Wilsons Investment Strategy Group wish clients and their families a happy holiday season. We will return in late January 2022 to once again share our views on key global investment trends and opportunities. Enjoy the break!

WILSONS

Asset Allocation: A View into 2022

Our weekly view on asset allocation.

20 December 2021

Issued by Wilsons Advisory and Stockbroking Limited (Wilsons) ABN 68 010 529 665 - Australian Financial Services Licence No 238375, a participant of ASX Group and should be read in conjunction with the disclosures and disclaimer in this report.

Our View and Positioning into 2022

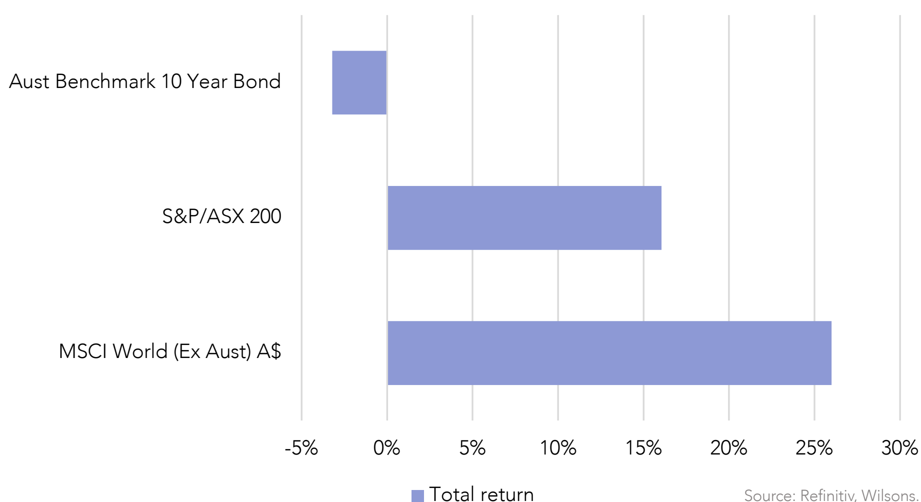
Looking at our economic outlook for 2022, global growth should remain above trend, while Australian growth should undergo a significant re-acceleration to an above-trend pace. US Inflation will likely prove stubborn in the next few months but ease through the year.

Equities: We remain overweight both global and Australian equities into 2022. At the margin, we favour value stocks and non-US equities.

Fixed income: we maintain an underweight to fixed interest. The US 10-year Treasury yield should rise to around 2%-by late 2022, but the selloff should be capped by evidence that inflationary pressures are easing. Corporate debt should outperform high-quality government bonds in 2022. We favour high yield over investment grade.

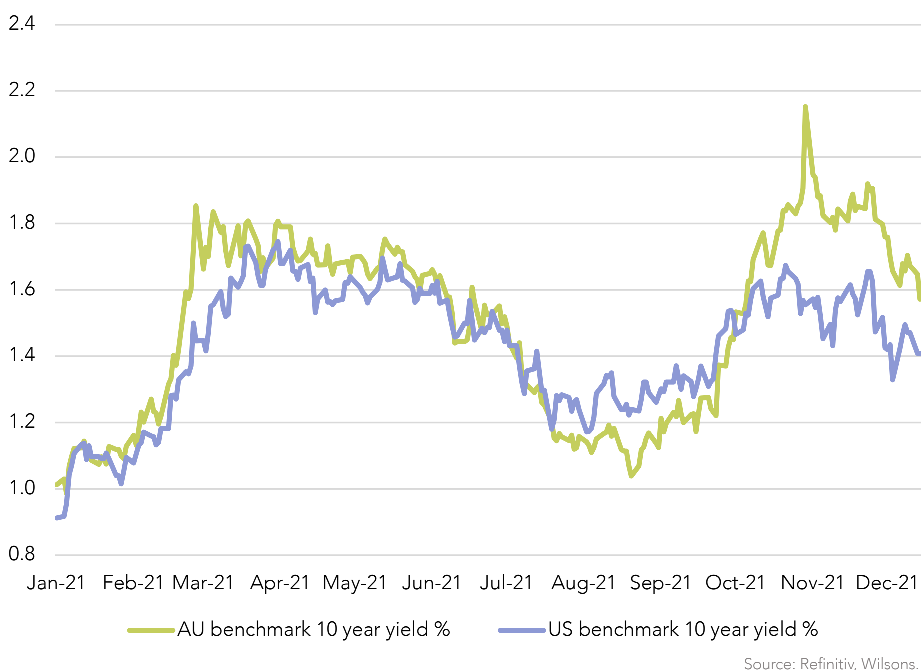
Alternatives: We continue to be overweight alternative assets. In part, this is due to our concerns around the potential for a capital loss in traditional fixed interest products as yields likely rise in 2022 as the economic recovery broadens. We see good risk-adjusted return opportunities in growth alternatives such as private equity and real assets such as infrastructure and property. At the same time, we favour private credit within our "defensive alts" component.

Exhibit 1: Strong returns from global and Australian equities in 2021



Source: Refinitiv, Wilsons.

Exhibit 2: Bond yields have risen in 2021 but in a stop-start fashion



Source: Refinitiv, Wilsons.

An Exceptional 2021 but Still Scope for 2022 Gains

2021 has delivered Australian investors strong returns from equities, with Australian equities on track to deliver mid-teens total returns while global equities (once again powered by the US share market) look set to deliver an A$ total return of around 25%.

Bond yields have risen moderately, resulting in modest single-digit losses for traditional fixed income portfolios. However, the rise in yields has not been significant enough to really worry equities with strong earnings growth powering the global equity rally.

Arguably the surge in global inflation was the biggest wildcard of 2021, with US inflation hitting a 39 year high by the end of November (6.8%). However, bond and equity markets have largely taken the inflation spike in their stride so far. Inflation outcomes will likely be the key to 2022, with the market betting that inflation is, for the most part, transitory.

The inflation surge has ultimately been enough to coax the US Fed off the sidelines with the announcement of an accelerated pace of QE tapering. The Fed has now ratified market expectations are for three rate hikes in 2022, beginning around June.

We think US inflation will come down significantly next year, though it will likely remain stubbornly high in the first quarter. US inflation should ease as we move through 2022 due to:

1. A much higher inflation base in year on year terms (from Q2)
2. An easing in supply chain pressures
3. A deceleration in year on year oil price gains
4. A rebalancing from overheated goods spending toward still depressed services spending

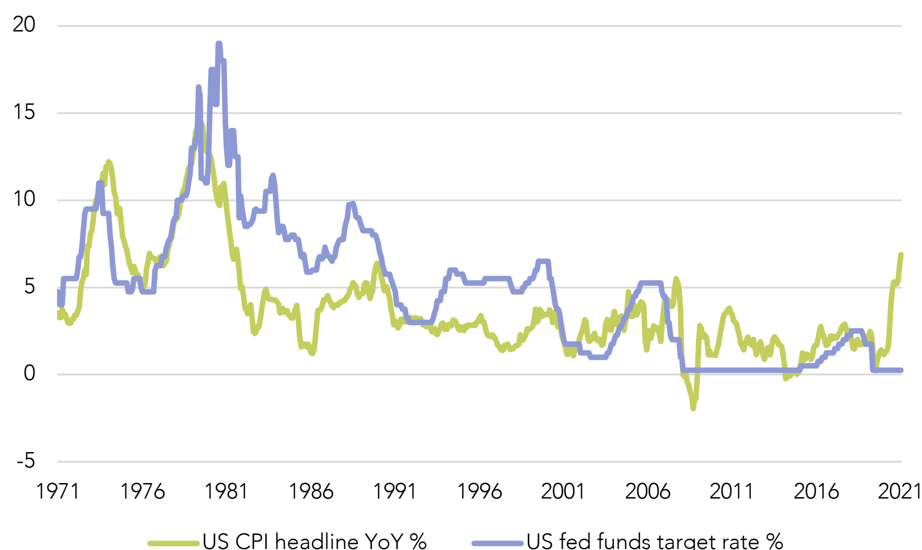
Easing price pressures beyond Q1 should keep the Fed between two and three rate rises in 2022, a "digestible" amount of tightening from an equity market perspective.

Another "Recovery Year" for the Global Economy

While inflation pressures should ease, 2022 should be another year of above-trend growth for the global economy, helped by further normalisation of economic activity as pandemic related headwinds continue to fade. The ongoing vaccine roll-out has so far kept severe illness and deaths "manageable" despite another surge in cases. While it is still a near-term headwind the pandemic influence should fade as we move through 2022.

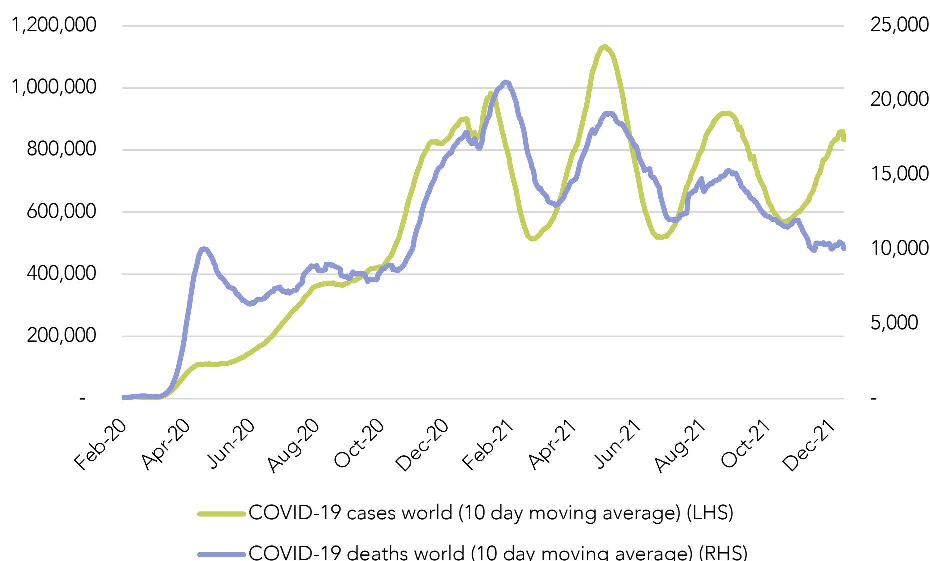
The release of pent-up consumer demand as excess savings are released is a key driver of our expectation of above-trend economic growth. US households have more than US$2 trillion in "excess" savings currently. Only a small portion of this needs to be spent in 2022 to drive a strong year of consumption. However, we will likely see a shift from goods spending to services.

Exhibit 3: Inflation has surged but should ease in 2022 as the Fed begins to lift rates



Source: Refinitiv, Wilsons.

Exhibit 4: Vaccines have so far kept severe illness and deaths "manageable" despite another surge in cases



Source: Refinitiv, Wilsons.

China Should do Better in 2022 as Policy is Eased

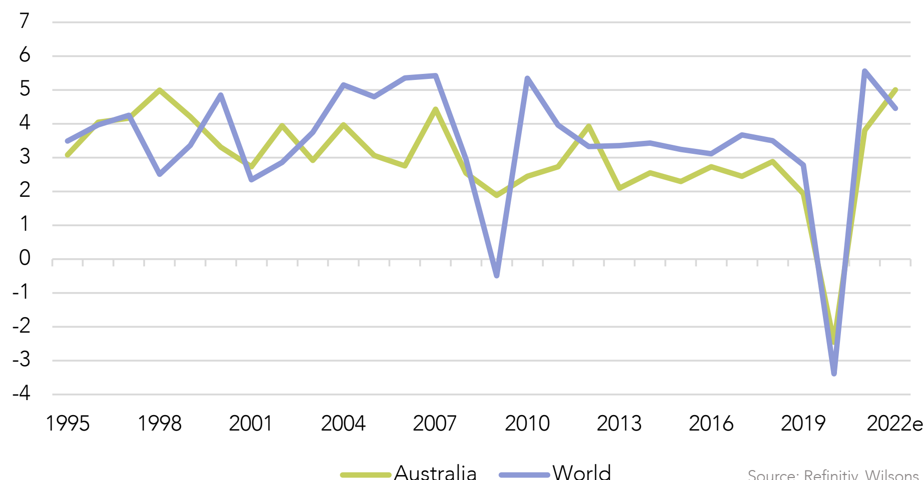
China's credit policy looks to be easing at the margin, and we expect Chinese growth will re-accelerate visibly beyond Q122 (post-winter Olympics). Authorities are attempting to strike a balance between short-term growth and structural reform targets. Thus, they will maintain a measured approach to stimulating the economy.

As a result, any improvement in growth momentum is unlikely to be dramatic, but this should help sentiment toward emerging market equities, which look cheap in our view. The fact that the Chinese central bank is now in easing mode while the Fed is tightening should all things equal support Chinese equities, the broader emerging markets (EM) universe and also commodities.

COVID Recovery for Australia in 2022

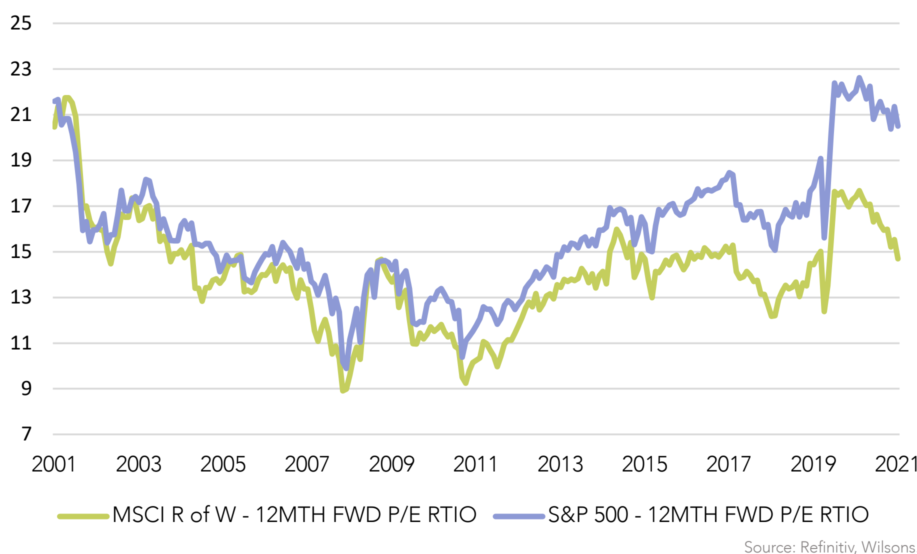
The Australian economy should be particularly strong as we recover from the impact of a 4-month lockdown in 2021. We expect a very strong recovery in the employment cycle, while ample consumer savings should help drive a strong spending recovery. This should help support the local market and the A$. Strong growth plus a pickup in inflation over the next 6 months should also be enough to coax the RBA into tightening either in late 2022 or early 2023 despite their still dovish current rhetoric. While the RBA appears too dovish, we see current market pricing for three rate hikes in 2022 as overly hawkish. Inflation is likely to pick up in the near-term but not to the recent levels seen in the US. The prospect of either no, or at worst one local rate hike in 2022 should support both the economy and the local share market in 2022.

Exhibit 5: Global and Australian GDP growth should remain well above average in 2022 with Australian growth accelerating



Source: Refinitiv, Wilsons.

Exhibit 6: Rest of world multiples have come back more than the US and look cheap into 2022



Source: Refinitiv, Wilsons.

Exhibit 7: Global Equities - consensus valution and earning growth outlook

	PE (12 Mth expected EPS)	CY21 EPS growth	CY22 EPS growth
US	20.5	50	8
Rest of world	14.7	60	6
Europe	14.8	63	8
UK	12.6	86	4
GEM	12.8	46	9
Japan	15.6	33	11
Australia	18	28	4

Source: Refinitiv, Wilsons

Key Asset Class Views for 2022

Global equities – real rates and rotation

As we discussed last week, global equities have delivered strong returns in 2021. While this was not a huge surprise, the renewed outperformance from the US market was interesting. While we have been moderately positive US equities in absolute terms the leadership of the US market (and renewed strength in the US$) against a backdrop of above-trend global economic and earnings growth and rising bond yields is unusual.

A number of investor risk factors, namely inflation, Fed stimulus withdrawal, and the path of the pandemic have bubbled up in the second half. This "wall of worry" has favoured the more defensive structural growth on offer in the US equity market as well as the safe-haven US$.

If our expectations of a good year for global growth, a fading in inflation, and easing in pandemic concerns are realised, this should favour the cheaper, more cyclical rest of world equity markets in 2022. The valuation discount between the rest of world and the US is at all-time highs. The rest of world earnings estimates look very modest in context of an above-trend year for economic growth.

From a style perspective, this should, at the margin, favour value over growth managers, particularly as we expect higher "real" interest rates as inflation falls, but economic growth stays relatively strong.

Fixed interest – the grind up in bond yields to continue

One notable surprise in 2021 was the relative resilience of bond markets to surprisingly strong inflation readings. Bond yields have risen moderately, resulting in modest single-digit losses for traditional fixed income portfolios; however, the rise in yields has been both modest and stop-start.

This suggests bond investors believe the surge in inflation is temporary, or if it does prove more stubborn, the Fed will prioritise inflation control over full employment, potentially slowing growth significantly.

This is consistent with the message on long-term inflation expectations derived from the inflation-linked bond market, with long-term inflation pricing easing back recently.

This is also evident in the profile of quite rapid hiking in 2022 and 2023 but a low "terminal" cash rate (1.5%). We think the Fed might be a bit slower in its rate hiking near-term given we expect inflation to ease in 2022, but ultimately the Fed may need to do more over the next 3 years to take the heat out of the US economy.

There is a risk that the market may fret about stubbornly high inflation over the next few months before it eases later in the year. As a result, there is the risk of volatility near-term, but we think the path of inflation over 2022 supports a continued positive stance toward risk assets and an underweight in bonds.

Inflation may re-emerge as an issue again in 2023 as strong growth sees the US labour market tighten.

Exhibit 8: Long-term US Inflation expectations remain moderate and have eased recently

Source: Refinitiv, Wilsons.

We cannot rule it out as a risk factor for late 2022 if the US economy powers ahead in 2022.

However, our base case is for moderately higher bond yields even though inflation should be lower a year from now. This is due to our view of strong growth driving real rates higher. This would not be a disaster for stocks, given earnings should be strong. However, it may cap the upside for equities in 2022 to some degree and suggest an underweight to fixed interest and a preference for strategies less reliant on traditional "duration-based" strategies. Credit should do better than government bonds as strong economic growth keeps corporate defaults very low and spreads tight for another year.

Australian equities – strong support from the local economy

While Australian equities had a decent year in 2021, the local market lagged global equities and posted its highs in August. In comparison, the US market hit new highs this past week.

Headwinds for Australia in 2021 were the east coast lockdowns from late June to late October, as well as the big Q3 pullback in the iron ore price as Chinese demand slowed. This saw earnings estimates slip into downgrade mode and GDP decline in Q3.

The economy is now on a recovery footing, and we expect a strong rebound to extend through 2022. This will likely be buoyed by a pre-election budget in April ahead of the likely election in May. This should help the earnings recovery.

The heavy skew of big-cap equities to banks and miners may not give as much leverage to a strong local economy, so an overweight to selected small-caps appears warranted. Normally banks have been a good way to leverage a strong domestic economy, but competition across a broad front and the ingrained margin pressures stemming from a low interest rate regime look set to continue to weigh. Bad debts should stay low, so dividend and capital management potential should be supportive for the sector.

In recent months, a significant slowdown in China's growth in the second half of this year has weighed on the iron ore price, albeit the price did reach unsustainable levels earlier in the year. As discussed, we believe a degree of easing in the Chinese credit cycle will provide a degree of support for commodities and therefore the Australian resource sector.

Alternatives – maintain overweight as the cycle matures

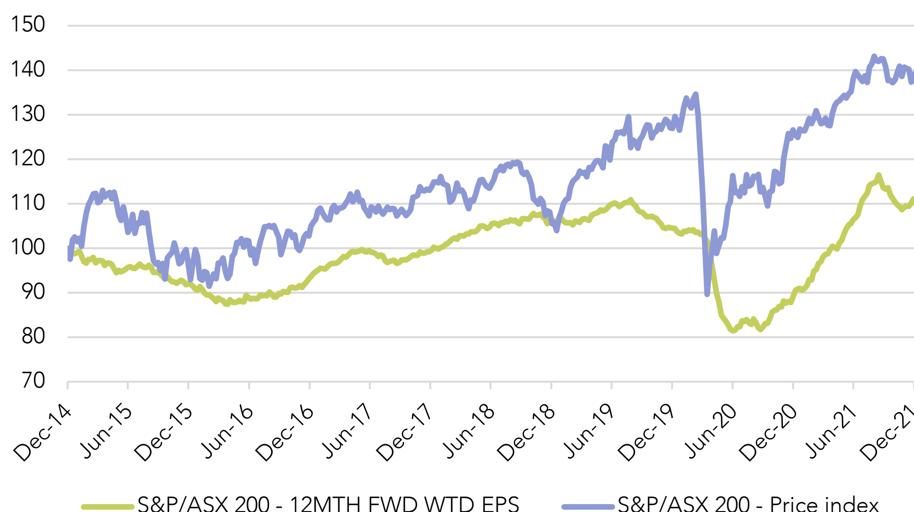
We have had a significant overweight position in alternatives through 2020/21 and increased our strategic weighting mid-year.

This increase in our strategic allocation is based on our 5-10 year view of asset class returns. Specifically, we believe traditional fixed interest returns are very unattractive on both tactical and longer strategic timeframes. We believe this inhibits the capacity of fixed interest to diversify portfolios. We still see reasonably attractive returns for equities on a cyclical horizon (2022 at a minimum). Still, we concede uncertainties around longer-term horizons due to high absolute valuation and potential vulnerability to an eventual shift in the very low interest rate regime currently supporting valuations.

We continue to hold a tactical overweight in alternatives due to our concerns around the potential for a capital loss in traditional fixed interest products as yields likely rise over the next 1-2 years as the economic recovery broadens, QE ends, and cash rates lift. We do not see cash as a particularly attractive alternative destination at present, with available cash rates still at close to zero. So, the opportunity cost of keeping some investing dry powder is still relatively high at present.

We see good risk-adjusted return opportunities in growth alternatives such as private equity and real assets such as infrastructure and property. Real assets appeal on the basis of providing a degree of insulation from higher than expected inflation. However, we would advocate well-focused "active" strategies for real assets given the uncertainties around some stranded assets in a post-pandemic, ESG focused world.

Exhibit 9: Australian earnings dipped in 2021 due to lockdowns and falling iron ore price



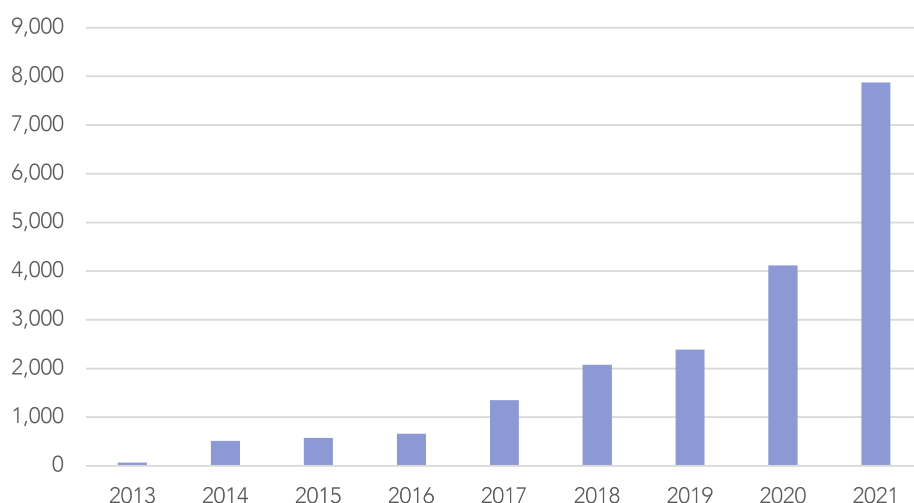
Source: Refinitiv, Wilsons.

We also see the opportunity to earn attractive income streams of 5-6% in defensive alternatives such as private credit. Our expectations for a strong local economy should support domestic private credit, while the floating rate nature of private credit provides insulation from rising rates over the next few years.

We retain some modest exposure to gold as a tail risk hedge - namely a hedge against unexpectedly high inflation or an unanticipated spike in market risk aversion. Gold has been somewhat lacklustre this year despite falling real rates. Undoubtedly crypto-currencies have hampered gold over the past year from a fund flow perspective. Our central case macro view of higher real rates and positive sentiment toward further reflation may act as a headwind for gold over the coming year, though a re-emergence of a weaker US$ could offset this to some extent.

While the outlook for gold is buffeted by a number of cross-currents, the "tail-risk" of inflation pressures re-emerging as a genuine threat at some point over the next couple of years suggests retaining some exposure. We remain sceptical of crypto-currencies as either a store of value or a reliable portfolio hedge. The recently renewed volatility in Bitcoin and other cryptos as the Fed begins to withdraw liquidity is cautionary, we believe.

Exhibit 10: Now that is inflation! (number of cryptocurrencies)



Source: Refinitiv, Wilsons.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

Disclaimer

All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

Wilsons Australian Equity Focus List (Focus List) is a weighted list of the Investment Strategy Group's (ISG) preferred companies. The Focus List can hold up to 25 companies, largely taken from the S&P/ASX 300. Stocks may be substituted at any time at the discretion of the ISG. Performance numbers around the Focus List are unaudited, and should be used only as a guide to indicate returns if investors were to follow the Focus List. For further information please contact your Wilsons Advisor.

This document has been prepared by Wilsons Advisory and Stockbroking Limited (AFSL 238375, ABN 68 010 529 665) ("Wilsons") and its authors without consultation with any third parties, nor is Wilsons authorised to provide any information or make any representation or warranty on behalf of such parties. Any opinions contained in this document are subject to change and do not necessarily reflect the views of Wilsons. This document has not been prepared or reviewed by Wilsons' Research Department and does not constitute investment research. Wilsons makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and opinions contained therein, and no reliance should be placed on this document in making any investment decision Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of Wilsons and therefore may not be realised in the future. Past performance is not an indication of future performance.

In preparing the information in this document Wilsons did not take into consideration the investment objectives, financial situation or particular needs of any particular investor. Any advice contained in this document is general advice only. Before making any investment decision, you should consider your own investment needs and objectives and should seek financial advice. You should consider the Product Disclosure Statement or prospectus in deciding whether to acquire a product. The Product Disclosure Statement or Prospectus is available through your financial adviser.

Wilsons Corporate Finance Limited ACN 057 547 323, AFSL 238 383 may have participated in some capacity with regard to capital raisings for some of the companies mentioned in this article. To manage any conflicts of interest with Wilsons Research, full disclosure on any relevant corporate transaction may be found on our website.

Wilsons contact

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au