Key investment issues in 2022

How we are managing our clients' portfolios

Paul Eitelman, CFA, Chief Investment Strategist, North America

Sophia Wang, Market Analyst, Non-Profit and Healthcare

Rising inflation and variant concerns loom over the markets as the COVID-19 pandemic creeps into 2022 and refuses to retreat quietly into the night. We believe the spike in inflation—fueled by supply-chain disruptions, labor shortages, and surging consumer demand—is mostly transitory, although it could reach uncomfortably high levels early this year before declining as supply-side issues are resolved. While global economic growth will be slower than in 2021, we anticipate it will remain above trend in 2022, nurturing a conducive environment for equities to outperform bonds.

Now, perhaps more than ever, it is critical for investors to stay anchored in a reliable, methodical investment decision-making process that cuts out the noise and focuses on business cycles, asset valuations, and investor sentiment. Our investment strategists are keeping a close watch on broad macroeconomic trends as well as rising COVID-19 infections and renewed lockdown risks, while our portfolio managers maintain moderately risk-on positioning relative to strategic levels in client portfolios, which is driven by our value equity managers and asset allocation views. We believe it is critical that investors are aware of the key drivers of risk and return as well as sources of bias in their portfolios that may limit exposure to upside opportunities—whether it be a bias for growth stocks or a home-country bias.

Here is how we are managing shifting forces in our clients' multi-asset portfolios, using our robust cycle, valuation, and sentiment (CVS) investment decision-making process.

Equities

Overall, in our clients' portfolios, we are maintaining an overweight to equities, with preferences for non-U.S. equities. We leverage underweight positioning to U.S. equities to fund overweights to Europe ex-UK and UK equities. This regional leaning is fueled by the rest of the world's overweighting of cyclical value stocks relative to the U.S., and we see strong potential upside there. We continue to prefer historically cheap, cyclically-oriented value stocks over expensive technology and growth stocks; this is because we believe value equities are favored by above-trend growth and higher long-term interest rates and will likely outperform their growth counterparts.

We maintain modest UK and Europe ex-UK overweight exposures based on relative valuations and positive cycle support, while our emerging markets positioning is closer to strategic levels. This is due to the headwinds that emerging markets face as they remain under pressure from the regulatory and property sector slowdown in China and central bank tightening across emerging-market economies to contain inflation pressures. However, emerging market equities are cheap relative to developed market equities, so we are keeping a close eye on active investment opportunities in the space. With our underlying managers' biases towards value being the primary risk driver, we maintain a long interest rate volatility strategy as a hedge to provide downside protection.

Bonds

While above-trend economic growth, solid profit growth, and central banks slowly removing accommodation all serve as supportive forces for equities, these same factors will put upward pressure on government bond yields. Overall, we prefer equity over credit for the same level of risk. We continue to view government bonds as slightly expensive, and yields will face upward pressure as above-trend growth exhausts spare capacity. Technicals also support higher bond yields as the supply of Treasury bonds is likely to rise in the year ahead while Fed purchases taper off. High-yield and investment-grade credit are expensive on a spread basis but are propped by a positive cycle view that supports corporate profit growth and keeps default rates low. We are underweight high-yield credit in favor of equity risk, as spreads are historically tight, back to pre-COVID levels, with poor skew relative to equity risk. We maintain an underweight with respect to credit risk and a modest overweight to duration to ballast our value positioning within equities.

Currencies

We believe the U.S. dollar is likely to weaken in 2022. It is characterized by stretched valuations relative to historical levels and should soften as expectations for Fed rate hikes are scaled back and global growth leadership rotates away from the United States. The main beneficiary of this shift is likely to be the still-undervalued euro. We also believe the British sterling and the economically sensitive commodity currencies (i.e., the Australian dollar, New Zealand dollar, and Canadian dollar) can make further gains. We are holding on to our overweight to the Japanese yen, which is a safe-haven asset that affords strong diversification benefits. We think the yen has good upside potential given its undervaluation and supportive real yield, and sentiment is also a positive with investors crowded into short yen positions.

Overall, at the total portfolio level, we are managing a slightly risk-on asset allocation, with underlying manager value and cap weights as the primary drivers of returns. Our seasoned team of investment strategists and portfolio managers will continue to monitor the markets and dynamically manage risk within desired levels, helping our clients navigate the months ahead. At the end of the day, our focus is on empowering our clients, and making sure we’re putting your money in the right place.

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