible for lifting all manner of things, not just the price of (micro) chips and ships, is receding. In its wake will be peak earnings, peak demand and peak prices. The question for 2022 is – how quickly will the tide recede and will there be crosscurrents?

Warren Buffet once famously said it is only when the tide runs out that you learn who has been swimming naked. We are adopting a more cautious stand. A lower tide means lower returns means higher chance of a mis-step. Taking fewer risks and being aware and comfortable with the risks we do take will be key in 2022.

US$190trn

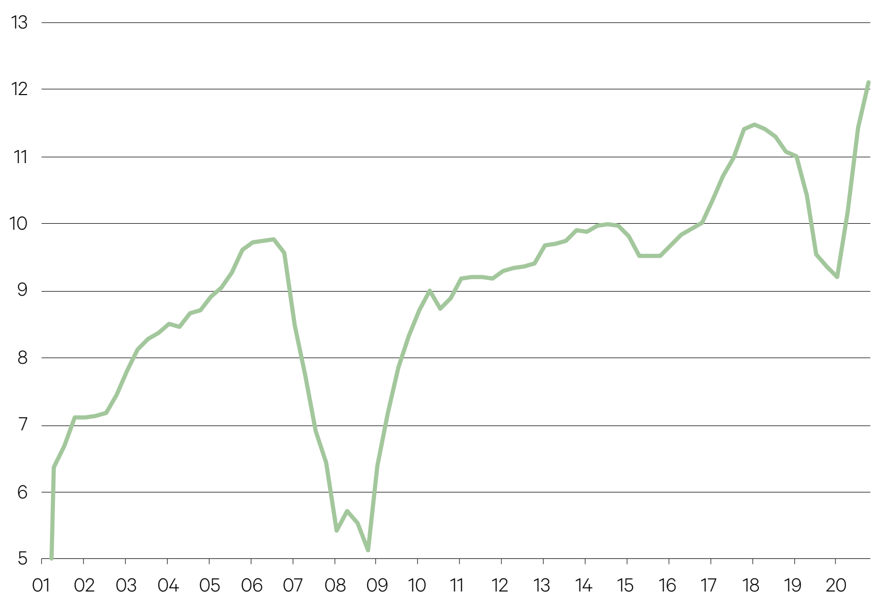
Total market cap of all listed stock and bond markets in the world.

1. Peak earnings but still high margins

Nearly two out of three of the biggest U.S. publicly traded companies reported fatter profit margins in 2021 than they did in 2019. Nearly 100 of these companies have booked 2021 profit margins that are at least 50% above 2019 levels.

Corporate profits in the United States rose to a record high of US$2.54 trillion in the third quarter of 2021. Slower economic growth in 2022 and higher input costs mean earnings will slow but growth will remain high by historical standards.

S&P500 profit margin (profit as % sales)



Source: Bloomberg

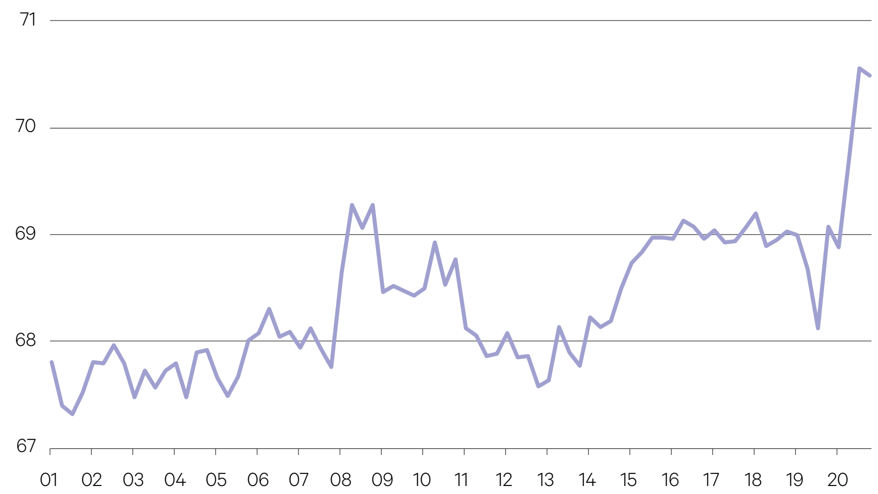
2. Peak demand but strong balance sheets

One of the weird paradoxes of the pandemic is that we're generally a lot richer than we were before it. And this is true even for the bottom 60% of households. U.S. household net worth is up by US$25 trillion. That wealth has spurred a surge in demand and will serve to cushion households in 2022.

While some parts of the economy still lag – including recreation, transportation, restaurants and hotels – three-quarters of the S&P 500 companies, as measured by market value, are in industries where output is significantly above where it would have been absent the pandemic, thanks to intense demand.

Given lockdowns, most of the demand was channeled into goods consumption. With 90% of the world's traded goods transported by sea, it is no wonder 2021 was a year of ship shortages and port congestion.

World consumption of goods and services % GDP



Source: Bloomberg

2022 will see a more open global economy allowing more of this consumption spending to be channeled back into services, which historically has accounted for around half of household consumption.

90%

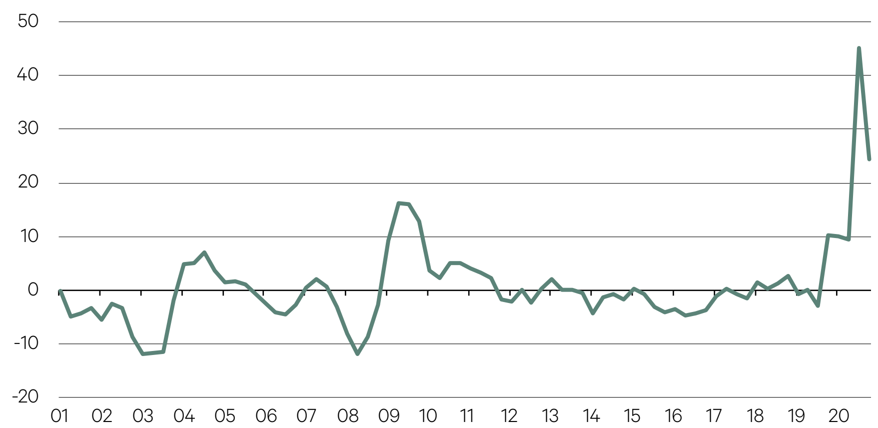
Percentage of the world's traded goods transported by sea.

3. Peak prices but a milder rate hike cycle

Consumer price inflation will likely be lower this year due to both an easing in supply-chain blockages and an easing in demand. Inventory levels will be key in 2022. The next phase of the supply chain crisis could easily be too much of everything as manufacturers respond to the shortages by stepping up production. It is a logical reaction, and basic economics: supply falls short of what's needed, prices rise and producers respond by boosting output, supply increases, and prices fall.

How fast the liquidity tide runs out will ultimately depend on the persistence of inflation. An easing of inflation will relieve the pressure on the US Federal Reserve to raise interest rates too aggressively. Indeed, the record high levels of debt in the system imply 2022 could be the start of the mildest tightening cycle on record.

US used car and truck price (yoy %)



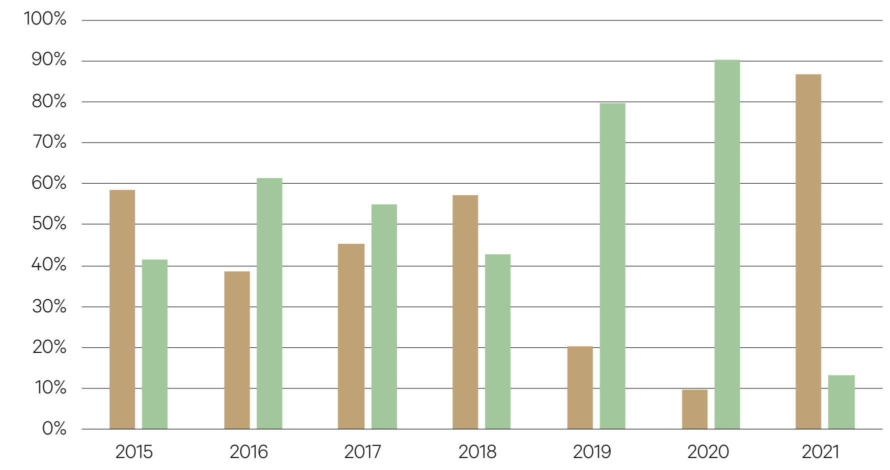
Source: Bloomberg

US$25trn

The amount US household net worth has risen.

The tide is already turning on monetary policy. In 2020, 90% of all central bank decisions were to lower official interest rates. In 2021, 87% of all central bank decisions were to raise official interest rates. Never before have we seen such a quick reversal of policy settings. Admittedly, the vast majority of these rate hikes came out of emerging markets where inflation is tracking uncomfortably high. Just four developed market economies, New Zealand, Norway, South Korea and the United Kingdom have tightened monetary policy so far. Canada and the United States are the most likely candidates to join them in 2022.

Tide running out on cheap money



% Rate rises % Rate cuts
Source: Bloomberg

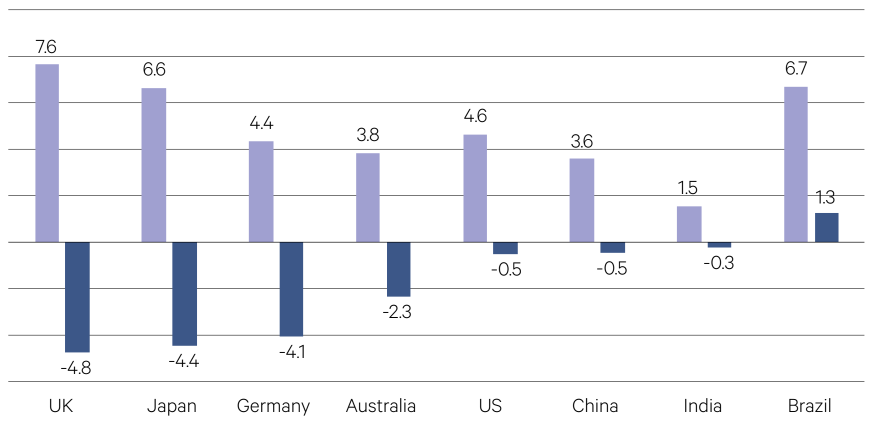
The tide is also turning for fiscal policy. In the U.S., emergency programs are ending and even though President Joe Biden's administration is pushing a longer-term spending plan, most of the new spending will be funded over a 10-year period. Europe's austerity debate from last decade is poised to flare up again, while the U.K.'s leaders claim a moral duty to start trimming budget deficits.

Japan's new Prime Minister plans on more spending, but it won't match the size of the country's record pandemic stimulus. China has been cautious with its budget, a stance that could shift as the economy slows. In some emerging nations like Brazil, soaring inflation is driving a debate about excessive spending.

In 2022, the largest post-war government-funded spending program will make way for a shift toward austerity many times larger than what followed the 2008 global financial crisis.

The addition to growth from fiscal policy will therefore turn into a subtraction. As with monetary policy, the policy reversal will be significant in some countries.

From fiscal boost in 2020 to drag in 2022 (ppts GDP)



2020 2022
Source: IMF

10 times

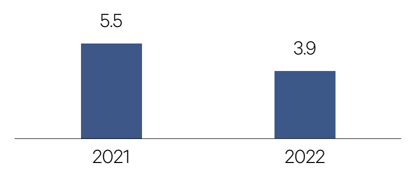
The multiple increase in the Fed balance sheet compared to pre-GFC.

Global Economy Breakdown

United States

The size of the US economy is back above its pre-pandemic peak. Fiscal policy swung from being a support for growth to a drag in 2021. That drag will get bigger in 2022. The Democrats confront a challenging political backdrop but based on history, markets don't mind a divided government.

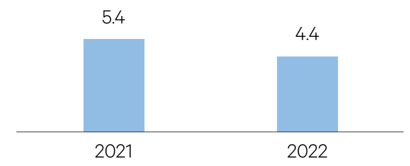
GDP %



Europe

The European economy is still just shy of its pre-pandemic peak weighed down by slowing trade with China. Tensions will likely flare between a German-led "sound finance" camp and their Southern neighbours more concerned with avoiding a repeat of last decade's austerity-driven slump.

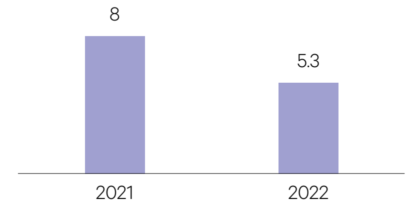
GDP %



China

2022 is a pivotal year with the 20th Party Congress where President Xi will seek confirmation of his third unlimited term. Political and social stability will be prioritised over growth as a result. Domestic priorities will take centre stage where heightened communist rule means tighter limits on the private sector.

GDP %



Japan

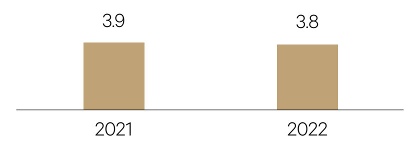
Japan's new prime minister has pivoted away from his predecessor's "Abenomics" economic policy that balanced fiscal spending with higher consumption taxes. Instead, Kishida is more focused on reducing inequality and reviving the economy before restoring fiscal balance.

GDP %

Australia

Delta hit the Australian economy harder than most other OECD nations leaving GDP still slightly lower than its pre-pandemic peak. The heavily indebted household balance sheet has some support from excess savings and a central bank that promises to be among the most patient in the world.

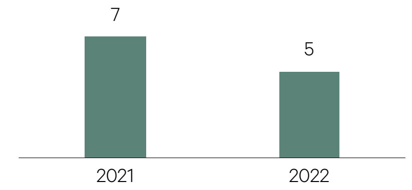
GDP %



United Kingdom

The UK economy still remains some 2% below its pre-pandemic peak. Around 70% of UK corporate earnings come from offshore, so one near-term risk is that further strengthening of the British pound dampens earnings growth. It also means supply chain disruptions and labour shortages could linger longer leaving inflation to moderate only gradually.

GDP %



Source: Bloomberg

Theme 1: Lower for Longer… Still

The lower for longer theme faced its greatest challenge yet last year. The tussle between labour and capital for the spoils of growth was writ large with the crisis that hit the poorest cohorts of society the hardest while big business got bigger. The move to address income and wealth inequalities was elevated as a result.

While much has changed in the past two years, we tend to be of the view that the structural trends that were driving the environment of lower growth, lower interest rates and lower inflation are not only still in place but have been significantly enhanced.

The tussle between labour and capital was writ large with the crisis.

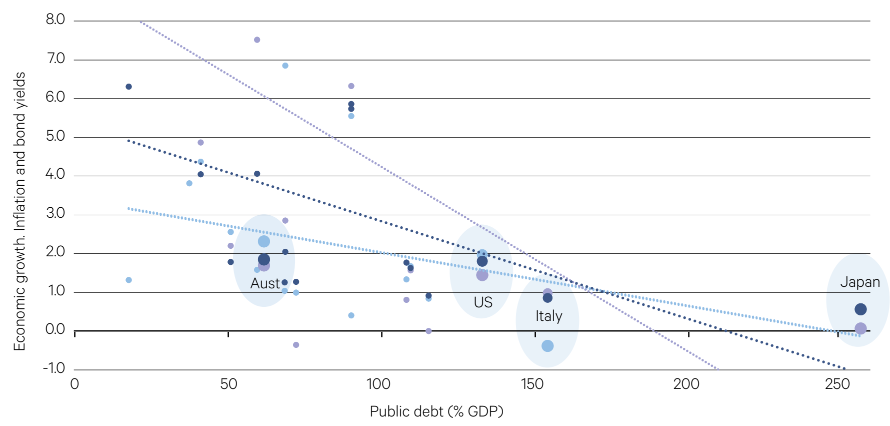
Big Government

The size of governments around the world has been trending higher since the mid-1990s. In the past two years that trend has taken a significant step up.

Government can help create a positive environment for business, by, for example, building productivity-enhancing infrastructure, enforcing the rule of law and contracts. But government doesn't create wealth, the private sector does. Innovation happens inside private companies, not inside public bureaucracies.

It is true government spending on infrastructure has picked up recently. The one trillion Biden Build Back Better program will be focused on infrastructure spending. But this spending will take place over a 10-year period and it will still leave the US economy with an infrastructure spending gap of US$2.6 trillion according to the American Society of Civil Engineers.

Relationship between public debt (horizontal axis) and growth, inflation and bond yields (vertical axis) for G20



Public debt goes up; growth, inflation and bond yields go down.

Bond Yields · Inflation · Economic Growth

Source: Bloomberg

Across the G20 economies, a clear negative relationship exists between the size of government and economic growth, bond yields and inflation. That is, the higher is the level of public debt, the lower is growth, inflation and interest rates.

US$2.6trn

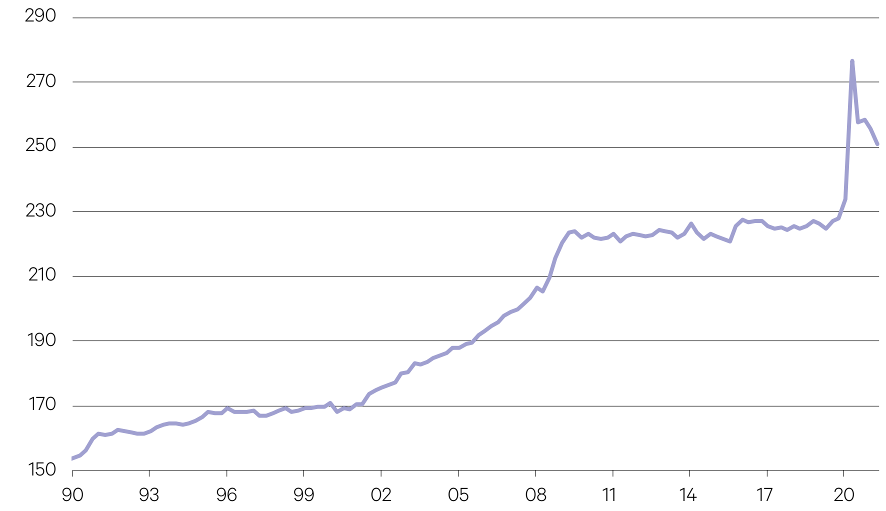
The infrastructure spending gap in the US.

Big Debt

The single biggest legacy of the pandemic is the rise in debt. Global debt increased by US$36 trillion compared to pre-pandemic levels taking the total to a record US$300 trillion. This rise was the largest, fastest, and most broad-based of four global debt waves since 1970.

This means economies are more sensitive to changes in interest rates now than ever before meaning central banks will be constrained in raising interest rates very far. Interest rates necessarily need to stay low to maintain the serviceability of these high debt levels.

Total US debt/GDP (%)



Source: Federal Reserve Bank of St Louis

Big Business

Many companies were able to take advantage of the policy environment over the last two years. By far, however, the companies that benefitted the most were the supersized companies. Big companies got bigger over the last two years.

The market value of the five largest technology companies in the US (Meta, Alphabet, Amazon, Microsoft, Apple) rose from just under US$5 trillion pre-pandemic to almost US$10 trillion as at December 3, 2021.

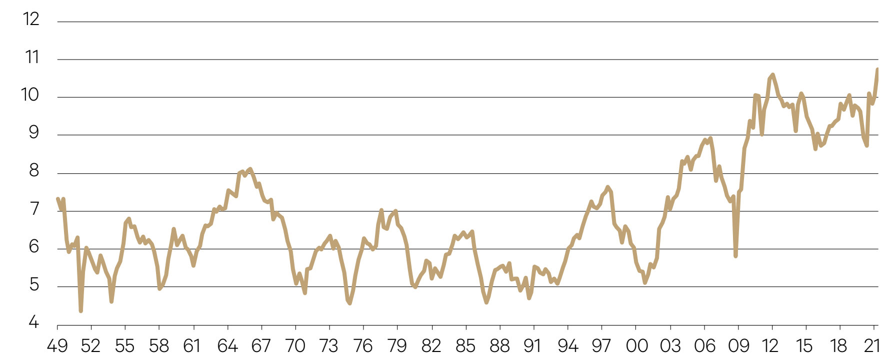
Companies in general are getting bigger and are more tech-oriented. According to Bloomberg, the top 50 companies in the world now make up 28% of global GDP. This compares to 12.7% just 10 years ago. The number of technology companies in the top 50 has risen from 8 in 2010 to 21 today.

Big technology businesses tend to be capital-lite and intellectual property-heavy. They also tend to employ fewer workers and pay lower wages.

It is no coincidence that this rise in big tech is occurring in the age of heavily administered markets. Once considered unconventional, quantitative easing (now the primary tool of monetary policy for the US and many other central banks) has the pernicious effect of favouring capital over labour. By reducing yields, it taxes savers but inflates the valuation of growth-biased tech companies. The profit share of the economy has taken a significant step up as a result (chart).

Notwithstanding recent efforts by governments around the world to address inequality and lift the productive growth rate of the economy structural forces driving the lower for longer environment remain firmly in play. This environment is supportive of growth-biased equity portfolios over value-biased; private markets over public; and low government bond duration strategies.

US corporate profit share of the US economy (%)



Source: Federal Reserve Bank of St Louis

US$435bn

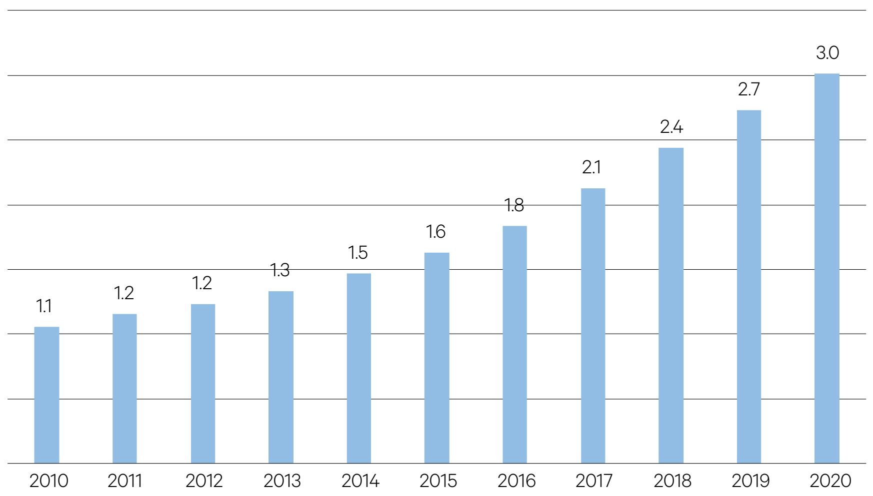
Amount of stock Apple has bought back over the last 8 years.

Theme 2:
Tech Disruption

Advancements in technology over the last two decades have made an enormous impact on our everyday lives and businesses alike. At the turn of the century, the internet was in its infancy, smart phones didn't exist, social media was unknown and Google wasn't a verb. Very little shopping was done online, traditional media of newspapers, TV and radio controlled the flow of information and entertainment and the sharing economy was yet to emerge.

Tech disruption has been a key driver in the rise of today's global equity market leading companies. Without doubt, it is going to continue to be a central theme of investment markets in the decade ahead and one that has been accelerated through the COVID crisis of the last two years.

The global operational stock of industrial robots almost tripled between 2010 and 2020 (million units)



Source: IFR World Robotics 2021 Industrial Robots report

The disruptive technologies of today and the future vary between those less obvious and others that are clear and well established, while they touch all sectors of the equity market. Some of the more significant technologies that will enable the leading companies of tomorrow include cloud computing, artificial intelligence (AI) and machine learning, 3D printing, advanced robotics, blockchain technology and the internet of things.

Smart manufacturing is incorporating several of these technologies simultaneously, including the use of robotics, AI, cloud computing and 3D printing, while increasing levels of machine connectivity provides the data to improve efficiency and reduce downtime. The adoption of cloud computing has been critical for service delivery and to enable businesses to maintain operations through the disruptions caused by COVID. Together, with wide access to fast broadband and 5G networks, the delivery of information and applications has never been easier, while the transition to subscription models has reduced upfront IT costs and barriers to entry in many industries.

For consumers, some trends will continue to grow, including increasing penetration of eCommerce, streaming media services and more connected devices within the home.

Faster connectivity deployed in mobility, healthcare, manufacturing and retail alone could boost global GDP by US$1.2trn to US$2trn by 2030.

McKinsey

Transport is a sector that will experience significant change over the next two decades. The electric vehicle revolution is already underway and is best represented by the rise of Tesla. Following this is expected to be the rollout of autonomous vehicles, which will utilise advanced AI, with benefits to flow through from vastly improved traffic management, fuel consumption and reduced road accidents.

In the last several years, technology has also begun to impact additional sectors of the economy, including those less susceptible to disruption due to higher levels of regulation, such as financial services and health care.

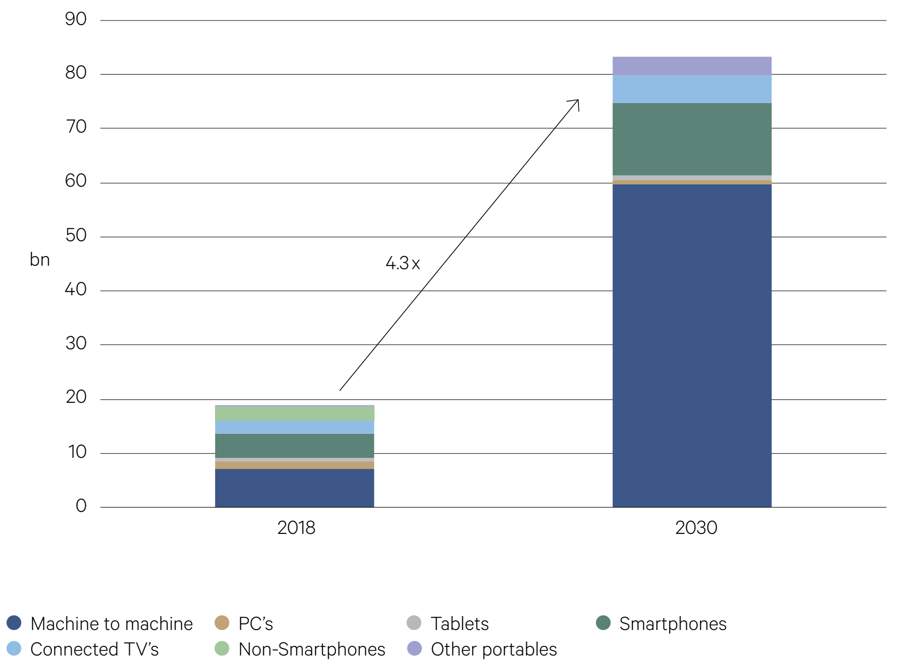
Within financial services, the rise of contactless payments, neobanks and credit providers such as buy now pay later (BNPL) companies have eaten into the market share of traditional banks, exposing cumbersome legacy systems. Additionally, the rapid evolution of blockchain technology has enormous implications for the future of financial settlements and how they are transacted through a decentralised and secure network, eliminating the need for intermediaries in the system.

In healthcare, telehealth services have seen rising adoption through COVID, blockchain will have various uses such as for secure medical record storage, while advanced genomics is leading to the more efficient diagnosis of disease in patients.

Many disruptive themes leverage off the growth in global 5G mobile subscriptions, which are forecast to expand from 660m in 2021 to 4.4bn in 2027.

Ericsson

Global connected devices are expected to rise from 19bn in 2018 to 84bn in 2030



Source: Connected world: An evolution in connectivity beyond the 5G revolution; McKinsey Global Institute

Tech disruption has also impacted older industries such as agriculture to help solve the problem of feeding an ever-growing global population in a sustainable manner. This wave of innovation is being enabled by improving network coverage in rural areas, allowing a range of connected devices to monitor crops and livestock, while advancements in AI and robotics has led to greater autonomy in machinery and in new devices such as drones, reducing labour requirements.

How should one view tech disruption from an investment context? The companies at the forefront of tech disruption are typically classified as growth stocks, with much higher rates of earnings growth than the broader market, high levels of business reinvestment and low levels of tangible assets. With a greater proportion of their value longer-dated in nature, their value is enhanced by a lower-for-longer interest rate environment. We recommend an active management approach to identify the companies that can capitalise on each theme.

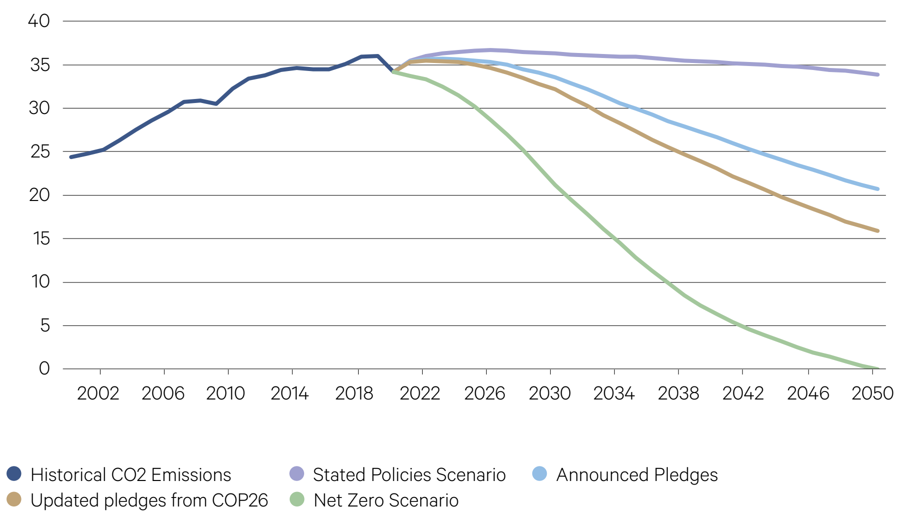
All sectors of the market will be touched by tech disruption in the coming decade.

Theme 3: Net Zero

"1.5°C Alive… but on life support." The closing remarks to the 2021 UN Climate Change Conference in Glasgow highlighted how big a challenge the world still faces in the fight to avoid a climate catastrophe.

Global leaders from 197 countries signed the Glasgow Climate Pact, the most progressive climate treaty since the Paris Agreement. However, resistance from some of the world's largest carbon emitters such as China and India left many frustrated.

Net zero pledges still have a lot of room to improve



Source: International Energy Association

The progress made by the private sector over the past several years was significant. The number of corporations announcing net zero targets for the first time grew to over 2,000, representing US$23 trillion in market capitalisation. The weight of capital is sizeable – 220 asset managers representing US$57 trillion in assets under management, and 61 asset owners representing US$10 trillion, have upped the ante with significant commitment to net zero alliances. The world's largest insurers and reinsurers have also committed to transitioning their underwriting portfolios away from fossil fuels.

To achieve net zero by 2050 it is widely agreed the next decade will be the most crucial. Current global emissions need to fall by 45% by 2030. Scientists currently forecast a rise of 14%.

The total investment required over this period is estimated to be in excess of US$30 trillion. Many believe decarbonising the global economy is the greatest opportunity for innovation the world has ever seen and compare climate technology today to the early days of software and computing. Disruptive innovations across power networks, charging networks, renewable energy and buildings upgrades will all be key to enabling a successful green transition.

Deflationary forces across many of these technologies will facilitate widespread adoption and contribute significantly to an accelerated shift to a low carbon future. The cost of solar panels has come down by 91% over the last decade; lithium-ion battery costs, a critical component in electric vehicles (EVs), have fallen by 89% since 2010.

Forecasts suggest improvements in energy grid capacity and battery storage can grow threefold from where we are today whilst some forecasts suggest breakthroughs in green hydrogen technology could help abate future global emissions by about 20%.

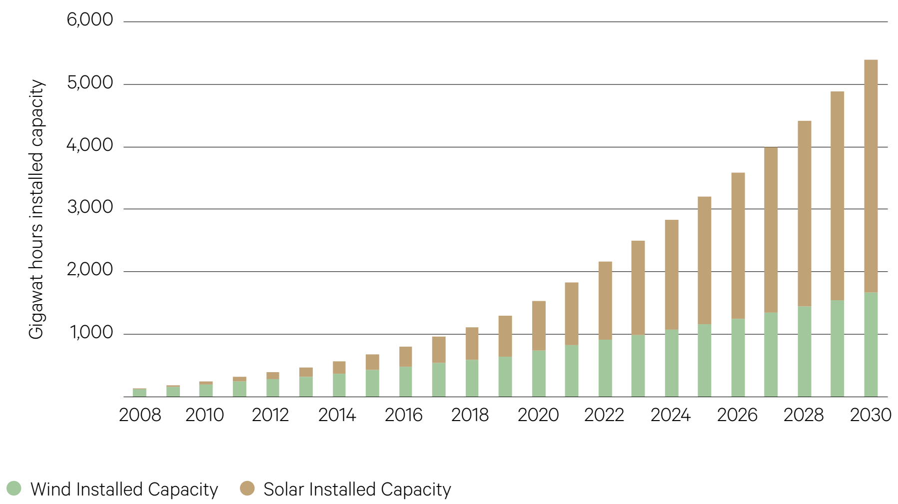
45%

Amount by which current global emissions need to fall by 2030.

Installed solar capacity is forecast to grow by 350% over the coming decade. Offshore wind power is seen as a key solution to tackling the intermittency problems faced by onshore wind and solar.

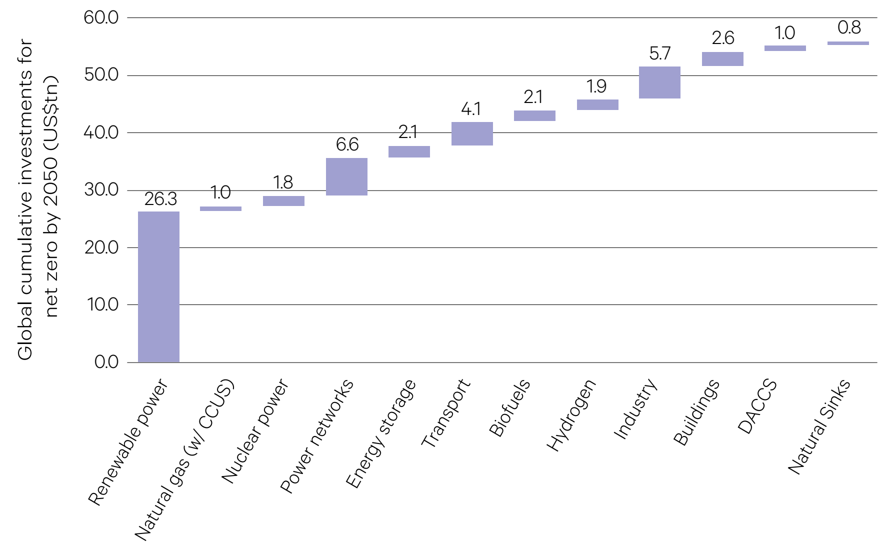
There is a significant growth potential for EVs given they represent just 4.6% of all new car sales globally and internal combustion engine (ICE) sales will be made illegal in many countries within the coming decade (Norway by 2025; UK, Ireland, Sweden, Iceland, Singapore & Israel by 2030).

Renewable energy installations forecast to grow strongly by 2030



Source: BloombergNEF

Total investment required to achieve net zero by 2050 is forecast to be US$56 trillion



Source: Goldman Sachs

Decarbonising the global economy is the greatest opportunity for innovation the world has ever seen.

A number of our investment managers employ strategies that aim to identify the long-term structural growth winners associated with tackling climate change and decarbonising the global economy.

Munro Climate Leaders specifically targets global companies whose earnings prospects should improve with the increased investment and focus on decarbonisation. Of specific focus are four areas: Clean Energy Companies, Transport and Batteries, Buildings and Efficiency, and Packaging, Waste and Water. Global equities manager Artisan Global target specific exposure to sustainable energy solutions looking to gain access to companies that design, manufacture, install, and service wind turbines across the globe. Our emerging markets manager, RWC, invests in "green" commodities such as copper.

Within unlisted infrastructure, Morrison & Co target multiple themes including renewable energy generation, distributed energy, energy storage, network infrastructure and water infrastructure.

Ultimately, companies that enable the decarbonisation process have the potential to become large, structural winners, while those relying on traditional fossil fuels will increasingly be challenged on their licence to operate.

Fixed Income

Tracey McNaughton
Chief Investment Officer

Fixed income had a difficult year in 2021. Australian bond investors experienced the worst returns in over 20 years with a negative return for the first time since 1999. The Australian 10-year government bond yield began the year at a paltry 0.97% before peaking at over 2.0% in October. The negative capital return as the price of bonds fell was only partially offset by the income generated by the low starting yield.

In a portfolio context, fixed income assets should serve three roles – diversification against equity risk, a stable income stream and liquidity to meet cash flow needs. The pandemic proved challenging for all three of these roles.

On the one hand, the amount of bonds available for private purchase hit record highs as government issuance surged. On the other, the availability of bonds for purchase hit a new low as central bank quantitative easing (QE) kicked into high gear.

Major economy money supply now totals about US$100 trillion. The amount of bonds available for purchase by the private sector constitutes a little more than 30% of that. The supply of bonds was large but so was the demand for them by the central banks. The aggregate free float has decreased in the age of central bank bond purchases. In some markets the decline has been dramatic. For German bonds, the free float of available bonds is less than 10%. In the US it is just above 50% while in Japan it is less than 30%.

Macro liquidity: bonds available for private purchase (Bloomberg Global Agg mkt cap – FX Reserves) (trn)

Source: Bloomberg

Market illiquidity: ratio of available bonds to global money supply

Source: Bloomberg

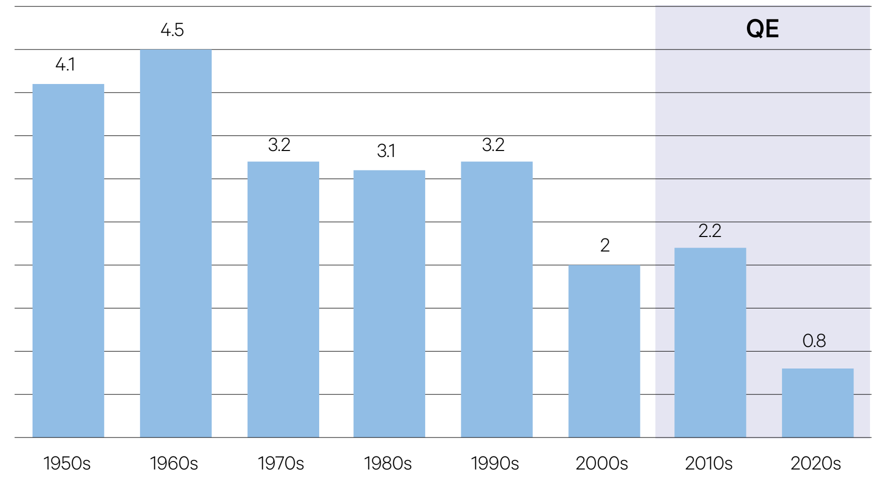
Macro liquidity met with market illiquidity creates volatility. This weakens the diversification, liquidity and income benefits that come from owning fixed income bonds in a portfolio.

10%

The free float of German government bonds available to investors.

Fixed income is no longer what it was. In the past 20 years, fixed income has generated a rolling negative, 12-month return, nine times. Six of those occasions were last year. On a rolling two-year basis, the return generated by fixed income has never been lower than it is today.

Average annual GDP growth (by decade)



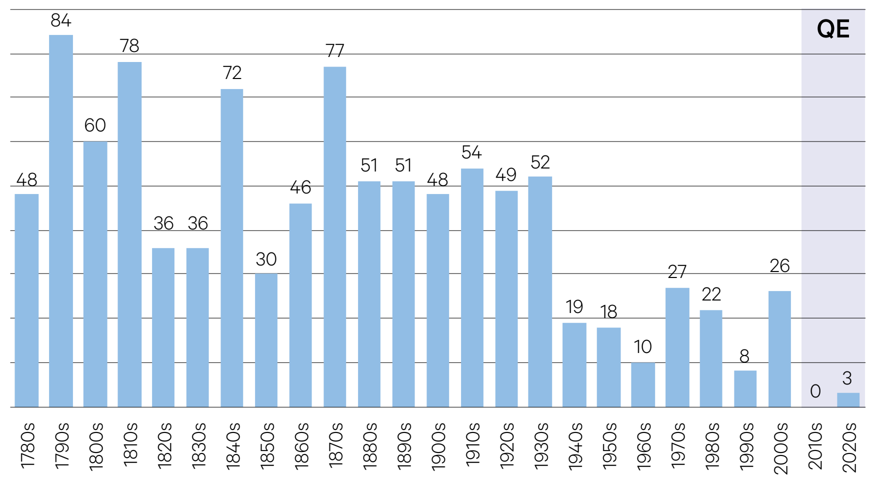
Source: Bloomberg

Investors in global credit had a better experience over the year as default rates remained at very low levels. Issuance was high as the supportive policy environment provided an opportunity for companies to cut interest expenses.

The act of buying assets to keep interest rates down interferes with the natural order of the business cycle. Underperforming companies are artificially sustained and the cycle artificially extended. A healthy economy is one where businesses are allowed to go bust. This ensures efficient allocation of resources and so drives potential economic growth higher. The US economy has spent just three months in recession since quantitative easing began in 2009. Ironically, the longer quantitative easing is maintained, the slower, more lethargic, less dynamic economic growth becomes, the more quantitative easing is relied upon as a stimulant.

In this environment bond investors need to be clear about the risks they take. Separating out government bond duration and clearly defining a liquidity bucket is crucial. Investors can improve the total return of their bond portfolios by investing in shorter maturity bond funds and higher-income-generating credit strategies.

Number months US in recession (by decade)



Source: Bloomberg

US$1.7trn

Amount of bonds issued by US companies last year.

Australian Equities

David Bruty
Investment Analyst

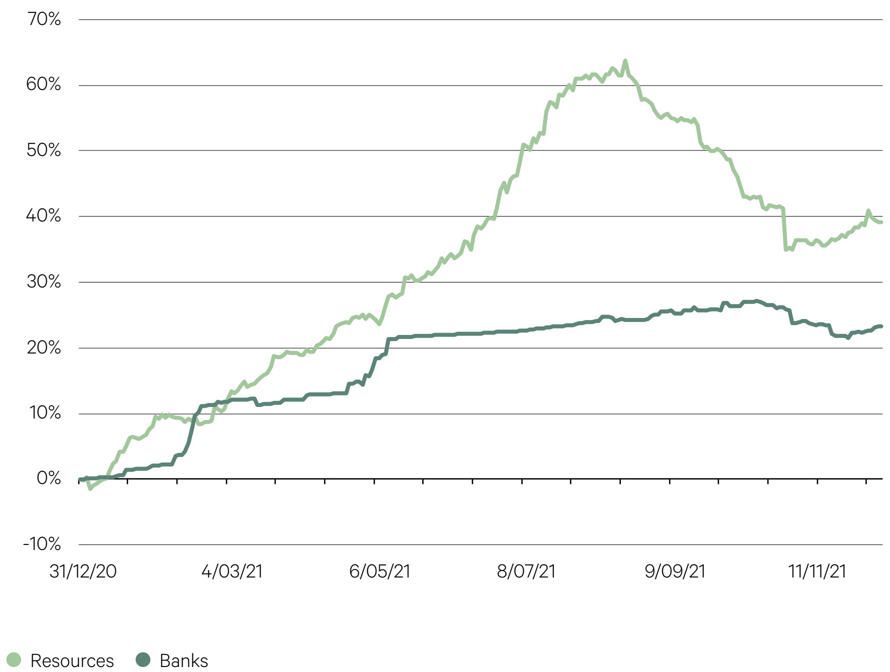
Following an impressive, sharp recovery from the depths of the COVID crisis, we anticipate more modest returns for the Australian equity market in 2022.

In the last 12 months we have experienced broad-based earnings growth, consistent with the early stage of the cycle and backed by coordinated monetary and fiscal stimulus. This more than offset the slight drop in valuations (as measured by the PE ratio) from elevated levels.

However, earnings momentum slowed noticeably in the second half of 2021, with some headwinds emerging in key sectors. While the initial phase of the recovery saw a wide participation across the market, we expect to see a greater level of dispersion in the year ahead.

Earnings growth in 2022 will be driven by industrial stocks that have been most impacted by COVID, while key cyclical sectors face emerging headwinds.

Cyclical earnings upgrades for resources and banks were very strong in the first half, though tapered into the second half of 2021

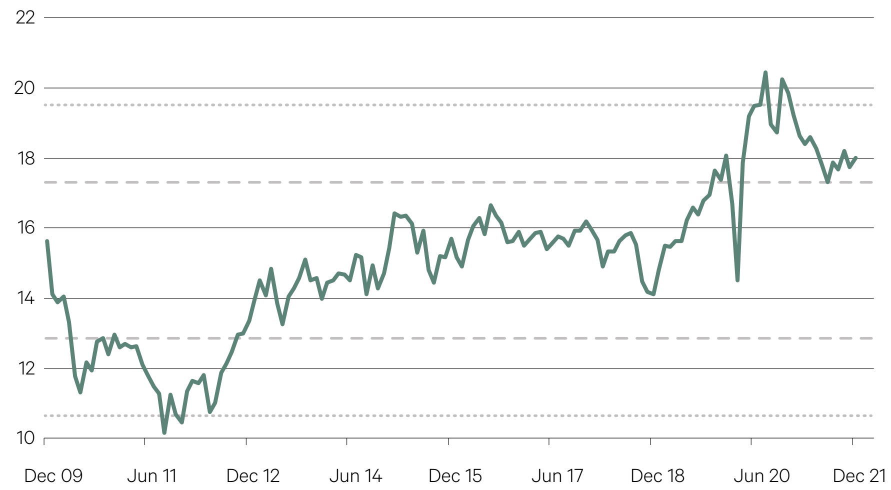


Source: Bloomberg

Some caution is warranted for the two key cyclical sectors of the market – financials and resources.

While financials are supported by stronger investment markets, the outlook for the banks is becoming more challenging, with the one-off benefit of bad debt normalisation now played out and moderating expectations for growth as margin and cost pressures are managed. Additionally, APRA has commenced the process of introducing policies to cool the housing market, which will tighten financial conditions in the market.

Australian equity valuations, as measured by the PE ratio, have fallen from their 2020 peak, though remain above longer term averages, supported by the low rates environment

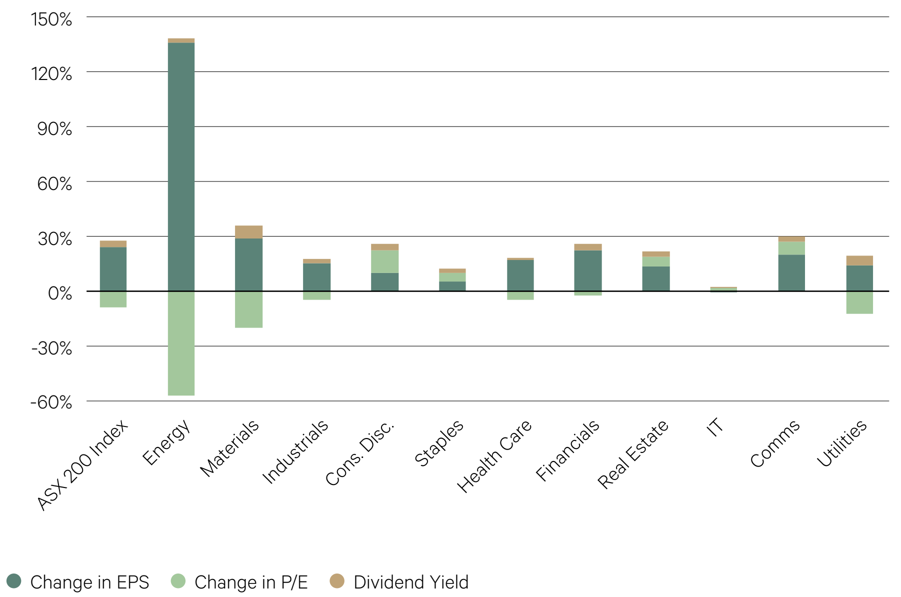


Source: Bloomberg

For resources, while other commodities have been strong, iron ore remains the key driver. With the iron ore price halving in the second half of 2021, it appears that earnings have passed their peak in this cycle, particularly given the backdrop of China's slowing economic growth and troubled property sector.

The outlook for industrials is split between those companies that experienced an increase in activity through lockdowns and those more services-orientated that stand to benefit as restrictions are eased. The prevailing high household savings rate as we enter 2022 should hold the latter group in good stead.

Stronger earnings were primary driver of returns for Australian equities in 2021 across all key sectors of the market



Source: Bloomberg

3.8%

The forward dividend yield of the ASX 200.

Supporting a more positive view is the strength of corporate balance sheets, a high level of corporate activity, a rebound in dividends (though dividends remain below pre-COVID crisis levels) and valuations that look high, though less so in the context of a low interest rate environment.

As always, risks abound, though are perhaps more heightened than most years, headlined by persistent COVID interruptions and the potential for central policy bank error. Currently, we hold a neutral view towards the Australian equities asset class, though the risks are tilted towards the downside.

International Equities

Tracey McNaughton
Chief Investment Officer

Investors poured almost US$900 billion into equity funds in 2021. According to the Bank of America, that exceeds the combined total from the past 19 years. Last year we noted "global stocks are now a US$100 trillion asset class". Today it is a US$120 trillion asset class, the highest in history and equal to 145% of world GDP.

Earnings expectations were compelling. In January, the market was expecting S&P500 company earnings to come in at US$168 per share. Over the course of the year, that figure jumped to US$209 per share. As a result, the S&P 500 printed a new all-time high 70 times through the year, the second-highest number ever.

Certainly, the expected earnings backdrop is less favorable for 2022.

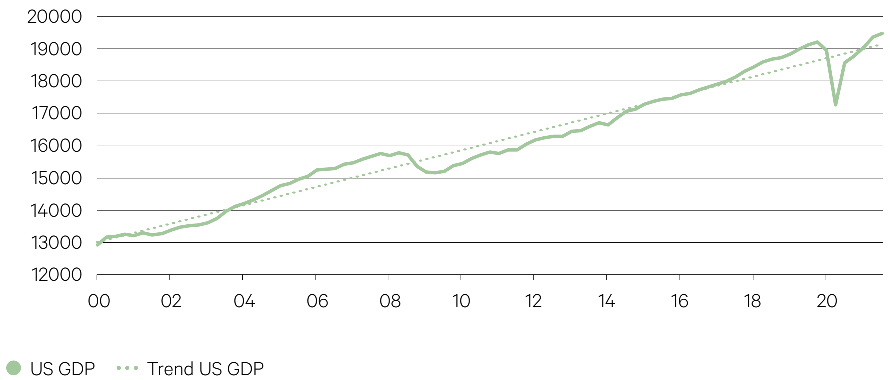
The market expects S&P500 company earnings for 2022 to come in at US$225 per share. This growth in earnings of 7.7% would be one of the lowest expected growth rates of the past three decades.

While valuations are expensive compared to history, we believe equities can still perform reasonably well in 2022 for the following three reasons:

#01

The economic backdrop, while slower, still suggests growth at above trend levels.

US GDP versus trend

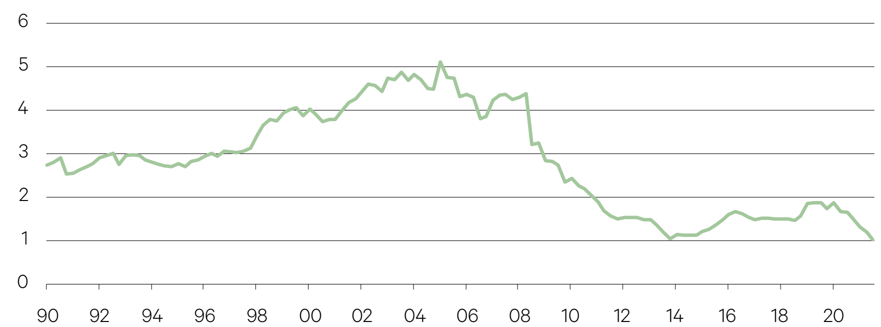


Source: Bloomberg

#02

High valuations and potential tax changes make buybacks less compelling but a healthy backdrop does exist for dividends given the current low payout ratio for the S&P 500 (33% vs its long-term average of 50%), low leverage and earnings stability.

S&P500 companies leverage (net debt/EBITDA)



Source: Bloomberg

#03

There are record amounts of cash sitting on the sidelines in money market funds.

Money market fund assets (US$ bn)

Source: Bloomberg

Companies are certainly cashed up. Cash and short-term investments on corporate balance sheets globally are at an all-time high of US$6.8 trillion. US companies have accumulated US$2.8 trillion with Apple, Amazon, Alphabet, Microsoft and Meta (former Facebook) making up a quarter of that cash pile. Balance sheets have been getting stronger as the recovery has proceeded.

Companies have paid US$522 billion in dividends this year and spent US$729 billion in buying back their own stock. Apple can't get rid of money fast enough. Last year, it spent roughly US$81 billion buying back its stock.

Apple shares outstanding (US$ bn) and market value (US$ trn)

Source: Bloomberg

US$6.8trn

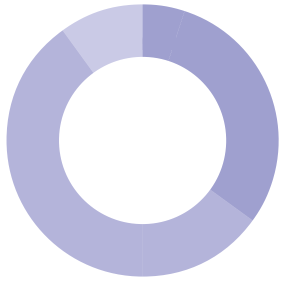
Cash and short-term investments on corporate balance sheets.

The torrent of inexpensive money has benefitted all types of businesses. It helped struggling businesses like cruise operators and airlines raise cash and ease the threat of bankruptcy. It helped thriving businesses lower interest expenses by refinancing older debt. And while we expect money to be more expensive in 2022, we are not expecting it to be significantly so. Particularly as we expect inflation to recede as supply rises and demand slows.

Inflation is the single biggest issue for equity investors in 2022 given the risk it could pose to profit margins. On this count, the type of inflation we have is key. Demand-pull inflation, where higher prices are driven by increased buying activity from consumers, is what we are experiencing currently.

Profit margins tend to be protected in this environment as good companies have the ability to pass on the higher costs to eager consumers. This particularly applies to the technology sector where margins are currently two-times the broader S&P500.

Alternatives

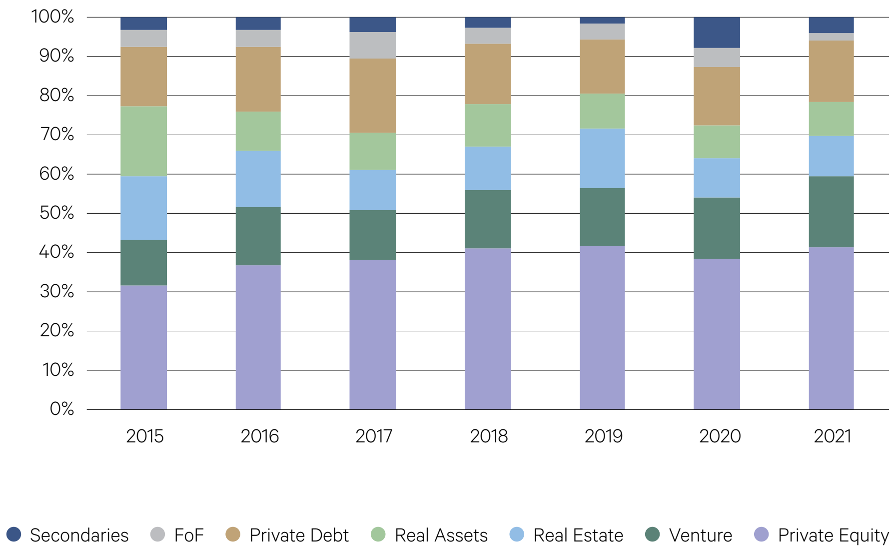


Darragh Kennelly
Investment Analyst

Stephen Dickinson
Investment Analyst

2021 was another strong year for alternatives with record numbers of deals and an acceleration of longer-term structural trends leading to good returns for many sectors in the universe. The combination of low interest rates, diversification and lower correlation with traditional public markets continues to provide an attractive investment landscape for the asset class. Private equity, venture capital and private debt saw strong inflows throughout the year.

Investors continue to allocate to private equity, venture and private debt



Source: Pitchbook

Infrastructure

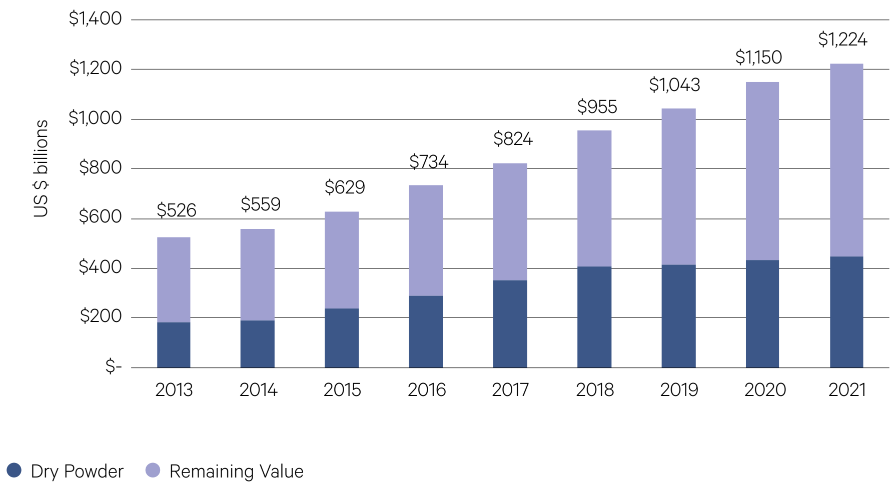
Infrastructure continues to demonstrate its defensive characteristics with a focus on assets with long term contractual cashflows and often high barriers to entry continuing to attract more investors to the space. Long term tailwinds for some of the more attractive subsectors of infrastructure like renewable energy and digital infrastructure continue to perform strongly. Key themes such as digitisation have provided significant opportunities in subsectors like wireless infrastructure, cell towers and 5G infrastructure, hyperscale and edge data centres and fibre networks. Decarbonisation will require infrastructure investment in opportunities across renewable power generation, grid stability and storage.

Decarbonisation will require infrastructure investment in opportunities across renewable power generation, grid stability and storage.

Private Debt

Growth in private debt continues to be fuelled by long-term secular trends – the disintermediation of bank lending channels due to regulatory developments in the wake of the GFC, sustained low interest rates on traditional fixed-income securities due to accommodative monetary policy and a broader pivot toward alternatives as an asset class with a low correlation to equities. Borrowers have taken advantage of the low rate environment and issued a record amount of debt. With a global loan market size of over one trillion and high dry powder for buyout and M&A activity, private debt offers ample investment opportunities.

Private debt continues to gain traction



Source: Pitchbook

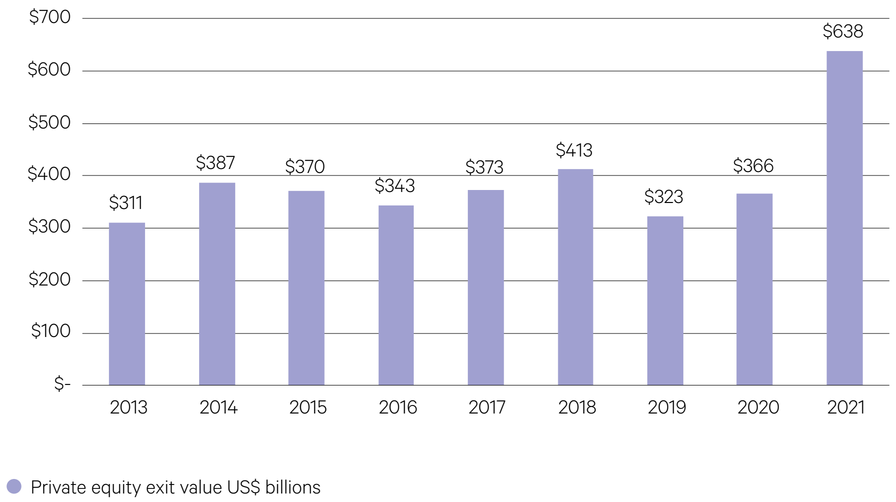
US$1trn

Global loan market size.

Private Equity

The private equity market has staged an extraordinary comeback since the early shocks of the pandemic. The combination of demand for capital, strong returns, more moderate risk, and an opportunity to invest for the long term have created prime conditions for private equity. This is especially the case for sectors benefitting from transformative trends that have been amplified by COVID, such as digitisation. Across all sectors, tech-enabled companies that are embracing the shift towards a more automated, digitised and cleaner world are positioned to gain market share and are especially sought after.

Private equity exit activity broke all records in 2021



Source: Pitchbook

Tech-enabled companies that are embracing the shift towards a more automated, digitised and cleaner world are positioned to gain market share.

Asset Class Quilt of Market Returns

Despite the ongoing pandemic with record numbers of COVID cases seen in almost every country, equity markets continued to surge ahead breaking records of their own. The S&P500 notched up 70 new all-time highs in 2021, the largest number in a single year since 1995.

Sharp drawdowns were notably absent from equity markets in 2021, just five trading days posted losses of two percent or more.

The biggest pullback in 2021 was just 5.6% in September.

US markets were the strongest performer over the year driven mainly by a big recovery in cyclical sectors. Australian equities lagged the rest of the developed world as the materials sector weighed on returns locally. Emerging market equities were crippled by regulatory crackdowns in China for much of the year.

Bond markets produced their first negative year in over 20 years. As inflation concerns dominated headlines for much of the year, rising yields and a flattening yield curve meant volatility remained elevated throughout 2021.

The removal of accommodative policy that supported investment grade credit and high yield markets in 2020 weighed on returns for these markets last year.

Cash markets continued to offer no return for investors highlighting the need to look to other asset classes for income focused investors.

The dispersion of returns across asset classes was the widest since 2017, emphasising the importance of remaining diversified. As markets continue to rotate at rapid speed, having an allocation to a diverse set of assets will add additional protection for investors during periods of volatility.

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
High	Gold 24.8%	EM Eq 51.6%	AE 27.6%	EM Eq 30.3%	EM Eq 29.2%	EM Eq 36.5%	AFI 14.9%	EM Eq 74.5%	Gold 29.6%	AFI 11.4%
	IG 14.8%	HY 32.4%	EM Eq 22.4%	AE 21.1%	AE 25.0%	Gold 30.9%	IFI 9.2%	HY 59.4%	EM Eq 16.4%	IFI 10.5%
	IFI 11.6%	IE 30.8%	HY 13.2%	Gold 17.9%	Gold 23.2%	AE 18.0%	Cash 7.6%	AE 39.6%	HY 14.8%	Gold 10.1%
	AFI 8.8%	US Eq 26.4%	IE 12.8%	IE 7.6%	IE 18.0%	IE 7.1%	Gold 5.8%	IE 27.0%	US Eq 12.8%	Cash 5.0%
	Cash 4.8%	Gold 19.4%	IG 9.5%	IFI 6.6%	HY 13.7%	Cash 6.7%	IG -8.6%	Gold 24.4%	IE 9.6%	IG 4.3%
	HY 4.1%	AE 15.9%	US Eq 9.0%	AFI 5.8%	US Eq 13.6%	IG 6.7%	HY -26.9%	US Eq 23.5	IFI 9.3%	HY 3.1%
	EM Eq -8.0%	IG 14.3%	IFI 8.9%	Cash 5.7%	IG 7.2%	IFI 6.6%	US Eq -38.5%	IG 19.2%	AFI 6.0%	US Eq 0.0%
	AE -8.1%	IFI 6.6%	AFI 7.0%	HY 3.6%	Cash 6.0%	AFI 3.5%	AE -40.4%	IFI 8.0%	IG 5.8%	IE -7.6%
	IE -21.2%	Cash 4.9%	Cash 5.6%	UE Eq 3.0%	IFI 4.4%	US Eq 3.5%	IE -42.1%	Cash 3.5%	Cash 4.7%	AE -11.4%
Low	US Eq -23.4%	AFI 3.0%	Gold 5.5%	IG -3.6%	AFI 3.1%	HY 3.2%	EM Eq -54.5%	AFI 1.7%	AE 3.3%	EM Eq -20.4%

2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
HY 19.6%	US Eq 29.6%	US Eq 11.4%	AE 3.8%	HY 14.3%	EM Eq 34.3%	AFI 4.5%	US Eq 28.9%	Gold 25.1%	US Eq 26.9%
AE 18.8%	IE 24.1%	IFI 10.4%	IFI 3.3%	AE 11.6%	IE 20.1%	Cash 1.9%	IE 25.2%	US Eq 16.3%	IE 20.1%
EM Eq 15.1%	AE 19.7%	AFI 9.8%	AFI 2.6%	US Eq 9.5%	US Eq 19.4%	IFI 1.6%	AE 24.1%	EM Eq 15.8%	AE 17.7%
US Eq 13.4%	HY 7.3%	AE 5.0%	Cash 2.3%	EM Eq 8.6%	Gold 13.5%	Gold -1.6%	Gold 18.3%	IE 14.1%	HY 0.9%
IE 13.2%	Cash 2.9%	IG 3.1%	US Eq -0.7%	Gold 8.1%	AE 12.5%	AE -3.5%	EM Eq 15.4%	IG 10.4%	Cash 0.0%
IG 11.2%	IFI 2.3%	IE 2.9%	IE -2.7%	IE 5.3%	HY 10.4%	IG -3.6%	HY 12.6%	HY 7.0%	IFI -1.6%
IFI 9.7%	AFI 2.0%	Cash 2.7%	HY -2.7%	IFI 5.2%	IG 9.1%	HY -4.1%	IG 11.5%	IFI 5.1%	AFI -2.9%
AFI 7.7%	IG 0.3%	HY 0.0%	IG -3.6%	IG 4.3%	AFI 3.7%	US Eq -6.2%	AFI 7.3%	AFI 4.5%	IG -3.2%
Gold 7.1%	EM Eq -5.0%	Gold -1.4%	Gold -10.4%	AFI 2.9%	IFI 3.7%	IE -10.4%	IFI 7.2%	AE 3.6%	Gold -3.6%
Cash 4.0%	Gold -28.3%	EM Eq -4.6%	EM Eq -17.0%	Cash 2.1%	Cash 1.7%	EM Eq -16.6%	Cash 1.5%	Cash 0.4%	EM Eq -4.6%

AE: Australian Equities
HY: High Yield Credit
Gold
IFI: International Fixed Income
EM Eq: Emerging Market Equities
Cash
AFI: Australian Fixed Income
US Eq: US Equities
IG: Investment Grade Credit
IE: International Equities

Source: Bloomberg

ESCALA
PARTNERS

Be second to none