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Asset Returns 2021 & Outlook 2022

Highlights

Pent-up demand boosts profits & inflation

Rising interest rates priced in for next year

A difficult environment for conservative investors

Inflation will dominate headlines in the coming months

Equities will continue to be the main driver of returns

Diversification remains key to stabilize portfolio returns

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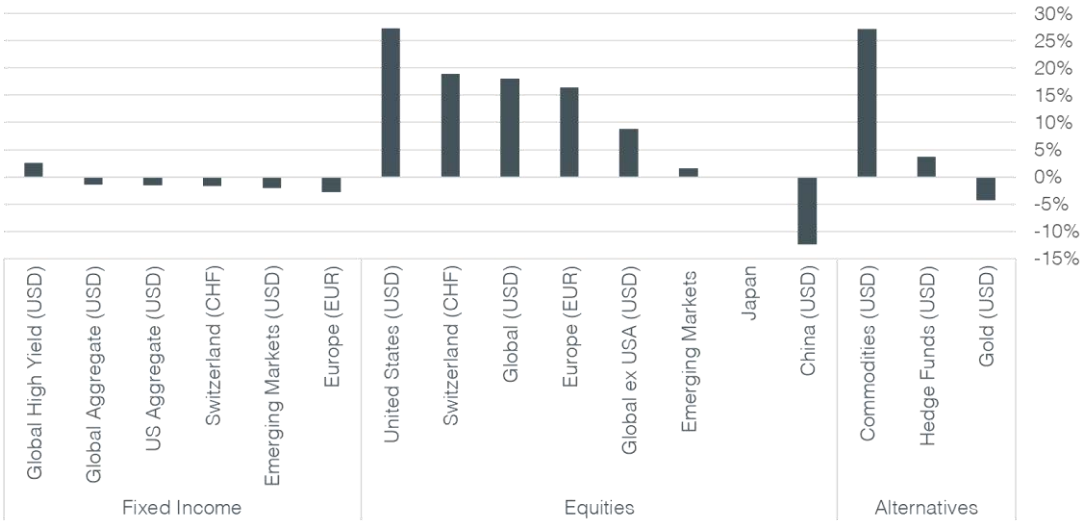
The great reset of the global economy

The pandemic-ridden year of 2020 was followed by yet another unusual investment year. After the lockdowns and their massive negative impact on the global economy, 2021 brought safe and effective vaccines and a sharp rise in consumer confidence.

As consumers began to increase spending in spring 2021, price levels also started to rise. The reason for this can be found in production gaps caused by COVID-19, low inventories and structural disruptions in various supply chains. The resurgence in demand led to massive delays, anomalies, and record-high freight rates. For the first time since the great financial crisis, inflation has spread into in the broad economy, reaching heights last seen during the oil price shock of the 1970s. Inflation and its development will be the main topic this year and thus dominate the further path of monetary policy.

Investment returns in 2021 reflect the economic development: Rising inflation forced central banks to reassess their loose monetary policy and as a result, the market is already pricing in higher interest rates over the coming months. For fixed-income investors, the combination of higher rates across the curve resulted in negative returns in almost all areas. For equities, the inflationary environment provided a positive backdrop, with corporate earnings getting a big boost from pent-up consumer demand in 2021. For the third year in a row, equities posted double-digit returns. However, the distribution of returns was very uneven across regions, sectors and individual securities.



In a nutshell, 2021 was mostly a mixed investment year. Stock market returns exceeded their long-term average. At the same time, it was the most negative year for bonds since 1994 - notably with the highest inflation since the 1980s. In other words, defensive investors and conservative investment styles had a difficult time. Fixed-income investors in particular were hardest hit by the effects of negative real interest rates and a repressive central bank monetary policy.

Datasource: Bloomberg

Sound Capital Asset Allocation 2021

Fixed Income

Our cautious stance on bonds which led us to avoid long maturities has paid off in 2021. In developed markets, investors were penalized for holding long maturities and high-quality bonds. Positive returns for fixed income investors were only possible through solid maturity management and good issuer selection. Still, there were a few ways to escape negative returns. Our exposures to inflation-linked and convertible bonds delivered positive returns and held up well in this difficult bond market environment.

On the other hand, our preference for emerging market bonds was challenged by a sharp widening of credit spreads in China, especially in the second half of the year. Stricter regulatory requirements in the local real estate market triggered a wave of uncertainty. Evergrande Real Estate, the country's second-largest real estate developer, became insolvent. As a result, credit spreads rose across emerging markets, pushing the performance of the entire region into negative territory for the year. However, we remain convinced that in the coming year, given the attractive credit spreads, a lot of investors will focus on emerging market bonds in search of yield.

Increasing interest rates in 2021 were primarily driven by the sharp rise in inflation. Central banks have been unable to escape the rising inflationary pressure and have felt increasingly compelled to act. Thus, the year 2021 marks a turnaround in the pandemic-induced expansionary monetary policy. While some central banks in the developed world (UK, Norway, New Zealand) have already hiked interest rates in 2021, the Federal Reserve is expected to increase key interest rate three times in 2022.

Rising interest rate expectations for the coming year also caused price setbacks at the short end of the maturity spectrum. Thus, holding short maturities has not prevented but only reduced losses.

Overall, it was an extremely challenging year for fixed-income investments. When looking at the global aggregate market (USD), one has to go back to 1994 to find a similarly negative result. Furthermore, the uncertainty caused by COVID-19 has not yet completely disappeared from the market and will continue to impact the further development of interest rates in the coming year. In conclusion, the past year shows us that active management is indispensable to generate positive returns and exploit opportunities in a very difficult fixed income environment.

Equities

We started the year with a cautious stance towards equities. In January, Sound Capital's Investment Committee saw signs of upcoming euphoria when looking at investor sentiment. A lower risk premium and record high equity prices led to a slight underweight of equities. Halfway through the year, the economic recovery reached record momentum and, in addition to earnings expectations, risk premiums started to rise again. Given the improved outlook, we upgraded equities and took a neutral view until the end of the year. Our cautious stance led to a lower return contribution, but also lower volatility, which in our view is reasonable in the current market environment.

Inflation also impacted the trading environment for equities. Investors heavily shifted assets into value-oriented sectors like energy and financials that benefited disproportionately. At the beginning of the year, the focus was mainly on cyclical stocks. This changed again towards the middle of the year in favor of quality growth companies. Above all, exceptional operating results in the US boosted heavyweights in the technology sector, which once again had a significant impact on the overall market.

Just under 30% of global stock returns can be assigned to only 6 US companies. Microsoft, Apple, Alphabet (Google), Meta (Facebook), Nvidia and Tesla – out of an index of 3,300 shares. These companies currently represent just under a quarter of the market cap of the S&P 500 or over half in the Nasdaq 100. In other words, taking concentrated risks in 2021 was rewarded by superior returns. However, as a professional investor, we see diversification as the most important foundation to one's equity allocation, especially given the current environment. It does not come as a surprise that in the US in particular, the majority of active fund managers lagged the market in terms of returns. When analyzing this peer group, over 90% of fund managers failed to outperform the benchmark.

The lowest returns in equities were delivered in emerging markets. Once again, regulatory requirements in China triggered great uncertainty among investors. Large-cap technology companies in particular suffered heavy losses, dragging the overall market into negative territory.

As expected, equities were the clear driver of returns in 2021. Despite great political uncertainty, an existing pandemic, high inflation and the prospect of rising interest rates, the market has only suffered one single drawdown in excess of 5% this year and ended the year near all-time highs. It comes as a clear sign to us, that in the absence of alternatives, equities should remain the key driver for portfolio returns in the upcoming year.

Datasource: Bloomberg

Outlook 2022

Fixed Income

- Keep duration risk low
- Avoid record low credit spreads
- Attractive spreads in emerging markets
- High volatility carries opportunities

The world of fixed-income investments is currently in a transitional phase in which aggressive monetary policy measures are giving way to rising inflationary pressures. In the US, the unemployment rate fell by a full percentage point to 4.2% from August to November. The tight labor market supports the Federal Reserve's change of course. Currently, markets are assuming five 25-basis-point rate hikes over the next 24 months.

While the market expects several rate hikes at the short end, the long end of the maturity spectrum paints a different picture. For example, the yield curve (US 2-10 years) is flattening ever since rate hike expectations creeped into the market. This means that in addition to rising interest rates, the market is expecting declining economic growth. We believe inflation peaked in 2021 and will moderate in 2022. However, continued upward pressure due to the omicron variant still poses a risk.

Due to the high level of uncertainty, investors have to adjust to a more complex environment. Moreover, central banks are buying fewer bonds, thus removing an important support to the market. Spikes at the long end of the US yield curve are likely to be seen as opportunities due to the interest rate differential versus the EUR. We currently see opportunities in emerging markets and in selective credits. We will continue to heavily underweight government bonds, as current yields no longer ensure the real value preservation of assets. Higher volatility and changing correlations validate our recommendation for broad diversification.

In the developed world, credit spreads are unusually low and appear extremely unattractive. A EUR investor in search for a yield of 2.5% has to go down the credit rating scale straight to junk and at the same time take 10 years of duration risk. In comparison, high dividend equities offer similar yield with the potential for additional capital gains and better inflation protection. Therefore, we continue to favor equities over bonds in the coming year and add alternative assets to stabilize portfolio returns in times of higher volatility.

Equities

- Risk premium remains attractive
- Equities remain the main driver of returns
- Ample liquidity provides upside potential
- Minimize concentration risk going into 2022

We see further upside potential for equities next year, although returns are likely to be lower than in recent years. The economic upswing is likely to continue, although leading indicators have lost some momentum. At the same time, the pandemic support provided by fiscal and monetary policy is fading and investors are not euphoric despite record high equity index levels. In aggregate, our factor model recommends a neutral weighting of equities.

Inflation currently poses the greatest risk to equity markets. Escalating inflation resulting in unexpectedly tighter monetary policy is a real threat for markets. That is why our Investment Committee is heavily focused on the relevant data points that observe the development of inflation expectations. For the time being, however, central banks have guided markets for higher interest rates through solid communication, without provoking an overreaction. Moreover, it seems quite likely to us that in today's heavily leveraged economy, lower monetary support will lead to weaker growth and ultimately lower interest rates.

Risk premiums still make equities the most attractive investment class in relative terms. High liquidity in the market should also be supportive. There are still record high levels of cash on the balance sheets of S&P 500 companies. This should provide a significant cushion against downside risks in 2022. Cash balances in the third quarter were near an all-time high of nearly $2.4 trillion.

When aggregating all analyst estimates, the upside potential for the overall equity market in the coming year is slightly over 10% (USD). While we see attractive valuations in materials and healthcare, we still maintain a broad diversification of equity exposure. In our view, quality and reasonably valued growth opportunities will hold up regardless of the market situation and provide stable portfolio returns. In particular, we see opportunities for the coming year in the Japanese market.

Datasource: Bloomberg