Review of this year, preview of the next…

Land ahoy?

2022 is targeted by many as the year the pandemic finally releases its grip sufficiently to allow a return to normality. The arrival of Covid pills may indeed strike the decisive blow as some suggest[1], allowing holidays, restaurants, and conversations that we can't end with the click of a button, to return. However, the question for all of us trying to peer through the fog of another pandemic-mired winter into 2022 is what has changed? Are we the same as our 2019 selves? Or have our collective preferences and incentives been changed more durably by the torment (real and virtual) of the last two years?

Will Hobbs
Chief Investment Officer

While some of these changes may be subtle at the individual level, when aggregated they become more substantial of course. As one South American leader remarked early on in the crisis, this was the first genuine world war.[2] To that extent, there can have been few events in modern times that will have shaped our collective priorities to the same extent, in the same way. From the role of government to the appetite for various types of work, much may have changed. These changes, whatever they may be, will help inform whatever parts of the world's capital markets perform (and not) in the years ahead. We have a look at some of the forces likely at work below.

2021

A growth boom

The capital markets leaderboard for the year (Figure 1) would tell you much of what you needed to know about 2021. Global demand continued to recover impressively quickly for much of the year, spurred by governments and consumers for the most

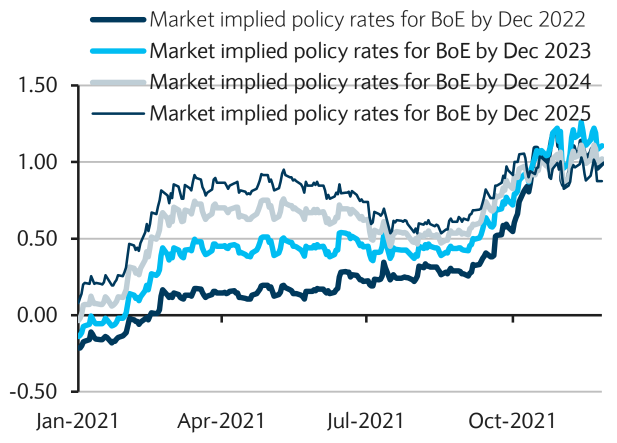
Figure 1: Asset class performance

	2021 YTD	2020	2019	2018	2017	2016
Cash & Short-Maturity Bonds	0.0%	0.3%	0.7%	0.5%	0.2%	0.4%
Developed Government Bonds	1.8%	6.3%	6.0%	0.1%	1.5%	6.3%
Investment Grade Bonds	-1.0%	7.2%	10.6%	-2.7%	4.6%	5.8%
High Yield & Emerging Market Bonds	-1.8%	3.0%	11.5%	-3.2%	6.6%	19.9%
Developed Market Equities	20.9%	12.3%	22.7%	-3.0%	11.8%	28.2%
Emerging Market Equities	-1.1%	14.7%	13.8%	-9.3%	25.4%	32.6%
Commodities	31.4%	-6.1%	3.6%	-5.8%	-7.1%	33.4%
Alternative Trading Strategies	4.5%	1.7%	2.2%	-3.1%	2.2%	4.3%

Source: Source: FactSet, Barclays. 2021 year-to-date performance is up to 25th November. ATS as of October 2021. Past performance is not a guide to future performance. Asset classes in GBP and represented by the following indices: Cash & Short Maturity-Bonds, Barclays Sterling Treasury Bills (0-12M) TR GBP; Developed Government Bonds, Barclays Global Treasury TR Hgd GBP (60%), Bloomberg Barclays Global Inflation-Linked TR Hgd GBP (40%); Investment Grade Bonds, Barclays Global Agg Corp TR Hgd GBP; High Yield and Emerging markets Bonds, BofAML US HY Master II Constrnd TR Hgd GBP (40%), JPM EMBI Global Diversified TR Hgd GBP (30%), JPM GBI-EM Global Diversified TR GBP (30%); Developed Markets Equities, MSCI World NR GBP; Emerging Markets Equities, MSCI EM NR GBP; Commodities, Bloomberg Commodity TR GBP; Alternative Trading Strategies (ATS), HFRX Credit Arbitrage TR Hgd GBP (25%), HFRX Merger Arbitrage TR Hgd GBP (25%), HFRX Active Trading TR Hgd GBP (25%), HFRX Systematic Diversified TR Hgd GBP (25%)

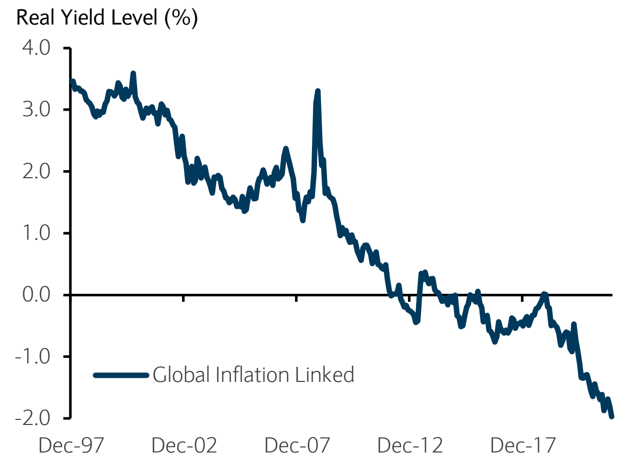
[1] *https://www.investmentbank.barclays.com/our-insights/the-flip-side-podcast/will-COVID-19-pills-be-a-game-changer-for-the-economy.html*
[2] *Tooze, A (2021) – Shutdown – How Covid Shook the World's Economy – Penguin books*

Figure 2: Expected borrowing costs have increased



Source: Bloomberg, Barclays

Figure 3: Global inflation-linked bond yield



Source: FactSet, Barclays

part. However, meeting that supercharged demand with adequate supply, from microchips to natural gas, proved challenging. The result was much less transitory inflation than planned for, as prices for a range of direct and indirect goods and services surged. This, in turn, fed sharply higher expected (nominal) borrowing costs for governments, companies, and consumers (Figure 2) as investors and central bankers reassessed what would be needed. However, importantly, the real (inflation-adjusted) cost of borrowing continued to sink as both incoming and expected inflation rose faster (Figure 3). As the world economy recovered and became less in need of the extreme monetary medicine of 2020, we essentially increased the dosage.[3]

Meanwhile, company profits soared (Figure 4), which in concert with that ever-more generous monetary setting, ensured stock prices and returns followed suit. Bubble worries seem to accompany all-time highs in stock markets like December and the misty crystal ball, however there may be a bit more substance this time. Valuations in parts of the world's stock markets, particularly those areas that fall under the broad banner of 'growth', look increasingly ill-acquainted with reality (Figure 5). At the level of stocks in aggregate, this froth in certain fashionable areas is offset by what we would see as excessive gloom in other, less hip, environs. The hopefully very familiar reminder is to not allow your investments to become too centred on a basket of recent winners.

> "2022 is targeted by many as the year the pandemic finally releases its grip sufficiently to allow a return to normality."

In spite of the many warnings of the regulator, this is an industry still in thrall to recent performance data. Those familiar with the concept of statistical significance will know well that very little actual information can feasibly be contained in a couple of years of performance data – would you bet your carefully accrued savings on a football club to win the premiership after watching three games? Any signal on the actual skill of the purveyor of that performance is simply drowned out by the noise of random market moves – luck or the lack of it tends to dominate in the short run. For those trying to separate that signal from all of the clutter and distortion, how performance has been generated should matter as much as how much.

This is why analysis of past performance is only a small part of the assessment our teams of fund sleuths make when selecting what we hope will be the fund manager stars of the future for you. The boom in growth stocks (Figure 6) over the last decade should provide important context for these performance conversations nonetheless. As suggested above, this is an area where prices have moved significantly faster than the fundamental reality that would support them. This is an elastic band that can only stretch so far. Those operating in the confines of 'growth' stocks have benefited enormously from this conditional popularity of the last decade. However, the decade ahead may be one where the opposite is true. That is particularly the case if, as we suspect, the regulator, the economy, and other important inputs are quite different to the decade in our rear-view mirror.

[3] https://www.piie.com/commentary/speeches-papers/what-federal-reserve-should-do-now-elaboration

2022

Cosmic significance…

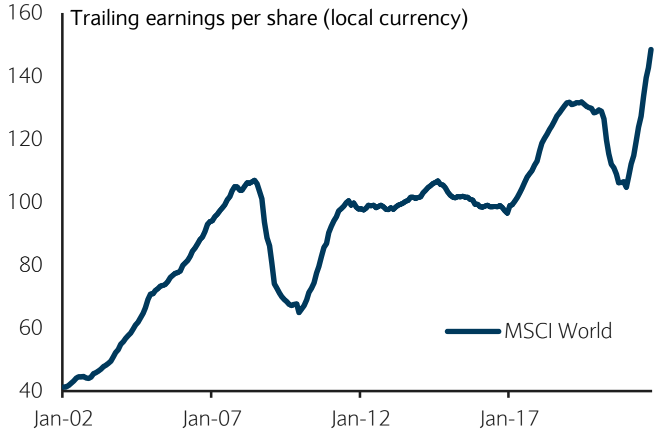
The common blow dealt by the pandemic has seemingly not served to unite our riven developed world society. The electorate remains perhaps mostly visibly polarised in the US, where responses to most news and events can be reliably predicted along party lines.[4] Some of this returning tribalism corresponds to the proliferation of TV channels this last few decades.[5] The inference being that programmers freed from the need to please all, could please and reinforce more surgically. Locked away from the mess of random interactions this last couple of years, our echo chambers – fed by carefully curated TV, social media and internet exposure – have been fortified. Our worlds have become smaller, in some ways more agreeable, but perhaps less intellectually robust as a result. The importance of meeting (and being forced to understand) people from beyond our little citadels of agreement is becoming ever more apparent.

Optimists for humanity's future point to our unique capability to generate *explanatory* knowledge as a reason to see us as having not just planetary but eventually cosmic significance.[6] The incredible growth of this store of understanding explains why our lives today, with food and goods arriving at our doorstep from all over the world, 100-tonne chunks of metal speeding through the sky, and fingertip access to all of the world's knowledge, entertainment and spitefulness, would have been considered totally magical only a century or so ago.

However, central to continuing to unlock the near unlimited potential of this cognitive superpower is the ability to error correct. This mix of curiosity and evidence-based challenge is plausibly seen as central to the first industrial revolution's birth in this country.[7] The 'tradition of criticism'[8] enabled (and was reinforced by) the scientific revolution of the 16th and 17th centuries. It seeped into society beyond the sciences, helping to fuel a sustained productivity and living standards take off that has doubled our life expectancy among many other things (Figure 7). Without these intellectual foundations, born of curiosity, shaped and hardened by challenge, the medical miracles of the last two years could not have come to our rescue. Wherever the Omicron variant leads, we can take some reassurance from the fact that tailor-made, highly effective, vaccines will likely be with us shortly.

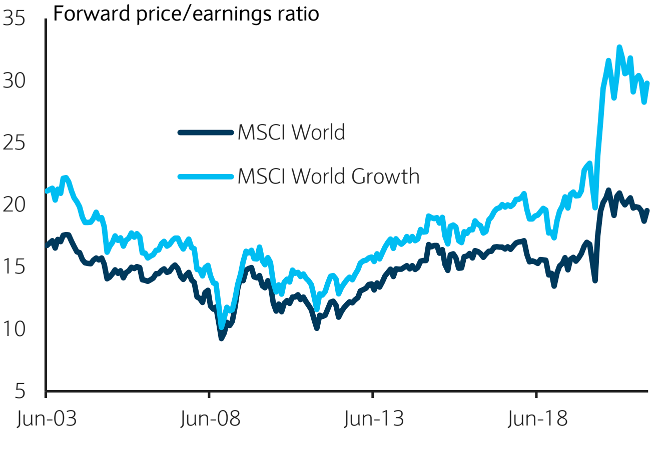
The media echo chambers we have retreated into are the antithesis of all that has taken us this far. Whatever answers we may personally think we have found for the world as it is today, they will need to evolve to fit the problems of tomorrow and beyond. This process is not simple of course. Trial and error requires effort, humility, curiosity and more besides, however discomforting and annoying.

Figure 4: MSCI World earnings per share (EPS)



Source: FactSet, Barclays

Figure 5: MSCI World vs. MSCI World Growth



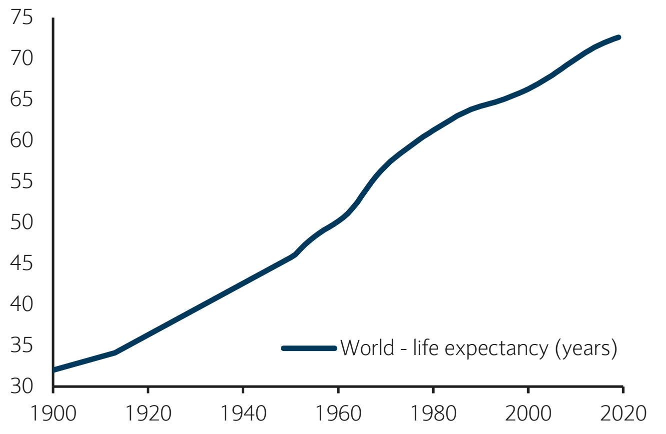
Source: FactSet, Barclays

[4] *https://www.brookings.edu/techstream/how-partisan-polarization-drives-the-spread-of-fake-news/*
[5] *https://blog.oup.com/2015/10/telecommunications-political-polarization/*
[6] *https://www.ted.com/talks/david_deutsch_a_new_way_to_explain_explanation?language=en*
and https://www.ted.com/talks/the_ted_interview_david_deutsch_on_the_infinite_reach_of_knowledge/transcript?language=en
[7] *Mokyr, J (2009) The Enlightened Economy – Britain and the Industrial Revolution 1700 – 1850 – Penguin books*
[8] *https://plato.stanford.edu/entries/popper/*

Figure 6: MSCI World Value vs. MSCI World Growth

Source: FactSet, Barclays

Figure 7:World life expectancy



Source: OurWorldInData.org, Barclays

The threat of war

Its supporters see the liberal democratic model, whatever its many flaws, as the political equivalent – an error-correcting model that ultimately weeds out the worst outcomes (rather than perpetually optimising for the best). Two of the geopolitical threats cited by many for 2022 surround the territorial mores of two regimes with a different governance model. The straits of Taiwan have been hotting up as has Ukraine's border with Russia. Ideology rather than economic interest are seen as key inputs.[9]

China's policymakers have much to congratulate themselves over this last few years, even decades. As we've noted many times before, there has never been anything like it in terms of poverty reduction (Figure 8). However, this growth model, buttressed by investment in real estate, will struggle to take them through the next stage of development, as further evidenced by the Evergrande affair. Deng Xiaopeng's famous observation that the colour of the cat should not matter, just whether it catches mice is surely useful in these times. The success of China to date owes much to the victory of pragmatism over ideology. Signs of ideology dampening the ability to criticise and course correct increase the risk of wrong turns, as they do anywhere, under any regime. History has illustrated the benefit of institutions capable of resisting the magnetism of the occasional charismatic individual again and again.[10]

> "Valuations in parts of the world's stock markets, particularly those areas that fall under the broad banner of 'growth', look increasingly ill-acquainted with reality."

However, right now many will argue that the liberal democratic model is the one that looks a little more rickety. Managing by consensus tends to make fast change difficult, a serious impediment when it comes to the needs of the environment. Meanwhile, seething, polarised electorates are plenty capable of self-harm. Recent work has plausibly made the link between those operating in jobs vulnerable to automation with sympathy towards authoritarian leadership, opposition to immigration and overseas trade and an overall darker view of their lives.[11] This should add to the concern of what the apparently in-motion fourth industrial revolution will do to that already fractured and unequal developed world society. Elections are going to continue to be nervy affairs for a while yet. US mid-terms and French presidential elections are probably the ones to watch in 2022.

[9] *https://www.brookings.edu/opinions/will-putin-miscalculate/*
[10] *Acemoglu, D & Robinson, J, A (2013) – Why Nations Fail – the Origins of Power, Prosperity and Poverty (Profile)*
[11] *https://www.brookings.edu/blog/techtank/2021/11/22/automation-and-the-radicalization-of-america/*

Inequality, inflation, and the planet

The technological change of the last few decades, among many other factors, has helped to widen the gap between the haves (the owners of capital) and the have-nots (the majority of the workforce).[12] There are giant forces at work here, mostly well beyond the ability of a single wealth manager to solve. However, we and other asset managers can play our part. It is vital to dramatically expand the base of 'haves' by ensuring that savings are appropriately exposed to diversified, inexpensive, and professionally managed capital ownership in the form of the multi-asset class funds and portfolios we offer – the democratisation of wealth that our CEO Dirk Klee and others have spoken of frequently. The tumbling price of access to diversified investments these last few decades should mean that it is no longer just the already wealthy that are in on this compounding trick (Figure 9). The potential return of more noticeable inflation only increases the importance of that core mission.

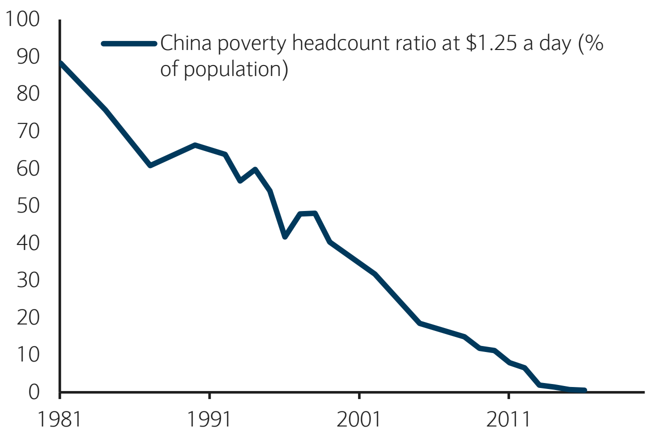
If the last few decades have been characterised by abundant supply, from workers to commodities, helping to keep price pressures contained amidst decent demand growth, the road ahead could be quite different. The clearing price for demand and supply in labour markets, namely wages, is already indicating that there is a mismatch – surging wages in many economies speak of the reduced supply of labour (Figure 10). Now some of that is surely temporary, associated with shorter term friction, with the pandemic (and the policymaker response) jumbling incentives and priorities for many workers. Nonetheless, we think central bankers are right to worry a bit more on this front.

> "The potential for a sustained period of industrial and technological change (or the fourth industrial revolution) represents a sufficiently plausible (and alluring) upside scenario for investors."

You could also argue that we're beginning to get a clearer view of the price we must pay for the move to renewable energy sources. We will still need fossil fuels to make that transition, but that energy will be pricier to access in a world where related investment is understandably more reticent. (Figure 11)

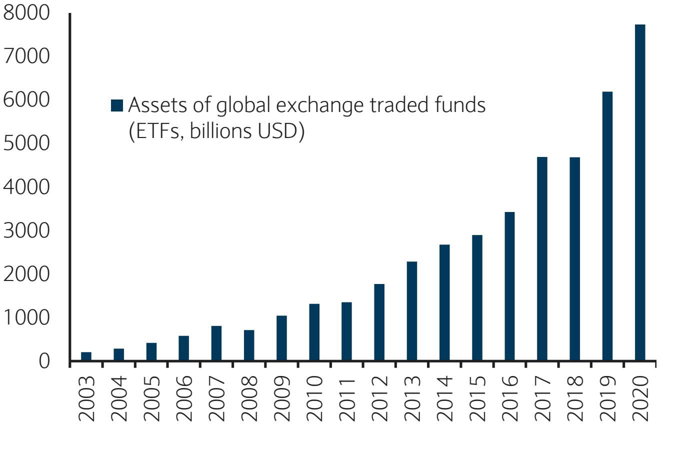
Stagflation (a period when slow economic growth and joblessness coincide with rising inflation) still feels like a stretch for now. The world economy simply has too much pent-up demand in its back pocket for that to be your base case. As supply chains continue to unclog in coming months and quarters, we should see some of that pressure released.

Figure 8: China poverty



Source: FactSet, Barclays

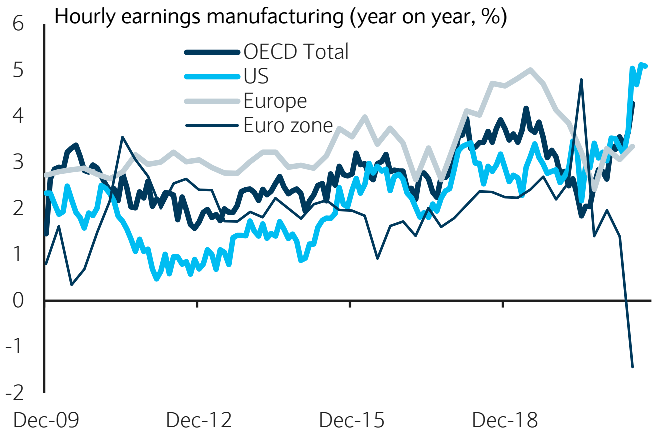
Figure 9: Global Exchange Traded Fund assets



Source: Statista.com, Barclays

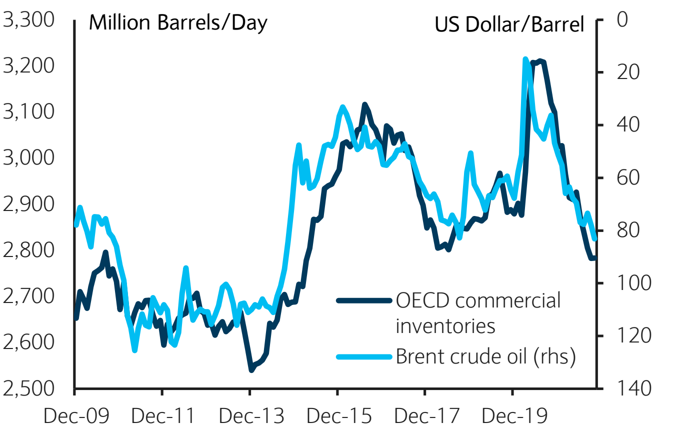
[12]https://www.piie.com/research/economic-issues/inequality and Acemoglu, D (2002) – Technical Change, Inequality and the Labor Market – Journal of Economic Literature, Vol. 40. No1 – pp7 - 72

Figure 10: Hourly manufacturing earnings



Source: Factset, Barclays

Figure 11: Oil inventory & price



Source: FactSet, Barclays

The good, the bad, and the ugly

The last few years have taught us plenty about our ugly side. Humanity's struggle to think of the collective good, to think ahead. Rather than talk of the 'great resignation' that has so interested many columnists, others have pointed to the less catchy, 'great rudeness'.[13] The fact that so much of this job quitting (Figure 12) has been in the services sector corresponds to the abuse and vitriol that has been directed at those serving us coffee, sandwiches, and other essentials, often for wages well below the average.

Nonetheless, there is still much to be optimistic about. The last several years (even decades) has been characterised, to the surprise of many, by low levels of productivity. In spite of the wondrous advances in communication, dissemination of information and many other areas, measured productivity has been disappointing in aggregate. Some have speculated that we've run out of the big ideas. It is the last few hundred years that were the productivity blip, now we return to the stagnation that has been the norm for the thousands of years until the 18th century.[14]

Such pessimism likely misunderstands the causes of the innovative spurt we have seen these last few centuries. The causal power of that explanatory knowledge took a while to gather, centuries in fact. However, as discussed above, it lacks imagination to argue that it is now spent. The reverse is more likely true. The innovation we are seeing in health-related areas in particular has the potential to transform the lives and productive capabilities of a much larger slice of humanity. This crisis has helped to divert greater flows of investment and attention both to biomedicine and indeed the climate abyss that lies in the path ahead if we don't act. Perhaps the correct productivity analogue is indeed the 1930s, admittedly a miserable time for many with policymakers mostly to blame, but a time when multiple innovations of the preceding decades coalesced to force a step-change in our productive capabilities.[15]

Our brains hold the key. The fact that ever more of us are getting the access to education and opportunity relative to decades past should be a source of encouragement. However, the tradition of criticism, of error correction, is absolutely central to making the most of this brain power. This is not the anonymous bile that seems to prosper so on various public forums – criticism and civilisation do not have to exist in opposition.

More parochially, this culture of criticism and self-reflection will continue to be so important in generating the maximum possible sustainable returns from capital markets. We have very deliberately designed a process with the various behavioural fallibility of individuals (the CIO in particular!) in mind.

We believe strongly in the power of specialism. We, of course, have the highest respect for the heptathletes of the investment world. An individual who can do a bit of asset allocation, stock selection, asset gathering, and the rest is worthy of admiration. However, we believe that in allowing teams of individuals to focus on distinct parts of the investment value chain and gathering the fruits of that specialism together, the net result will be higher risk-adjusted returns over time for our clients. For every individual discipline in the heptathlon, there is specialist who can run faster, jump higher, throw further.

[13]*https://foreignpolicy.com/podcasts/ones-and-tooze/great-resignation-worry/*
[14]*Gordon, RJ – (2012) Is US productivity growth over – faltering innovation confronts the six headwinds – NBER working paper series*
[15]*Bakker, G; Crafts, N; Woltjer P (April 2019) – The sources of growth in a technologically progressive economy – the United States, 1899 – 1941 (The Economic Journal)*

Investment outlook

At the asset class level, almost everything appears steep. Interest rates at all maturities everywhere are close to all-time lows (however many hundreds of years of history you want to incorporate). Stock market valuations are high around much of the world, as are levels of profitability. In our rear-view mirror lies one of the three great secular bull markets of the post-War era (Figure 13). Its birth in 2009 was characterised by a very different context – low valuations, low profitability, and higher interest rates. Then too, as it goes, the talking heads were urging investors to accept the reality of lower returns to diversified investment than they had become used to. The gloom then was founded primarily on the reflexive pessimism of a soothsayer community bruised by its revealed lack of prescience – as with most crises, it was mostly only the stopped clock doom-mongers that 'foresaw' the Great Financial Crisis.

The expectation of lower returns looks a little better founded this time even if, as usual, there are likely a wide range of potential outcomes around that baseline. As suggested above, the potential for a sustained period of industrial and technological change (or the fourth industrial revolution) represents a sufficiently plausible (and alluring) upside scenario for investors. To scoop the rewards here though, you will likely need a different investment toolkit to the one that plundered the spoils of the last cycle. Different parts of the stock market would likely prosper at the expense of some of the big names of the last decade and much of the bond market would offer return-free risk rather than anything more financially edifying.

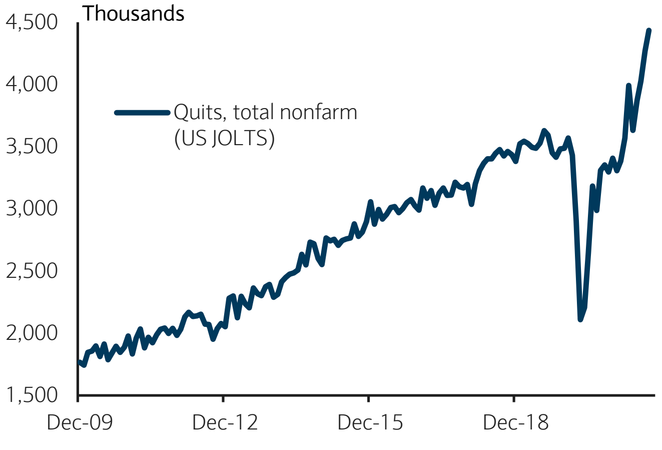
> "I feel a rational optimism with regards to the future, whatever the market makes available."

The run into the end of the year has perhaps provided us with a sneak peak at the path ahead. Investors have been unevenly incorporating a little extra compensation into longer bonds. This extra yield reflects a more uncertain outlook for inflation and a central bank community now visibly looking for opportunities to begin unwinding some of the epic generosity of the crisis response.

Meanwhile, as stocks in aggregate look highly priced (for the most part justifiably when taking the wider context into account), there are certainly divergences to profit from underneath the surface. The gap between so-called cheap and expensive stocks is at historically mouth-watering levels, a gap that cannot be explained by an unusually large chasm in fundamental quality.[16] At the moment, the fate of this trade seems to be tethered to the direction of inflation-adjusted interest rates. While this has not been a terribly dependable relationship over time, it is likely easier to argue a 10-year view that sees real interest rates move higher than lower from current levels.

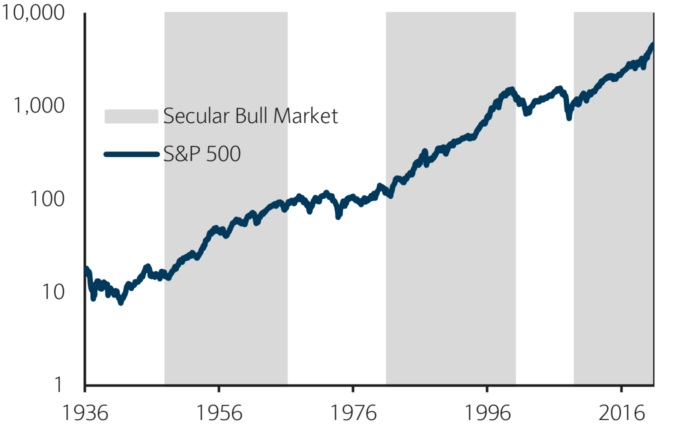
At the time of writing there is some turbulence associated with the latest variant's sting in the pandemic's long tail. However, we would do well to remember that even the darker scenarios associated with this new mutation will only take a chip of the future cash flow mountain you are accessing when you buy stocks. It should have no influence on the long-term investor's plans.

Figure 12: Total non-farm job quitting



Source: Factset, Barclays

Figure 13: S&P 500 Index performance



Source: FactSet, Barclays

[16]https://www.aqr.com/Insights/Perspectives/Are-Value-Stocks-Cheap-for-a-Fundamental-Reason

So what should your investment toolkit look like for both the months and decade ahead? There are a few points to bear in mind.

First, if the base expectation is for flatter overall returns to diversified investment (although still likely inflation-beating), it is likely important to find plausible ways to add to that 'market return'. The starting point here remember is the assumption that markets are relatively efficient – prices mostly quickly reflect all that we can know, assume, and guess about the future. This is well-established fact and should help you weed out the charlatans offering investment something for nothings. Self-serving though this will ultimately sound, this starting assumption suggests that you will be best served by getting full-time professionals on the job whether you are looking at it from the perspective of inefficiencies and incentives in individual stocks and bonds (which we outsource to a carefully curated list of professional fund managers) or from the asset class level (where we have dedicated internal resources to exploit the opportunities).

Second, that core mix of assets you deploy to scoop up whatever broad return the market makes available – you might describe as the investment returns derived from global output growth – needs careful thought. The rear-view mirror may not be that helpful, certainly not one that only takes in the last decade. The passive 60/40 (60% stocks, 40% bonds) portfolio that has trounced pretty much all comers in the last few decades (past performance is not a reliable guide to future performance) will surely find the years ahead tougher from the current starting point. Trends in productivity, inflation, regulation, and much more besides have the potential to look entirely different in the years ahead to the years just gone. This suggests that the capital markets leaderboard could also bear little resemblance. Humility, as ever, is appropriate.

This mix of humility and professionalism is exactly what we aim to deliver in our multi-asset class funds and portfolios, from asset allocation through to the painstaking selection of professional fund managers. Past performance is certainly not a reliable indicator of future returns – the regulatory warnings are entirely correct as repeatedly noted above. However, as a CIO on the hook for delivering repeatable performance to our many treasured clients, taking into account both where and how those returns have been achieved in the last decade and the quality of the teams and individuals that are *really* responsible for delivering them, I feel a rational optimism with regards to the future, whatever the market makes available.