



A winding road to normality

Outlook 2022 (in-brief)

→ Policy and markets are likely to become increasingly 'normalised' in 2022 as major central banks turn less accommodative and equities and corporate bonds deliver positive, but increasingly modest and volatile, returns. Any path to normality, though, is likely to follow the twists and turns of the inflation debate, virus mutations and policy shifts.

→ We expect equities to outperform bonds and cash, even if returns are muted relative to recent years. We prefer US and Euro area equities, in particular.

→ Minimising interest rate and FX sensitivity is key to selecting bonds. We prefer Asia USD and US/European High Yield corporate bonds.

→ Aside from our foundation allocations, we see tactical opportunities in selective cyclical sectors and strategic opportunities in multi-year themes.

Letter from the CIO



Rewind the clock to the end of 2019. If you had been told that there will still be a worldwide pandemic for two years and counting, would you have predicted that global equities would be up over 30% during that period?

As we write this 2022 Outlook, the world is facing increased uncertainty with the emergence of the Omicron COVID-19 variant and its spread across the world. Relatively little is known about how this will impact the global economy. It appears more transmissible than the Delta variant, but symptoms may be much less severe. We also have limited information on the efficacy of existing vaccines in reducing either of these key variables.

In this 2022 Outlook, we have assumed Omicron will not be the defining feature of the year. This does not preclude the risk of continued short-term volatility, which is always present, especially after a near straight line appreciation of global equities over the past 20 months.

So, how should investors position themselves in the coming 12 months? I think there are two key lessons for investors from the past 24 months. The first is: stay invested. Rewind the clock to the end of 2019. If you had been told there will be a worldwide pandemic for two years and counting, would you have predicted that global equities would be up over 30% during that period?

Second, stay diversified. This is common sense, but not always common practice. Humans have a tendency to 1) get excited by the standout performance of individual companies and new fads and 2) over-estimate our ability to identify the winners ahead of time. By building a diversified foundation portfolio, you make sure that you start on firm ground. Thereafter, if you want to supplement this with opportunistic ideas – whether they be structural investment themes, self-selected equities or bonds or even derivative

strategies – there is nothing wrong with that. We all want bragging rights when we meet with our friends, but it is more important for your family that the foundations are solid to start with.

For those who are already invested and diversified, well done! You have resisted the temptation to sell in the depths of despair in Q1 2020 – global equities have almost doubled since those lows. Staying invested means you have probably outperformed the vast majority of individual investors.

However, I still speak to far too many of you who kept delaying, initially waiting for the outlook to improve and then waiting for a pullback to buy on dips. For these would-be investors, I would offer a third piece of advice – start slowly (but still start) and accelerate investments as different asset classes go on sale. This is the best way to manage your emotions. The key is to invest in a way that allows you to remain invested when sentiment is at its weakest. If you are really lucky, you could actually look forward to market sell-offs as you know this is when you can find some of the best bargains.

Steve Brice
Chief Investment Officer

01

Equities and gold are preferred



Prefer equities:
Earnings growth to drive returns, but at a more modest pace and with higher volatility compared with 2021



Prefer gold:
Mitigates inflation, weak USD and equity volatility risks

02

Strategies within equities key for equity performance

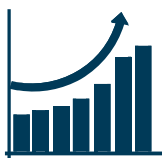


Prefer US and Euro area equities on strong growth and supportive policies

Prefer equity long/short strategies amid stock/sector dispersion opportunities

03

Position multi-asset income strategies for modest equity returns and inflation risks



Prefer Europe high dividend yield equities given their attractive yield

Tilt to covered call strategies as they can outperform amid modest equity returns

Prefer Asian High Yield and subordinated bonds for added yield

Prefer floating rate loans to mitigate inflation and interest rate risks

Our Outlook 2022

views at a glance



04

Minimising rate sensitivity and FX risks key for bonds

Prefer US/European High Yield bonds, which typically outperform when the Fed kicks off a rate hiking cycle

Prefer Asia USD bonds where we see value

USD likely to drift lower in 12 months after initial surge

05

Tailor opportunistic allocations around sectors and themes

US



Technology

China



Industrials



Consumer discretionary

Europe



Technology



Consumer discretionary



Financials



Industrials

Longer-term (3-5 year) themes

Winds of Climate Change | Embracing a Digital Future | China's 'Common Prosperity'



What could go wrong?

Inflation proves to be higher or longer-lasting than expected

Central banks tighten too much, too quickly

Geopolitical event or vaccine-evading COVID-19 strain takes markets by surprise

Investment strategy and key themes

Steve Brice
Chief Investment Officer

Manpreet Gill
Head, FICC Investment Strategy



Our foundational preferences over a 12m horizon

- Prefer Global Equities and Gold
- *In equities*: US and the Euro area
- *In bonds*: DM HY, Asia USD
- *In FX*: Bearish USD bias

Longer-term (3-5yr) themes

- The Winds of Climate Change
- Embracing a Digital Future
- China's 'Common Prosperity'

Sector preferences over a 12m horizon

- *US*: Technology
- *Euro area*: Industrials, Financials, Technology, Consumer Discretionary
- *China*: Consumer Discretionary, Industrials

A winding road to normality

- Policy and markets are likely to become increasingly 'normalised' in 2022 as central banks turn less accommodative and equities and corporate bonds deliver positive, but increasingly modest and volatile, returns. Any path to normality, though, is likely to follow the twists and turns from the inflation debate, virus mutations and policy shifts.
- We expect equities to outperform bonds and cash, even if returns are muted relative to recent years. We prefer the US and Euro area, but would watch for improvements in the Emerging Market equity outlook as vaccine coverage broadens and the USD peaks.
- Minimising rate and FX sensitivity is key to selecting bonds. We prefer Asia USD (including High Yield) and US/European High Yield corporate bonds. Income strategies should benefit from tilts to covered calls, subordinated bonds and floating rate loans.
- Aside from our foundation allocation, an opportunistic allocation is likely to benefit from our largely cyclical sector picks and our three longer-term themes – The Winds of Climate Change, Embracing a Digital Future and China's 'Common Prosperity'.

A return to trend?

In our assessment, 2022 is likely to see policies start to return to more 'normalised' settings, resulting in more modest equity market returns, with somewhat greater volatility than in 2021.

We expect economic growth in 2022 to stay well-supported, above its long-term trend, with H1 likely stronger than H2. The Fed is likely to start hiking interest rates by H2, but the level of central bank policy is likely to remain far from levels that hold back equity markets. The US and Europe are likely to lead global growth, while China is likely to manage a soft landing.

The inflation debate, though, is unlikely to abate quickly. As a base case, we side with a view of moderating inflation. While many supply constraints are likely to extend into the early part of 2022, these are likely to ease as supply catches up and demand growth softens from 2021's historically high levels. This could still leave US inflation in the region of 3%, though we believe this is unlikely to excessively concern the Fed unless signs of a wage-price spiral emerge, inflation expectations reach a new high or there are other signs of broadening inflation.

A significant upside inflation surprise, a policy over-tightening error, a significant geopolitical event or a vaccine-evading COVID-19 variant are key risks to our base scenario.

Fig. 1 Capturing the US inflation debate – An Analysis of Competing Hypotheses (ACH)

| Arguments for above-consensus inflation | Arguments for below-consensus inflation |
|--|---|
| Actual and potential GDP gap smaller than expected | Stimulus-end brings more people back to labour force |
| Excessively expansionary fiscal and monetary policy | Premature fiscal and monetary policy tightening |
| Fall in labour force participation rate is structural | Long-term inflation expectations within historical ranges |
| Transport, shipping delays last longer than expected | New capacity investment to alleviate supply shortages |
| Inflation broadens beyond sectors hit by supply chain issues | Rising productivity offsets wage price increases |
| Service sector inflation returns | Lending remains weak and a firm USD curbs import costs |
| Work-from-home productivity gains short-lived | Continued immigration relieves labour market pressure |
| Pass through of rising energy prices | Economy less energy intensive today than in past decades |
| De-globalisation and/or rising China producer prices | China growth slowdown eases prices and weakens currency |

Source: Standard Chartered Global Investment Committee

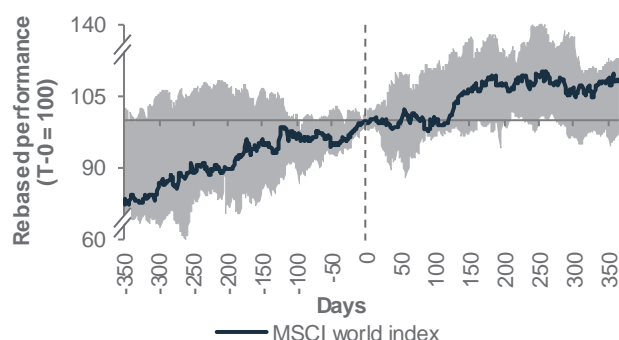
#1 – Against this backdrop, equities and gold are preferred and expected to outperform Investment Grade bonds and cash

Q1 2022 marks two years since the start of the pandemic-driven recession and markets are likely well beyond their initial recovery surge. We expect equities will still outperform bonds and cash in 2022, but at a more modest pace than 2020-2021 and with somewhat higher volatility.

This is not unusual, but characteristic of a more ‘normal’ environment for equities outside of recession-recovery years. Equity earnings growth is likely to be the main driver of returns, with history demonstrating equities perform well in the 6-12 months ahead of the start of a Fed rate hiking cycle.

Fig. 2 Equities have historically performed well in the lead-up to the first rate hike of a Fed hiking cycle

12m MSCI World index (Developed Market equities) returns before and after the first hike of a Fed rate hiking cycle



Source: Bloomberg, Standard Chartered; Data from 1980 onwards; Grey area shows min/max performance over different Fed cycles

Our preference for gold, though, is driven by a variety of factors. First, it offers an attractive hedge should inflation prove to be higher, or longer-lasting, than we expect. Second, we expect it to offer some mitigation against bouts of equity market volatility. Third, modest USD weakness should eventually offer a pillar of longer-term support for gold.

#2 – Strategies within equities are expected to be increasingly important for equity allocation performance

We have a regional preference for the US and Euro area, going into 2022. Our preference for Developed Markets (DM) over Emerging Markets (EM) is driven by three factors. First, we believe the US and Euro area are in a relative sweet spot characterised by strong growth (which supports earnings) and supportive policy levels.

Second, while consensus economic and earnings growth expectations are beginning to turn in favour of EM over DM in 2022, we believe three conditions for an equity market rotation towards EM – USD weakness, a significant turn in Chinese policy direction and an economic recovery led by widespread COVID vaccinations – are not imminent. Having said that, we would be on watch should these conditions change and start pointing to a rotation into EM equities.

Third, gradually rising volatility, combined with still-attractive stock and sector dispersion, means equity long/short alternative strategies can offer an attractive risk/reward. Also, we would consider using volatility to generate income, especially when volatility temporarily spikes.

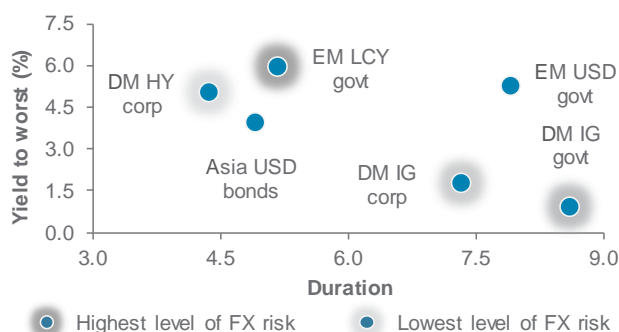
#3 – Minimising interest rate sensitivity and FX risks likely to be key for bond investors. Expect High Yield (HY) bonds to outperform and the USD to weaken over 12m.

We expect bonds will largely deliver returns in line with the yield on offer in 2022, with the avoidance of downside or defaults being key.

Our first preference is for Asia USD bonds. The bonds offer attractive value for an asset class with relatively high credit quality and low interest rate sensitivity, in our view. Within this, we like HY bonds. Default concerns remain elevated, although we balance this with the historical learning that periods of inexpensive valuations led to very attractive returns for most HY markets worldwide on a 6-12 month horizon, even if timing the precise asset class trough was difficult. A softening of China's policy stance is likely to be the trigger for recovery.

Fig. 3 Our preferred bond asset classes exhibit high yields with relatively low rate and FX sensitivity

Bond asset classes illustrating yield, duration (rate sensitivity) and FX sensitivity trade-offs



Source: Bloomberg, Standard Chartered

Our second preference are US and Euro area HY bonds. While valuations are relatively elevated, we note HY bonds, being risky assets, have historically outperformed their higher quality peers as the Fed embarks on a rate hiking cycle. HY bonds also have lower sensitivity to rising interest rates, a key characteristic we prefer in 2022. Rising interest rates hurt firms with the weakest credit quality the most, but we do not expect policy to come close to that point next year.

Fig. 4 Momentum points to 1-3 month USD strength, but 6-12 month drivers have a bearish bias

USD Index (DXY) key drivers

| Momentum indicators (1-3 months) | | Valuation indicators (12 months) | |
|------------------------------------|---|--|---|
| Relative Strength Index | ● | 12m change in US-EU 2y real yield differential | ● |
| Commodity Channel Index | ● | Y/y change global vs US equity market return | ● |
| Moving Avg. Convergence/Divergence | ● | Lagged difference in US-EU inflation | ● |
| Stochastics | ● | Y/y Change in commodity prices | ● |
| Market Diversity | ● | Lagged US current account, fiscal balance | ● |
| | | Lagged difference in US, EU GDP growth | ● |

Source: Bloomberg, Refinitiv, Standard Chartered

Legend: ● Bullish signal | ● Bearish signal | ● Neutral

In terms of managing currency risks, though, the USD index's strong upward momentum is difficult to ignore. This, together with rising short-term US bond yields and expectations of a Fed policy lift-off, means USD strength has room to temporarily extend over the next 1-3 months. In bonds, this is behind our preference to minimise exposure to FX risk.

Beyond this horizon, though, it is equally difficult to ignore fundamentals that point to a weaker USD over a 6-12 month horizon. The USD is expensive from a valuation standpoint and relative yield differentials have room to move further

against the greenback once a Fed cycle is fully priced in and attention moves to an eventual policy shift outside the US. A move towards greater outperformance of non-US equity and bond markets may very well catalyse a turn in the USD later in 2022.

#4 – Position multi-asset income strategies for modest equity returns and inflation risks

Rising policy rates (we expect one Fed rate hike in 2022) and modestly higher bond yields are likely to be positive for income strategies by raising the yields on offer across income asset classes. In 2022, though, we would look to adapt income strategies to account for more modest equity returns and the risk of higher inflation and bond yields.

Within high dividend equities, we have a modest preference for Europe, given the more attractive yield on offer compared to other regions. We also add a tilt towards covered call strategies given their usual outperformance in modest equity return environments.

Within bonds, Asian HY bonds are likely to add both yield and price returns over a 6-12 month horizon, while a tilt towards subordinated and floating rate bonds is likely to offer attractive yields and, in the case of floating rate loans, some mitigation against inflation and interest rate risks.

#5 – Tailor opportunistic allocations around sector strategies and our longer-term (3-5yr) themes

Our four views on core foundation allocations notwithstanding, we believe an additional opportunistic allocation can help take advantage of more tactical or thematic opportunities.

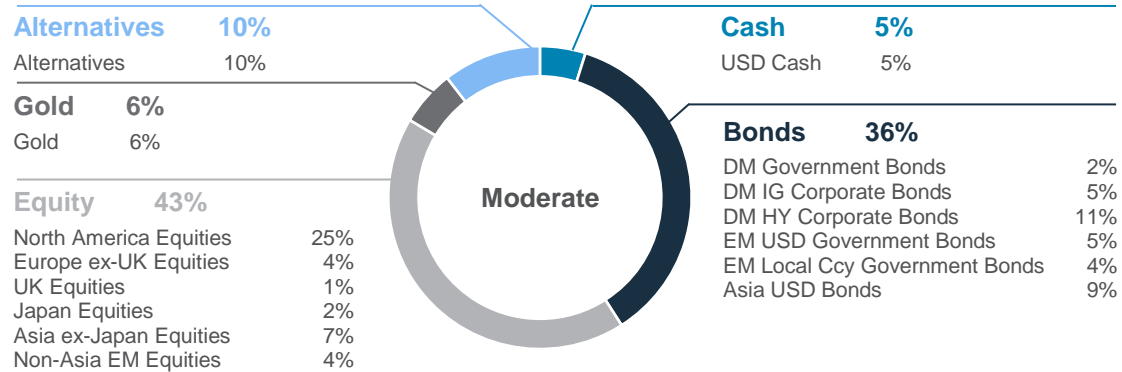
In terms of sectors, in the US, we prefer the technology sector. Rising bond yields could still pose a headwind for technology, but we believe the positive earnings growth outlook is likely to more than offset this. In China, we prefer consumer discretionary and industrials. Regulatory risks for the consumer discretionary sector are likely past their peak, allowing a refocus on growth prospects. Industrials, meanwhile, align with policy priorities.

In Europe, we prefer the technology, consumer discretionary, industrials and financial sectors. European financials are likely to benefit from deep value and easy ECB policy delaying a flattening of the European yield curve (ie. narrowing of the 10-yr-2yr government bond yield gap).

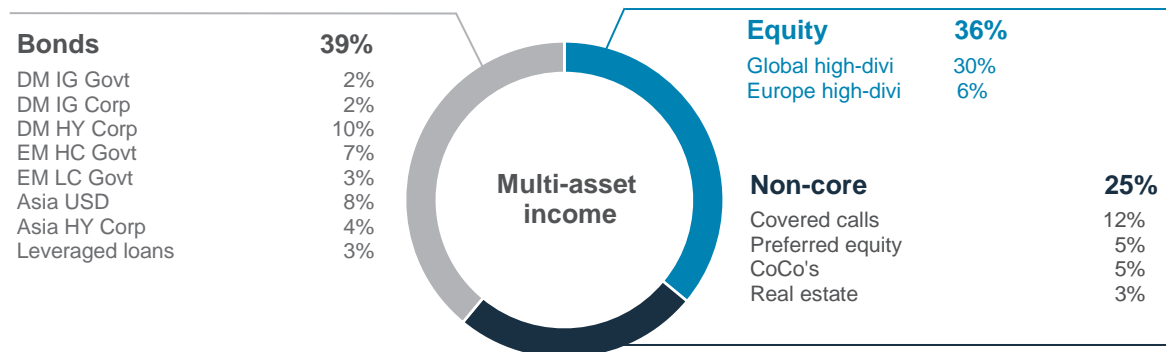
Longer-term (3-5 year) strategic equity allocations are likely to benefit from a thematic approach. First, 'The Winds of Climate Change' theme is likely to be a key focus, within which we favour water scarcity, electric vehicles (EVs) and infrastructure/green capex as investible areas. Second, our 'Embracing a Digital Future' theme captures investible opportunities in 5G/Internet of Things (IoT), cybersecurity, fintech and blockchain. Third, China's 'Common Prosperity' favours high-tech manufacturing, green energy, and internet companies.

Foundation tactical asset allocations

Global* allocation for a moderate risk profile



Multi-asset income allocation for a moderate risk profile



| | View | Detail |
|---------------------|------|--|
| USD cash | ▼ | + Safety - Close to no yield |
| Bonds | | |
| DM Govt | ▼ | + High credit quality, policy support - Very sensitive to rising US bond yields |
| DM IG Corporate | ▼ | + Policy support - Very sensitive to rising US bond yields |
| DM HY Corporate | ▲ | + Attractive yield, low rate sensitivity - Valuations, falling credit quality |
| EM USD Govt | ◆ | + Attractive yield, attractive value - Sensitive to rising yields, near-term USD strength |
| EM Local Ccy Govt | ▼ | + Moderate yield, USD weakness over 6-12 months - Rising policy rates in some EMs |
| Asia USD | ▲ | + Moderate yield, low volatility - Default contagion risks |
| Equities | | |
| North America | ▲ | + Growth, earnings rebound, policy support - Faster Fed taper, potential tax rise |
| Europe ex-UK | ▲ | + Vaccinations, policy support - Renewed COVID-19 wave |
| UK | ▼ | + Attractive valuation - Policy tightening risk, Brexit-related uncertainty |
| Japan | ◆ | + Global economic recovery - China slowdown, structural deflation |
| Asia ex-Japan | ◆ | + Earnings rebound - China slowdown, COVID-19 risk, USD rebound |
| Gold | ▲ | + Weak USD, equity vol hedge - Return of risk appetite, short-lived inflation |
| Alternatives | ◆ | + Diversifier characteristics - Equity, corporate bond volatility |

Source: Standard Chartered Global Investment Committee

Legend: ▲ Most preferred | ▼ Least preferred | ◆ Core holding

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