

Q1 outlook: New year, new narrative

Even though 2022 has begun with an abrupt change in the macro narrative, stoked by the Fed, we hold the line on our bullish outlook for risk assets.



Emiel van den Heiligenberg
Head of Asset Allocation

Last year was a great period for risk assets, but not an easy one for investors. Our morning meetings were packed with discussions about the pandemic, inflation and China. This year is likely to be even more challenging, with lower expected returns and higher expected volatility, as Tim explains below.

Indeed, the first quarter has begun with bang, with an abrupt change in the macro narrative stoked by the US Federal Reserve (Fed), which market participants now expect to be more hawkish than previously anticipated. Nevertheless, we hold the line on our bullish outlook for 2022.

Yield spike

Not completely unexpectedly, the S&P 500 rallied 5% in December, clocking yet another all-time high on the 29th and topping up a strong fourth quarter for a 10% return over the period.¹ As you can imagine, this kind of market strength does not happen too often.



Minutes from the Federal Open Market Committee's December meeting, published earlier this month, revealed that the US central bank is prepared to normalise the size of its balance sheet faster than during the previous cycle. Real yields increased, while equities wobbled.

On a day-to-day basis the correlation between interest rates and equities can be negative, especially when yields spike.

But we believe that over the longer term, at these low levels of interest rates, rising yields don't matter too much for equities until monetary policy becomes more restrictive later in the cycle. Equity drawdowns caused by spikes in bond volatility usually correct themselves when bond markets stabilise. Yields don't necessarily have to come down; they can just stop rising for equities to revert.

1. Source: Bloomberg as at 31 December 2021

Grey swans

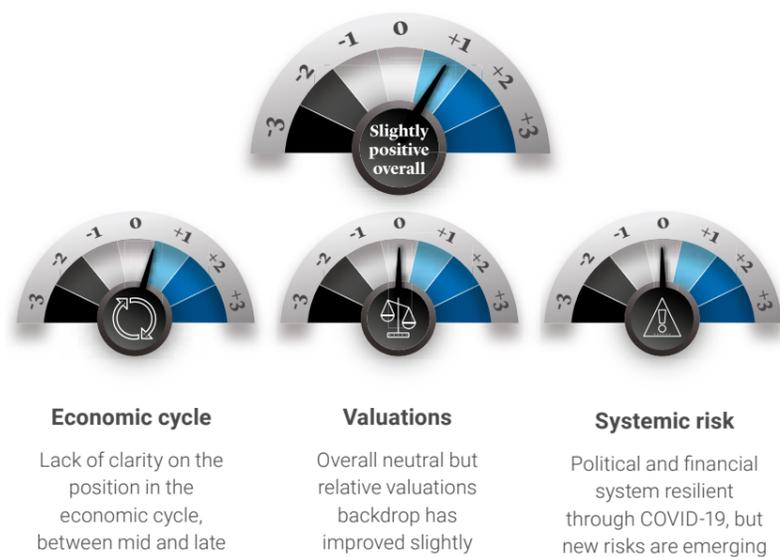
With this in mind, we hold the line on our bullish equity view, detailed by Lars and James below. Tighter monetary policy is to be expected, and our outlook is to some extent priced in, but overall liquidity conditions are still extremely loose.

Our research shows that even a late-cycle view isn't necessarily bad for risk assets as long as recession risk remains very low. Our economists think [12-month recession risk](#) will increase only marginally from close to zero at the moment.

And while equities look expensive – not least in the US – with some pundits going as far as to proclaim that markets are in a bubble, I believe [several conditions](#) of this phenomenon are not yet met. There is still plenty of money on the side lines, leverage is low, and – although stock-market enthusiasm among retail investors and the media is increasing – we are nowhere near the frenzy we saw in the 1990s.

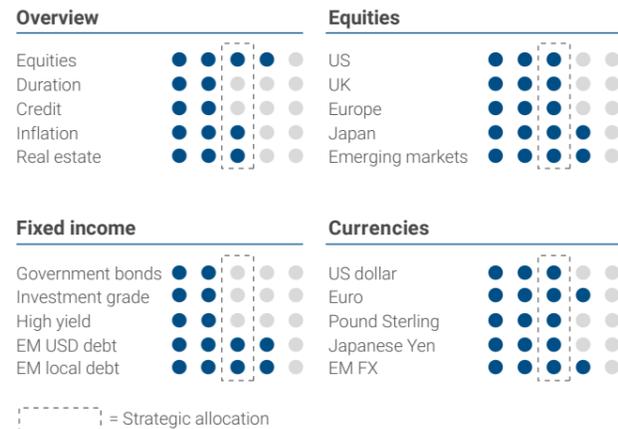
Meanwhile, we continue to watch out for 'grey swans' fluttering on the horizon. These are events that are possible but not necessarily probable, which could cause market ructions. Examples include a conflagration in the Middle East, triggered by Iran's nuclear ambitions; and another spate of leaks about governments, worsening social tensions and strengthening anti-establishment leaders.

Summary of LGIM's asset allocation core view



Source: LGIM. Views current as at 12 January 2022. **Forward-looking statements are, by their nature, subject to significant risks and uncertainties and are based on internal forecasts and assumptions and should not be relied upon.**

Our key asset class views



This schematic summarises the combined medium-term and tactical views of LGIM's Asset Allocation team as of 6 December 2021. Asset allocation is subject to change. The midpoint of each row is consistent with a purely strategic allocation to the asset/currency in question. The strength of conviction in our medium-term and tactical views is reflected in the size of the deviation from that mid-point. **The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

Economic cycle

- Bottlenecks to ease as we normalise, but tight labour markets will persist
- Accommodative policy may need to be reversed quicker than expected
- Recession risks remain subdued and corporate profits look healthy

Valuations

- Relative valuations remain a positive factor
- Absolute valuations of equities remain above average, especially in US
- Credit spreads below average and less attractive

Systemic risk

- Impressive institutional resilience through Covid
- Troubled relationship between US and China persists
- Concerns around house prices, Chinese high yield, EU politics



Christopher Jeffery
Head of Rates & Inflation Strategy



Tim Drayson
Head of Economics

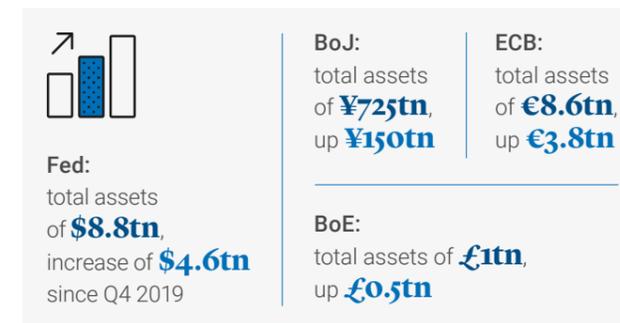
What does the end of QE mean for markets?

Since the start of the pandemic, the combined balance sheets of major developed-market central banks have expanded by nearly \$8 trillion, with dramatic implications for asset prices. Now, as policymakers look to unwind this emergency stimulus, the process will clearly be a key determinant of the market outlook in 2022 and beyond.

Electronic money-printing on such an enormous scale has facilitated the purchases of a range of assets. And while these have been focused on government bonds, we have also seen buying of corporate bonds, commercial paper and even, in some cases, equities.

That tide of liquidity has washed through financial markets. Debate is raging about the extent to which these purchases have suppressed real yields, contained credit spreads, and pushed up equity multiples. But the direction is not really in question.

The central bank splurge



Source: Bloomberg, as at 31 December, 2021

The impact of QE

The stimulatory impact of asset purchases flows through two broad channels. First, by buying such large quantities of government debt, central banks have effectively bankrolled the unprecedented fiscal response to the pandemic, which prevented a protracted slump in economic activity.

That real world channel is complemented by a financial channel: by buying assets, central banks have displaced private sector holders. Investors unwilling to operate with sustained higher cash balances have driven up asset prices as they rebalance their portfolios.

We believe we have now reached the high watermark. The Bank of England (BoE) has signalled that balance sheet reduction will begin when its Bank rate hits 0.50% – a threshold likely to be reached in February. Across the Atlantic, the December FOMC minutes suggested the Fed could move quickly to 'quantitative tightening' as early as mid-year.

In continental Europe, meanwhile, the European Central Bank will probably be slower to adjust, having committed to a programme of asset purchases throughout 2022, but its run rate is steadily tapering off. And even in Japan, the talk about policy normalisation has started.

Smooth and steady

We believe central banks will try to keep this process as orderly as possible. The BoE has laid out criteria for both a passive run-off of its portfolio and later active sales. In the US, balance-sheet shrinking can contribute to monetary tightening, but it is intended to be conducted in a smooth and predictable way.

Once the timing and speed has been determined, this will be on a relatively steady course, in our view, unless the macro environment changes dramatically. Because the maturity of their holdings is so much shorter, we think that unlike the BoE, the Fed will not have to actively sell any of its holdings to reduce their portfolio.

Markets will have to learn to cope without the presence of steady, predictable and price-insensitive buyers.

As the transfer of risk from private to public sectors goes into reverse, it seems reasonable to believe that the price of holding that risk will also have to adjust. This does not mean that the transition from quantitative easing to quantitative tightening marks the market top, but we believe it will probably entail a greater focus on fundamentals and likely heralds an increase in market volatility.



James Carrick
Global Economist



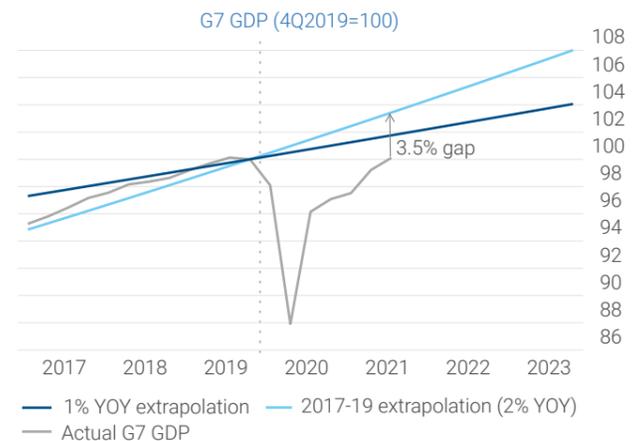
Lars Kreckel
Global Equity Strategist

Slower long-term growth and the outlook for equities

The G-7 group of advanced economies grew by 2% between 2017-2019, a number that is often used as a counterfactual to judge how much output can bounce back when economic troubles stemming from COVID-19 end. This means there's a gap of 3.5% between the previous trend and the latest GDP estimate – although, this likely overestimates potential G-7 growth.

That's because advanced economies were growing at an above-trend pace pre-pandemic, with unemployment falling to historical lows. Pay growth was picking up – albeit from depressed levels – thanks to record low inflation expectations. Extrapolating that 2% GDP trend implies even lower rates of unemployment.

How close to full capacity are advanced economies?



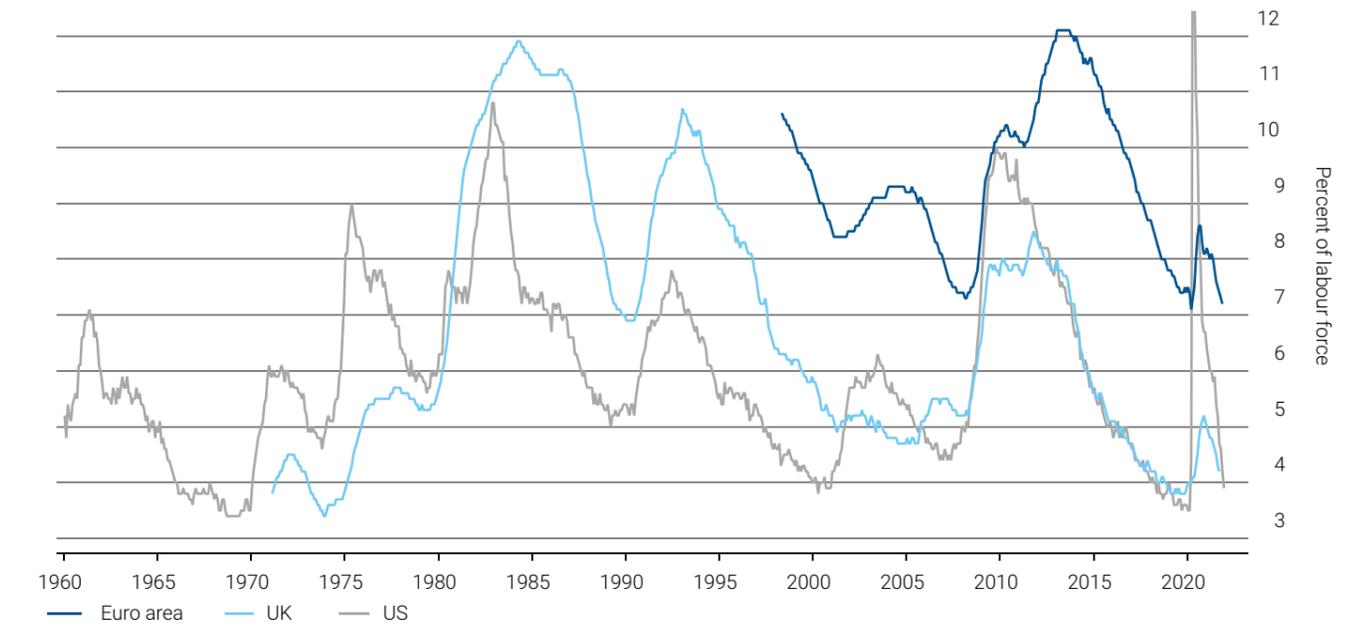
Source: Macrobond, as at 14 January, 2022. **There is no guarantee that any forecasts made will come to pass.**



The rate of G7 GDP growth consistent with stable unemployment seems much closer to 1% than 2%, in our view. Trend growth has slowed, primarily as a result of ageing populations. As time progresses, the chasm between these two trends widens further.

There's optimism that adoption of new technologies as a result of COVID-related restrictions can boost potential output. For example, working from home appears to have increased labour market participation of mothers of young children in the UK. But in the near term, the negative effects of early retirement and lack of immigration during the crisis years are bigger drags. This problem is particularly severe in post-Brexit Britain, where the stock of EU migrant workers is much lower than the counterfactual.

Unemployment rates



Source: Macrobond, as at 14 January, 2022

Fiscal largesse

While many manufacturing and labour market bottlenecks should ease as societies (and demand for goods vs services) revert towards normal, we worry that we'll still be left with tight labour markets.

Moreover, while memory of and expectations for inflation were depressed before the pandemic, thanks to the sharp fall in energy prices in 2015 and post-financial crisis austerity, we've seen the opposite in recent years. Bottlenecks and fiscal largesse have spurred goods prices to soar, while Europe is experiencing an energy crisis.

Tight labour markets and higher inflation expectations suggest GDP needs to slow to prevent overheating. In the near term, corporate earnings can be supported as firms pass on higher costs. But any wage-price spirals would increase recession risk further out.

Pricing power

What are the equity market implications? In isolation, rising wages and input costs from inflation and bottlenecks clearly weigh on corporate profits. But last year's experience served as a reminder that most companies can cope well in an environment where these costs are driven higher by strong demand. Against such a backdrop, most companies enjoy abundant pricing power, with operating leverage helping profits to rise.

As a result, we believe equity investors should remain focused on recession risk, as the timing of the next bear market will most likely be determined by the timing of the next contraction. But the earnings growth generated in the period until that point will be the key determinant of how much further stocks can rise.



Martin Dietz
Head of Diversified Strategies



Patrick Greene
Strategist

The role of commodities in strategic asset allocation

Commodity investments can provide diversification and hedging benefits against inflation risk, but are far from a panacea for asset allocators.

Good performance in inflationary periods is typically offset by lower long-term return expectations. As a result, the trade-off suggests a small strategic allocation to the asset class is appropriate, for the portfolio diversification benefits.

Back in vogue

Commodities have drifted in and out of favour among investors. Having grown in popularity during the China-led supercycle in the early 2000s, they fell out of favour in the 2010s. The spike in inflation, and strong commodity performance, has unsurprisingly led to a resurgence in interest.

A key feature of commodity exposure is inflation hedging. Commodities themselves are often a driver of inflation (e.g. oil prices), but they are also real assets. These are physical goods or infrastructure that have an intrinsic value: for commodities this is linked to their use in production or energy generation. The intrinsic value of real assets tends to cause their prices to rise in inflationary periods, maintaining their real value.

Commodity exposure also typically provides diversification across the business cycle. Commodities tend to do well later in business cycle expansions, when demand is strong and commodity producers are bumping up against capacity constraints. The late stage of the business cycle is often associated with central bank tightening and greater uncertainty, when commodities can offer valuable diversification for a multi-asset portfolio.

Roll yield and total return

These helpful hedging and diversification properties are balanced against low return expectations. Commodities do not generate a cashflow or have an associated return premium. In real terms, spot prices for many commodities trend downwards over long time periods, as technology improvements lead to more discoveries and cheaper production.

To be clear, supercycles, like the one seen in the early 2000s, can cause prolonged and significant price gains, but they cannot be relied upon for strategic allocation horizons.

In addition, investors can no longer rely on other sources of commodity returns. When the spot price is above the price of longer-dated contracts (a process known as 'backwardation'), buying the longer-dated contract can generate a roll yield – the price gain from futures contracts converging to the spot price as they approach expiration date.

Historically, backwardation added to commodity returns but over the last ten years this roll yield has been negative: -4.5% p.a. according to the BCOM index, as the chart shows. And while commodity markets are currently in backwardation, this reflects an expected normalisation in energy prices rather than a reversal of structurally negative roll yields. Enhanced commodity strategies might avoid some of this negative return, but not infallibly so.

Taken together, these mixed characteristics inform our view within the Asset Allocation team as to the appropriate exposure to commodities within our portfolios. We believe a small strategic allocation adds the hedging and diversification benefits, without lowering the expected return of the portfolio too much.



The gap between commodity prices and the returns achieved by investors



Source: Bloomberg, as at 10 January, 2022. The Bloomberg Commodity (BCOM) index represents a diversified basket of commodity futures. It is weighted to reflect both trading volumes and global commodity production. It includes metals, energy and agricultural commodities with no single commodity accounting for more than 25% of the index. **The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.**

Contact us

For further information about LGIM, please visit lgim.com or contact your usual LGIM representative



Key risks

Past performance is not a guide to the future. The value of an investment and any income taken from it is not guaranteed and can go down as well as up, you may not get back the amount you originally invested.

Important information

The information contained in this document (the 'Information') has been prepared by LGIM Managers Europe Limited ('LGIM Europe'), or by its affiliates ('Legal & General', 'we' or 'us'). Such Information is the property and/or confidential information of Legal & General and may not be disclosed by you to any other person without the prior written consent of Legal & General.

No party shall have any right of action against Legal & General in relation to the accuracy or completeness of the Information, or any other written or oral information made available in connection with this publication. Any investment advice that we provide to you is based solely on the limited initial information which you have provided to us. No part of this or any other document or presentation provided by us shall be deemed to constitute 'proper advice' for the purposes of the Investment Intermediaries Act 1995 (as amended). Any limited initial advice given relating to professional services will be further discussed and negotiated in order to agree formal investment guidelines which will form part of written contractual terms between the parties.

The Information has been produced for use by a professional investor and their advisors only. It should not be distributed without our permission.

A summary of investor rights associated with an investment in the Fund shall be available from www.lgim.com/investor_rights.

The risks associated with each fund or investment strategy are set out in this publication, its KIID, the relevant prospectus or investment management agreement (as applicable) and these should be read and understood before making any investment decisions. A copy of the English version of the prospectus of the Fund and the key investor information document relating to the Fund is available on lgim.com and may also be obtained from your Client Relationship Manager. Where required under national rules, the key investor information document will also be available in the local language of the relevant EEA Member State.

Confidentiality and limitations:

Unless otherwise agreed by Legal & General in writing, the Information in this document (a) is for information purposes only and we are not soliciting any action based on it, and (b) is not a recommendation to buy or sell securities or pursue a particular investment strategy; and (c) is not investment, legal, regulatory or tax advice. Any trading or investment decisions taken by you should be based on your own analysis and judgment (and/or that of your professional advisors) and not in reliance on us or the Information. To the fullest extent permitted by law, we exclude all representations, warranties, conditions, undertakings and all other terms of any kind, implied by statute or common law, with respect to the Information including (without limitation) any representations as to the quality, suitability, accuracy or completeness of the Information.

Any projections, estimates or forecasts included in the Information (a) shall not constitute a guarantee of future events, (b) may not consider or reflect all possible future events or conditions relevant to you (for example, market disruption events); and (c) may be based on assumptions or simplifications that may not be relevant to you.

The Information is provided 'as is' and 'as available'. To the fullest extent permitted by law, Legal & General accepts no liability to you or any other recipient of the Information for any loss, damage or cost arising from, or in connection with, any use or reliance on the Information. Without limiting the generality of the foregoing, Legal & General does not accept any liability for any indirect, special or consequential loss howsoever caused and, on any theory, or liability, whether in contract or tort (including negligence) or otherwise, even if Legal & General has been advised of the possibility of such loss.

A decision may be taken at any time to terminate the arrangements made for the marketing of the Fund in any EEA Member State in which it is currently marketed. In such circumstances, investors in the affected EEA member state will be notified of this decision and will be provided with the opportunity to redeem their shareholding in the Fund free of any charges or deductions for at least 30 working days from the date of such notification.

Third party data:

Where this document contains third party data ('Third Party Data'), we cannot guarantee the accuracy, completeness or reliability of such Third-Party Data and accept no responsibility or liability whatsoever in respect of such Third-Party Data.

Publication, amendments and updates:

We are under no obligation to update or amend the Information or correct any errors in the Information following the date it was delivered to you. Legal & General reserves the right to update this document and/or the Information at any time and without notice.

Although the Information contained in this document is believed to be correct as at the time of printing or publication, no assurance can be given to you that this document is complete or accurate in the light of information that may become available after its publication. The Information may not take into account any relevant events, facts or conditions that have occurred after the publication or printing of this document.

Telephone recording:

As required under applicable laws Legal & General will record all telephone and electronic communications and conversations with you that result or may result in the undertaking of transactions in financial instruments on your behalf. Such records will be kept for a period of five years (or up to seven years upon request from the Central Bank of Ireland (or such successor from time to time)) and will be provided to you upon request.

In the United Kingdom and outside the European Economic Area, it is issued by Legal & General Investment Management Limited, authorised and regulated by the Financial Conduct Authority, No. 119272. Registered in England and Wales No. 02091894 with registered office at One Coleman Street, London, EC2R 5AA.

In the European Economic Area, it is issued by LGIM Managers (Europe) Limited, authorised by the Central Bank of Ireland as a UCITS management company (pursuant to European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations, 2011 (S.I. No. 352 of 2011), as amended) and as an alternative investment fund manager with "top up" permissions which enable the firm to carry out certain additional MiFID investment services (pursuant to the European Union (Alternative Investment Fund Managers) Regulations 2013 (S.I. No. 257 of 2013), as amended). Registered in Ireland with the Companies Registration Office (No. 609677). Registered Office: 70 Sir John Rogerson's Quay, Dublin, 2, Ireland. Regulated by the Central Bank of Ireland (No. C173733).

LGIM Managers (Europe) Limited operates a branch network in the European Economic Area, which is subject to supervision by the Central Bank of Ireland. In Italy, the branch office of LGIM Managers (Europe) Limited is subject to limited supervision by the Commissione Nazionale per le società e la Borsa ("CONSOB") and is registered with Banca d'Italia (no. 23978.0) with registered office at Via Uberto Visconti di Modrone, 15, 20122 Milan, (Companies' Register no. MI - 2557936). In Germany, the branch office of LGIM Managers (Europe) Limited is subject to limited supervision by the German Federal Financial Supervisory Authority ("BaFin"). In the Netherlands, the branch office of LGIM Managers (Europe) Limited is subject to limited supervision by the Dutch Authority for the Financial Markets ("AFM") and it is included in the register held by the AFM and registered with the trade register of the Chamber of Commerce under number 74481231. Details about the full extent of our relevant authorisations and permissions are available from us upon request. For further information on our products (including the product prospectuses), please visit our website.

© 2022 Legal & General Investment Management Limited. All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, including photocopying and recording, without the written permission of the publishers.