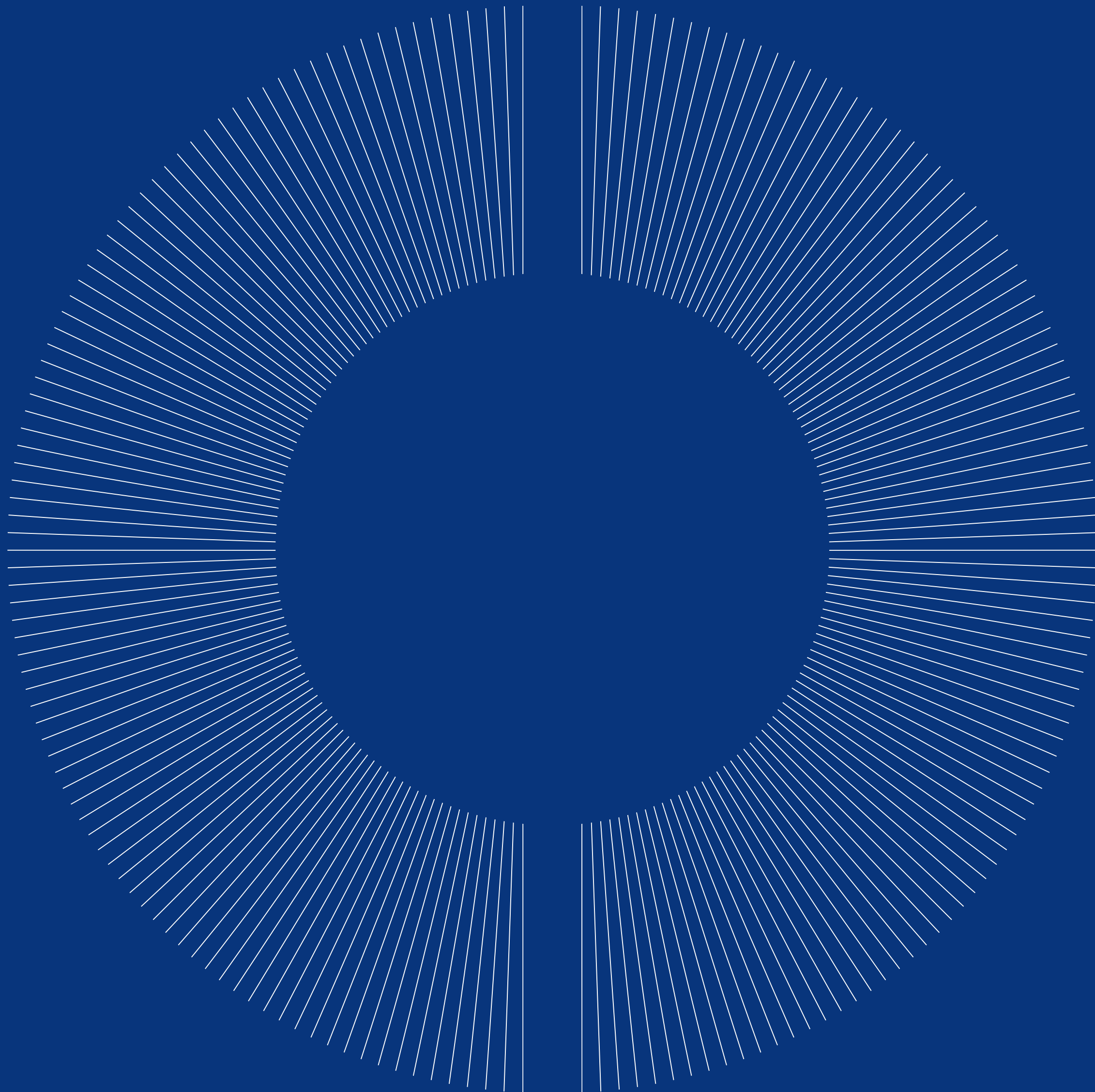
2022: the year ahead
Wealth Management Outlook



Cazenove Capital

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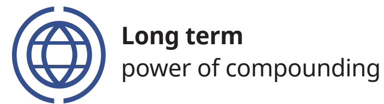
2022 Summary views

- **Global economy:** another year of above average growth
- **Inflation:** to peak in the first quarter of 2022 and settle at a higher level than we saw before the pandemic
- **Corporate earnings:** set to increase modestly. But pricing power will be crucial and some companies may struggle to protect margins from higher costs
- **Climate change:** to remain a key focus for consumers, governments, companies and investors
- **Monetary policy:** Central bank stimulus measures in developed markets will come to an end
- **Interest rates:** to move modestly higher in the UK and US but unlikely to return to long-term average levels
- **Covid-19:** Omicron and other variants could pose a threat to our outlook for continued economic recovery and / or inflation

Year-on-year change (%)	2021	2022	2023
Real GDP			
World	5.6	4.0	3.2
US	5.4	3.2	2.2
UK	6.9	5.2	3.1
CPI			
World	3.4	3.8	2.7
US	4.6	4.5	2.3
UK	2.5	3.8	1.1

Source: Schroders Economics Group, December 2021
Forecasts included are not guaranteed and should not be relied upon.

Cazenove Capital's investment philosophy

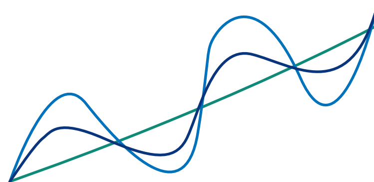


Real returns (% pa) since 1899

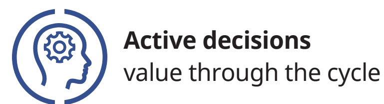
	50 years	118 years
Equities	5.6	5.1
Bonds	3.1	1.3
Cash	1.2	0.7

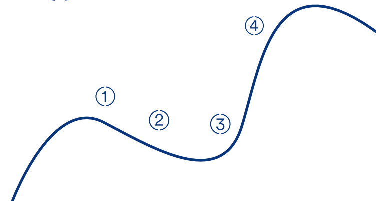
- Equities outperform over the longer term but are volatile
- Bonds are unlikely to repeat the performance of the last 20 years (yields are now below inflation)

Diversification
to help the journey



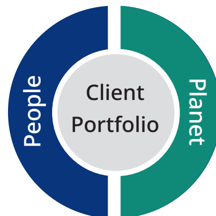
Multi-asset portfolios | Global equities | Inflation target





1. **Slowdown:** prefer corporate bonds
2. **Recession:** prefer government bonds and cash
3. **Recovery:** favour developed market equities
4. **Expansion:** favour developing market equities

Impact
on people and planet



"Impact is the third dimension of investing alongside risk and return"

"In order to have impact, we must measure impact"

Source: Cazenove Capital

At Cazenove Capital, we are focused on preserving and growing our client's wealth in a responsible manner to fulfil their lifetime and multi-generational goals. We meet this objective by looking to achieve a reasonable inflation-adjusted return for portfolios, whilst placing significant emphasis on capital preservation.

We tailor investment portfolios specifically to fit clients individual requirements, while following these key Wealth Management principles:

- **We construct investment portfolios with a medium to long-term time horizon**. This is intended to align portfolios to clients' longer-term objectives and also allow their capital to benefit from the power of compounding returns. This does not preclude us from considering shorter-term investments.
- **We typically hold a range of investments to diversify portfolios**. Diversification can dampen the volatility of returns and improve the expected return for a given level of risk.
- **We take active decisions on asset allocation and investment selection**. Asset allocation is based on our assessment of each asset's risk / reward profile in the context of the business cycle and longer-term secular trends. Individual investments are selected based on an evaluation of the opportunity set and expected return net of investment costs.
- **We believe that all investments have an impact on people and planet**. This impact, where measurable, must be considered alongside the risk and return characteristics of each investment. Where applicable we use our influence to engage with managers and companies to improve the impact of their activities.

2022 views at a glance

Positive | Neutral | Negative

Asset classes	Outlook	
Equities	Positive	Equities should continue to benefit from rising corporate earnings and strong economic growth. There may be greater variation in regional performance.
Government bonds	Negative	Valuations are expensive and rising yields could be a headwind over the course of the year. However, government bonds still have a valuable role to play as a defensive asset within portfolios. Our preference is for Chinese government bonds, which offer a relatively attractive yield, and bonds with inflation protection.
Credit	Neutral	Credit markets should continue to benefit from rising corporate earnings and strong economic growth. Valuations generally look expensive. We see opportunities in asset-backed securities, which offer a relatively attractive yield.
Absolute Return	Positive	Valuation differentials across and within markets provide an attractive opportunity set for absolute return strategies.
Real Assets	Positive	Assets offering long-dated, inflation-linked revenue streams look attractive in the current environment. We see opportunities in digital infrastructure and exposure to private companies.
Cash	Neutral	Cash can protect portfolios in potentially volatile markets.

Source: Cazenove Capital as at December 2021
Forecasts included are not guaranteed and should not be relied upon.

Theme 1:
Inflation, growth and the threat of "Stagflation"

Chris Lewis, Investment Director

Inflation in both the UK and US has risen significantly in 2021 and it could continue to rise in the near term. We see UK and US inflation peaking in early 2022 before declining over the remainder of the year as supply-side bottlenecks ease.

There are risks to this outlook. Omicron, a new Covid variant, could result in new restrictions on activity and further supply disruptions. Rising wages could also result in more persistent inflationary pressure throughout the economy. As former President of the Bundesbank Karl Otto Pohl once commented: "Inflation is like toothpaste. Once it's out, you can hardly get it back in again."

It is likely that we will see some wage inflation in the UK, particularly after the Chancellor of the Exchequer ended the public sector wage freeze in the recent budget. However, the level of unionisation in the UK has declined very considerably over the past 50 years. As such, wages are determined by market forces and are less likely to automatically adjust with inflation, as they have done historically.

Over the medium term, wage growth is likely to mean inflation settles at slightly higher levels than we saw in the decade before the pandemic. However, wages probably won't be as significant a source of inflationary pressure as they have been in the past.

Growth and the threat of stagflation

We expect strong growth in 2022, though slower than in 2021. Pent-up consumer demand and inventory rebuilding should keep growth at above-trend levels in major economies. As vaccination rates in countries such as Japan and India improve, the easing of Covid restrictions could see a further pick-up in activity.

However, the rate of improvement in economic activity has likely peaked and we could see global growth slow from current levels. Furthermore, there remain threats to growth, including the emergence of the Covid variant Omicron and a Chinese slowdown. Against a backdrop of continued inflationary pressure, this raises the risk of a period of "stagflation" - an environment of rising inflation and weaker growth.

How can investors prepare for potential stagflation?

Historically, gold has proven to be the best hedge against stagflation. Other commodities, which are themselves often a cause of higher inflation, have tended to perform well. Inflation-linked government bonds also stand to benefit from a combination of rising inflation expectations and greater investor uncertainty.

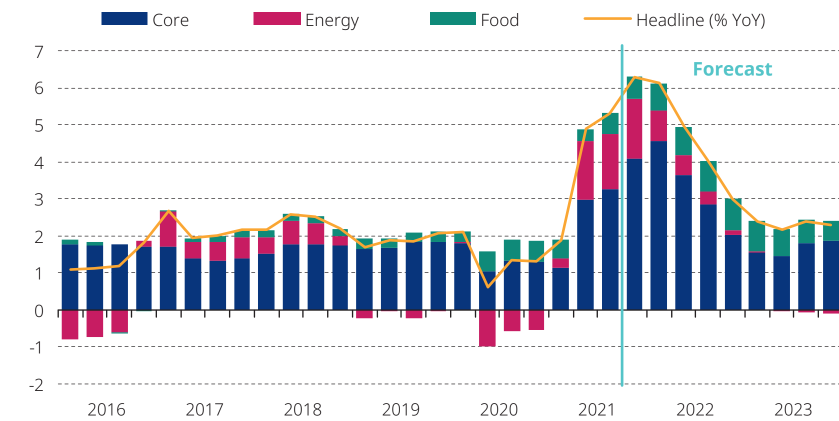
Stagflation has often proved challenging for equities. However, energy and materials companies can benefit from rising commodity prices. More defensive areas of the market, such as utilities, have also performed relatively well as growth has slowed.

As we move into 2022, we maintain exposure to both gold and US inflation-linked government bonds as a hedge against stagflation. We should also benefit from our expsoure to real assets with inflation-linked returns.

We continue to monitor our positioning in the context of the economic environment to ensure we are well positioned to both deliver returns and mitigate risks for our clients.

US inflation set to peak in the first quarter of 2022

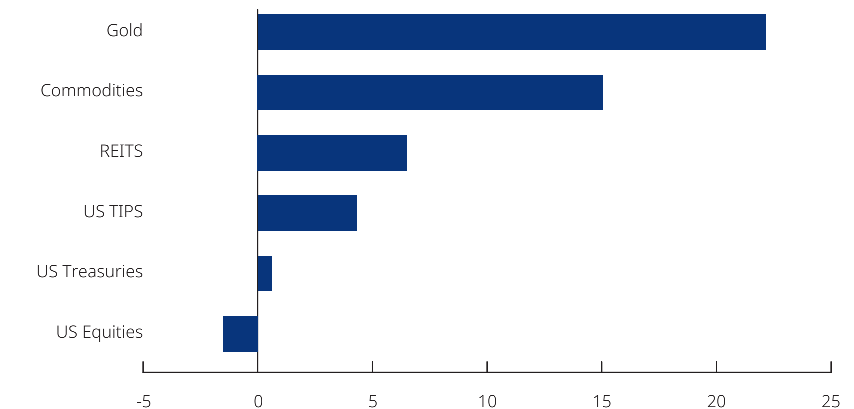
US Consumer Price Index (CPI) by quarter



Source: Refinitiv, Schroders Economics Group. November 2021
Forecasts included are not guaranteed and should not be relied upon.

Gold and commodities the best performers during periods of stagflation

Average annual inflation-adjusted total return during periods of stagflation since 1973 (1997 for TIPS)



Source: Refinitiv, Cazenove

Theme 2:
Moving beyond peak liquidity

Chris Lewis, Investment Director

With both fiscal and monetary policy set to tighten in 2022, it looks very likely that we have moved past "peak liquidity." This could have implications for both economic growth and financial markets.

Fiscal policy is becoming less stimulative as Covid support packages come to an end. We expect fiscal spending will remain elevated, but the scale will be lower and there will be an increased focus on financing it through higher taxation.

Central banks are also set to end the quantitative easing ("QE"), or asset purchase, programmes they introduced in response to the pandemic. The Federal Reserve started "tapering" its asset purchases in November, while the Bank of England is set to conclude its QE programme by the end of 2021.

The end of QE is likely to pave the way to interest rate rises as central banks look to curtail inflationary pressures. Following November's US inflation data, the Federal Reserve recognised that inflationary pressures are not simply a result of "transitory" supply side factors, but also a reflection of higher consumer demand as well.

The market continues to expect that interest rates will rise sooner rather than later. However, recent volatility in both currency and government bond markets are a reminder that the extent and timing of any interest rate rises remain unknown. Omicron further complicates the picture.

Another unknown is what level interest rates will settle at over the longer term. There are several reasons to think that we will not see interest rates return to pre-2008 averages of 3-5%.

The key one is the amount of government debt. The UK, along with the US, Europe and Japan have been able to maintain debt at such elevated (and rising) levels because the cost of servicing that debt has been consistently falling over the past 30 years. This accelerated following the introduction of quantitative easing after the financial crisis of 2008-9. Governments may be unable to afford the higher cost of debt if interest rates were to rise too far. They also stand to benefit from a degree of inflation, which reduces the real value of national debt. For both of these reasons, the extent of interest rate rises is likely to be limited.

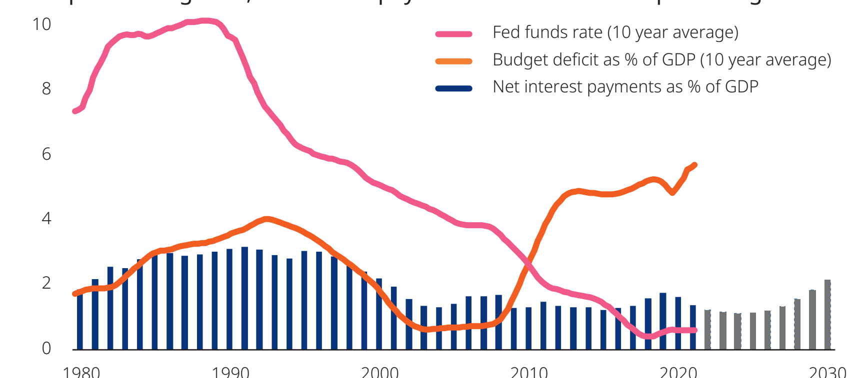
What are the market implications?

The provision of liquidity from central banks and governments has been a key source of support for risk assets since March 2020. As this support starts to decline, investment fundamentals will matter more. Earnings growth is the key driver of equity markets over the long term and the fact that it remains in positive territory should support shares in 2022. However, reduced monetary and fiscal support could lead to greater uncertainty and volatility.

It is also worth bearing in mind that policy changes will not occur in a globally synchronised manner. The European Central Bank, for instance, is likely to raise interest rates significantly later than the Fed and the BOE. This could lead to greater divergence in regional performance in both equity and fixed income markets.

Why interest rates have to remain relatively low

Despite soaring debt, US interest payments remain low as a percentage of GDP



Source: Cazenove Capital, Refinitiv Datastream
Forecasts included are not guaranteed and should not be relied upon.

Markets may be entering a more difficult phase

Tighter monetary policy raises the risk of corrections

Monetary policy	Corporate earnings	
	Strong or strengthening	**Weak or Weakening**
Easy / easing	**Bull Phase** – Easy monetary policy – Improving corporate earnings – positive equity markets and low volatility	**Late Cycle Phase** – Easing of monetary policy – Weakening corporate earnings – Greater uncertainty and more volatility
Tight / tightening	**Correction risk phase** – Positive corporate earnings – Tightening monetary policy – Greater uncertainty and more volatility – Corrections less likely to be deep or prolonged in an expanding economy	**Correction phase** – Tight monetary policy – Weak corporate earnings – Negative impact on equity markets

Source: MRB, Cazenove

Theme 3: Earnings and productivity

Chris Lewis, Investment Director

In 2020, the rally in equities was driven by an expansion in valuation multiples. This is often the case at the end of a recession, as investors pay higher multiples in anticipation of economic recovery and a rebound in profits. In 2021, the market's strong performance has been driven by robust earnings growth on a global basis.

In 2022, continued earnings growth will be critical if equity markets are to rise further.

On balance, we expect earnings to continue rising in 2022, but at a slower pace than we have seen over the last year. After a period of very strong earnings growth, it is likely to be harder for companies to continue beating investor expectations. This may translate into lower and more volatile equity market returns.

We could also see profit margins come under pressure, albeit from near record levels. In the near term, companies have largely been able to weather higher input costs by passing them on to consumers. This has been possible in an environment of strong demand and high savings rates. However, as consumers spend excess savings, they may be less willing or able to pay higher prices and some businesses may struggle to pass on further input cost increases.

In this scenario, higher quality businesses with strong pricing power and the ability to protect margins would look relatively more attractive. Some sectors will be better placed than others.

Productivity growth

One way that companies can continue to grow earnings is by improving productivity. For companies in developed markets, the way to do this is by investing in equipment and technology. There are signs that this is now happening. Companies currently have a lot of cash as a result of fiscal support measures and a period of strong profitability. Many are now looking to re-invest in their businesses, with capital expenditure picking up in the second half of 2021.

Political considerations may be playing a role: after governments and central banks supported the economy through the pandemic, companies may be feeling some pressure to invest rather than buying back shares or paying dividends.

Global supply chain considerations are also a spur to domestic investment. For many years, developed market companies have outsourced manufacturing to China. However, the cost benefit has fallen significantly in recent years – even before the spike in shipping costs we saw in 2021.

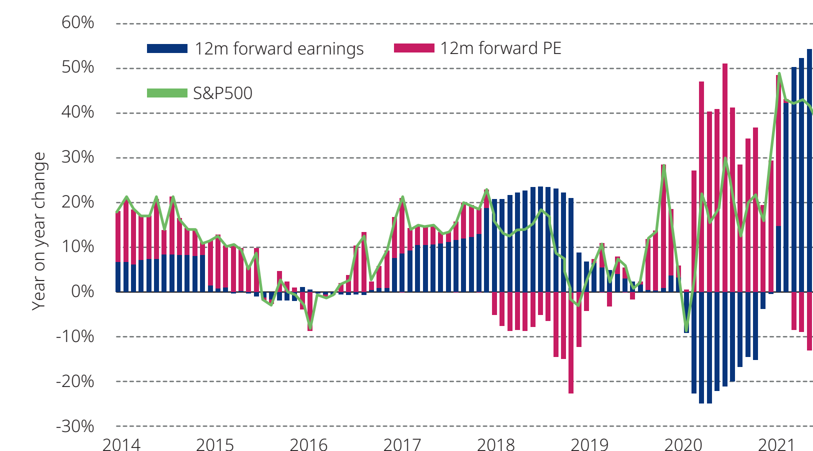
The pandemic and geopolitical tensions have both highlighted the importance of supply chain resilience for global businesses, providing a further incentive to bring supply chains closer to home. There has been a flurry of "reshoring"[1] announcements from US companies recently and the trend looks set to continue.

"Reshoring" is likely to result in many ageing domestic factories being modernised, with greater automation likely playing a significant role. This in turn could drive improving productivity and profitability for many mature companies.

[1]Reshoring refers to the process of returning the production and manufacturing of goods back to the company's original country

Strong earnings growth drove equity market returns in 2021

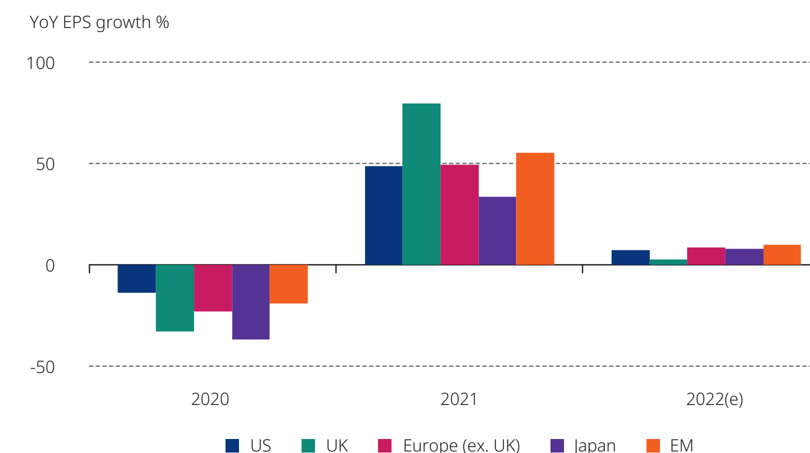
Contribution to S&P500 returns from earnings growth and valuation multiples



Source: Refinitiv, Cazenove. Data to 31st October 2021

Modest earnings increases expected in 2022

Historic and expected earnings growth for key regional equity markets



Source: Refinitiv, Schroders. Data to 31st October 2021
Forecasts included are not guaranteed and should not be relied upon.

Theme 4:
The protectionist agenda and geopolitical risk

Ahmet Feridun, Investment Director
Paul Muir, Investment Manager

"History is replete with examples of epidemics subverting social order and ultimately causing social unrest," note the authors of a recent IMF study. However, "social scarring in the form of unrest may not show up quickly." During an epidemic or pandemic, restrictions on gatherings often prevent unrest. And social cohesion may in fact increase as people come together to fight a common foe. The experience of Covid-19 appears to fit this pattern, with the IMF research showing that the number of major unrest events worldwide fell to its lowest level in almost five years in 2020. History suggests this could well change as the health threat recedes.

One potential flashpoint is the widespread perception that inequality increased over the past eighteen months, with the wealthiest benefiting from booming stock markets. Inequality is likely to remain a key issue for governments of the largest economies - and increasingly also their central banks. In the US and Europe we expect to see a greater focus on taxation and more targeted fiscal activism linked to social outcomes. In China the drive for "common prosperity" may lead to further regulation.

There are also many sources of geopolitical tension that could erupt over the coming years. China and the US remain at loggerheads over issues such as Taiwan, data sovereignty and the treatment of Uighur Muslims. While it is unlikely that we will return to the mud-slinging that characterised Sino-US relations during the Trump presidency, scepticism of China remains high among Americans. Many in the Biden administration support a harder line against China and international sanctions are not out of the question.

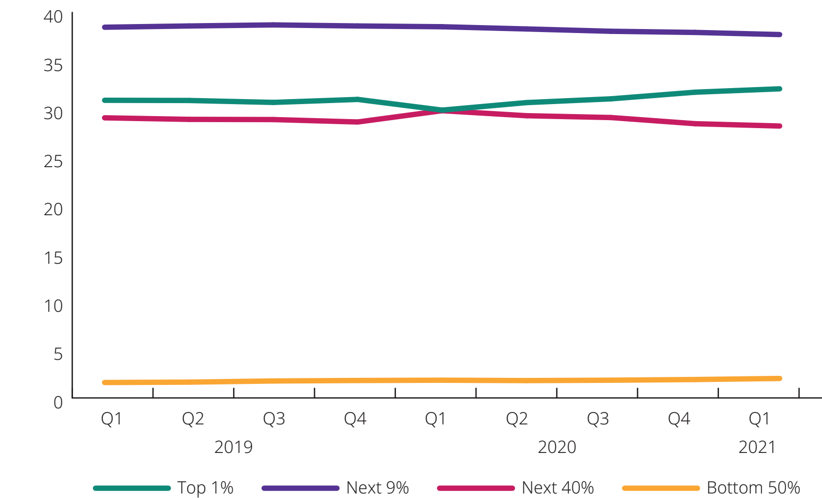
Meanwhile in Europe the strategic direction of the Eurozone will continue to come under scrutiny. The recent election in Germany, and French elections in 2022, could have a significant impact. The fallout from Brexit will also continue to be apparent, particularly if the UK triggers Article 16 creating further rifts with the Eurozone.

Many governments may turn to protectionism and populism as a way of dealing with both domestic and international tensions. This is likely to be a global theme. Hopefully, countries will be able to put their differences aside in order to tackle the climate challenge, although so far energy transition initiatives have been largely country specific rather than collective.

Greater protectionism could accentuate the supply chain bottlenecks that have developed post- Covid, especially in strategically important industries such as semiconductors. Measures to mitigate these issues – such as onshoring production - are likely to increase, especially if we see further tensions between China and Western nations and further protectionist rhetoric. This could make smaller, domestic companies with less exposure to these risks look relatively more attractive.

In the US, the top 1% increased their share of wealth during the pandemic

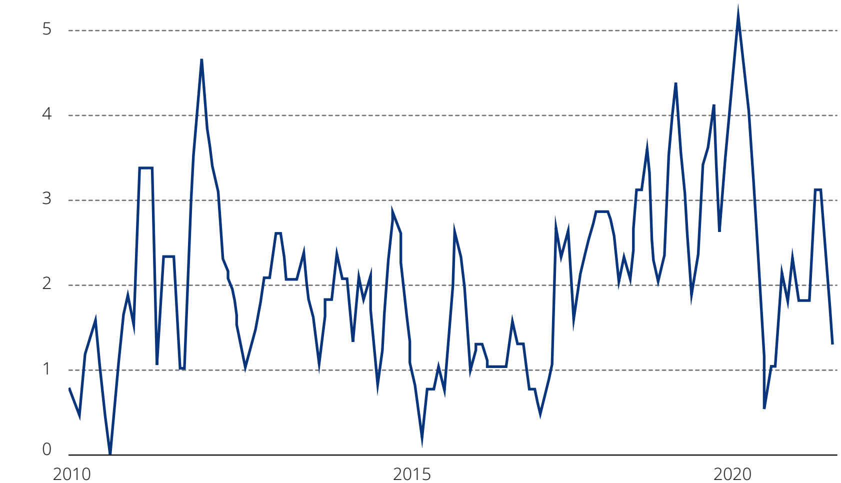
Share of net worth by wealth group



Source: Federal Reserve, August 2021.
Wealth Inequality and COVID-19: Evidence from the Distributional Financial Accounts

Social unrest fell during the pandemic – but history tells us to expect more

Percentage of countries experiencing significant social unrest



Source: IMF, The Economics of Social Unrest' by Philip Barrett and Sophia Chen, August 2021

Strategic viewpoint 1:
Energy transition and the economic cost of de-carbonisation

Catherine Hampton, Sustainable Investment Lead

To avoid the potentially catastrophic consequences of climate change, we need to achieve "net zero" emissions by 2050. This requires us to reduce emissions as much as we can, and then remove any remaining emissions that cannot be eliminated from the atmosphere through technologies like carbon capture and storage.

Over 75% of historic emissions come from energy use, according to the World Resources Institute. So decarbonising energy systems, including power, transport, buildings and industry will go a long way to achieving our net zero target.

But it will come at a cost. The International Energy Agency estimates that the energy transition will require $150 trillion of total investment over the next 30 years. At $5 trillion a year, that's greater than the annual US tax base. One benefit of this surge in spending will be a net increase in jobs. There could be a four-fold increase in renewables jobs alone to 42 million by 2050, according to the International Renewable Energy Agency. The spending will also spur growth in the manufacturing, engineering and construction industries, which have seen growth rates stagnate over the past decade. If those spending targets are met, the energy transition could accelerate GDP growth by 0.3-0.5% percentage points per annum.

The easy wins and harder challenges of decarbonisation

Power and transport are likely be the sectors that decarbonise fastest because there are readily available alternatives and the economics already make sense. For example, wind and solar are now globally cheaper than coal and, in most cases, also cheaper than gas. Grid operators therefore have an economic incentive to increase the share of renewables in their power systems.

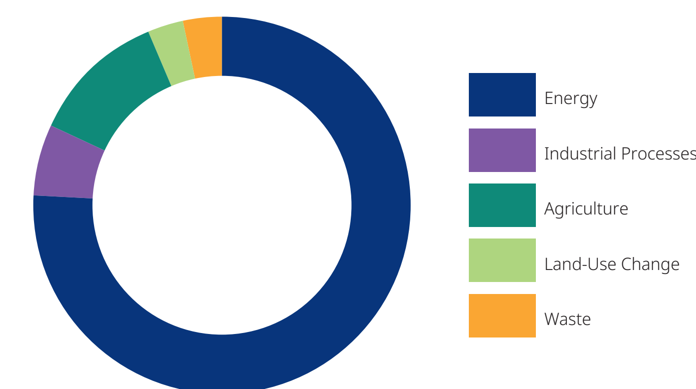
Passenger transport is another area that will likely decarbonise quickly. Governments have made this a focus of their decarbonisation plans because it involves relatively little behavioural change from consumers. While electric vehicles (EVs) are still more expensive than petrol cars, the cost of production could reach parity by 2024, according to a forecast from UBS, further boosting demand.

However, there are other sectors that will be much harder to decarbonise because of technological and behavioural challenges – for example cement and agriculture.

Cement production methods are currently highly carbon intensive, accounting for 8% of global emissions, according to research from Chatham House. Furthermore the demand for cement, particularly in emerging markets, is likely to remain elevated. China used more cement in the three years ending in 2013 than the US did over the entire 20th century. Yet significant further investment is required to close the infrastructure gap with around 1 billion people still living more than 2 km from an all-weather road.[2] While studies into less carbon intensive production methods are ongoing, they are both currently more expensive and unproven for use in building. In the nearer term, technological challenges are holding back faster decarbonisation efforts.

Energy accounts for the largest share of emissions

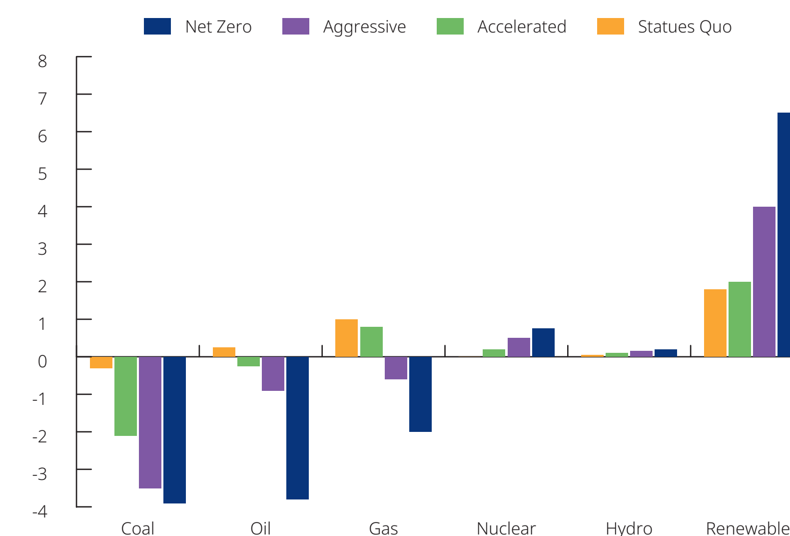
Global greenhouse gas emissions by sector



Source: Climatewatchdata.org

Global energy consumption growth (2019 to 2050)

Renewables increase their market share across all scenarios



Source: IEA, Equinor, Shell, BofA Global Research estimates

Technological advances alone will not solve our climate problems, however. Human behaviour also needs to change, especially when it comes to consumption and waste. Food production currently accounts for a quarter of the world's greenhouse gas emissions, with meat and dairy accounting for two thirds of this.[3] If the population of the US reduced its meat consumption by 25%, it is estimated that we would save 82 million metric tonnes of greenhouse gas emissions per year, just over 1% of the global total.[4] Food waste also remains a significant issue. In the US, 40% of food is lost or wasted, which costs over $200billion annually, equivalent to 1.3% of GDP.[5] Changing behaviour around food to eat less meat and waste less could not only help solve our emissions problem, it could also save billions of dollars annually.

There were positive developments from COP26, with more than 40 countries committing to "phase down" unabated coal use. The use of phase "down" rather than "out" disappointed many – but this is the first time coal has explicitly been mentioned in a global climate agreement and is a positive step. Furthermore, the economics suggests that regardless of stated policies, coal production will decrease under any scenario as renewables become more cost effective.

[2] 'The Global Infrastructure Gap: Potential, Perils and a Framework for Distinction'. Camille Gardner and Peter Blair Henry. New York University. April 2021

[3] UN Food and Agriculture Organization

[4] 'Environmentally Optimal, Nutritionally Sound, Protein and Energy Conserving Plant Based Alternatives to U.S. Meat'. Gidon Esdhel, Paul Stainier, Alon Shepon and Akshay Swaminathan. August 2019.

[5] https://www.epa.gov/international-cooperation/international-efforts-wasted-food-recovery

Strategic viewpoint 2:
The opportunity in private asset markets

Luca Serino, Investment Director

After a sharp slowdown in the first half of 2020, private markets have experienced one of their strongest ever periods of activity over the past 18 months. The industry has surpassed previous records on almost any measure. Buyout deals completed in the first three quarters of 2021, for example, have already broken previous annual records both in terms of the number and value of deals.

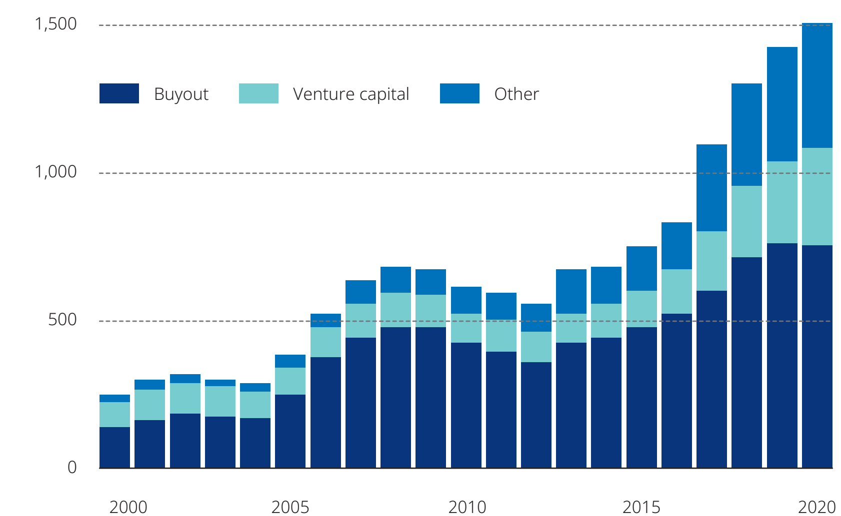
Fundraising in private markets is also on track to match or exceed previous records. As a result, "dry powder" – capital that has been committed to private market funds but not yet invested – has continued to accumulate. Private equity managers had $2.3 trillion of committed capital as of August 2021, according to data from S&P Global and Preqin. Over 20% of this was controlled by just 25 managers as "mega funds" have become increasingly prevalent.

This accumulation of dry powder, coupled with pressure to deploy capital after the slowdown in the first half of 2020 has continued to drive valuations higher in private markets. This has been particularly evident in larger deals, which are typically the area of focus for "mega funds" with large amounts of capital to deploy into a limited pool of opportunities. The strength of public markets has further supported this dynamic by providing a favourable backdrop when exiting earlier investments. Increasingly, managers are benefiting from an increase in the valuation of investments when they come to sell, further validating high valuations for the rest of their portfolios.

Low interest rates and highly accommodative liquidity conditions have supported valuation multiples and kept borrowing costs in check over the past eighteen months. However, rising inflation and higher interest rates could be a headwind over the coming years. Increased borrowing costs could hamper dealmaking activity and put downward pressure on valuations. Inflation may also depress earnings of businesses that are unable to pass on cost increases to customers. These developments could lead to a more challenging market for exists in coming years as multiple expansion and earnings growth – two of the key sources of return that private markets investors rely on – come under pressure.

Private equity funds have record "dry powder"

Unused committed capital by type ($bn)



Source: Preqin

There is another potential challenge that has emerged as a result of the pandemic: increased concern over security and supply chains. This could hamper investment activity in future. In the UK, high profile acquisitions of supermarkets and defence businesses by US private equity houses have been scrutinised by policymakers as potential threats to food and national security.

Despite the near term headwinds, we expect private markets will continue to grow in size and relevance and remain a source of attractive returns. Careful manager selection will be essential. We think that more specialised managers – with a focus on a particular sector, geography or stage of investment – are best positioned in the current environment. We also believe that systematically allocating capital to private assets over a period of time is the best way to secure the most attractive risk-adjusted returns.

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Risk warnings

Private Assets - Investment risk: Past performance is not a guide to future performance. The value of an investment and the income from it may go down as well as up and investors may not get back the amount originally invested. Investors should only invest in private assets (and other similar illiquid and high risk assets) if they are prepared and have the ability to sustain a total loss of their investment.

The success of these funds is dependent in part on the skill and performance of the investment professionals managing the underlying assets. No representation has been or can be made as to the future performance of the funds. The value of the funds' assets may be affected by uncertainties such as political developments, changes in law, tax, currency fluctuations and other developments in the countries in which investments may be made. Whilst investment in the funds can offer the potential of higher than average returns, it also involves a corresponding higher degree of risk and is only considered appropriate for investors who can afford to take that risk. Investors must be capable of evaluating such merits and risks.

Taxation: Any change in the funds' tax status or tax legislation or its interpretation, could affect the value of the investments and their ability to provide returns. Statements concerning taxation are based on our understanding of the taxation law in force at the time of publication. They are not intended to constitute tax advice. Investors should obtain independent legal and tax advice before making an investment.

Illiquidity: Private Assets are more illiquid than other types of fund. Shareholders may well not be able to realise their investment prior to the relevant exit dates. Any secondary market tends to be very limited. Although the shares may be listed on a stock exchange, the expectation is for very limited liquidity and minimal trading activity. An investment in the funds is therefore illiquid when compared to exchange traded equities.

Exchange rates: If the currency of the investment or any underlying assets is not your base currency, then currency fluctuations may impact the return you receive.

Debt securities: Investments in bonds issued by borrowers with lower credit ratings may result in a greater risk of default and have a negative impact on income and capital value. Income payments may constitute a return of capital in whole or in part. Income may be achieved by foregoing future capital growth.

Emerging markets: There are additional risks associated with investment in emerging and developing markets. These include: higher volatility of markets; systems and standards affecting trading, settlement, registration and custody of securities all possibly lower than in developed markets; lack of liquidity in markets and exchanges leading to lower marketability of securities and greater price fluctuation; significant currency volatility, possibly resulting in adoption of exchange controls; lower shareholder protection or information to investors provided from the legal infrastructure and accounting, auditing and reporting standards.

Unregulated collective investment schemes: Unregulated collective investment schemes and other non-mainstream pooled investments (NMPIs) are unlikely to offer a level of investor protection equivalent to that available for UK regulated investments. Such schemes may deal infrequently and may limit redemption.

Gearing: Some of the investments we may make on your behalf could be in investment companies which use gearing as a strategy or invest in other investment companies which use gearing, such as investment trusts. The strategy which the issuer of such securities uses or proposes to use may result in movements in the price of the securities being more volatile than the movements in the price of underlying investments. Such investments may be subject to sudden and large falls in value and you may get back nothing at all if there is a sufficiently large fall.

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