Press Release

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Investment Outlook 2022 KBC

Review 2021

TRINA rules the country

2021 got off to a solid start. The first months of the year saw a continuation of the price recovery that began in 2020. Despite the surge of the Covid delta variant, the pandemic appeared to be under control and hope was growing of a further normalisation of the economy. There were dreams of a ‘summer of freedom’, and the notion of the ‘roaring twenties’ even made a brief comeback. On top of that, US President Biden proposed a new stimulus package and central banks continued to preach a prudent approach.

There was a pause in the optimism just before the summer. Fear of inflation reared its head and there was anxiety that central banks would turn off the money tap abruptly. Interest rates surged ahead, inflation-linked bonds were flavour of the month and the equity markets took a step backwards. The nervousness was short-lived, however. Yet again, the central banks managed to convince investors. There was a consensus that the inflationary tensions were temporary in nature. Interest rates fell back again to their levels at the start of the year, and share prices resumed their upward trend, fuelled by rock-solid corporate results.

The strong economic recovery not only manifested itself on the floor of the stock exchange. When the 'Ever Given’ container ship blocked the Suez Canal, it became clear that the supply chain cycle was in difficulty. In the third quarter, the just-in-time model began to show severe cracks. Strong demand pushed up energy prices and the shortage of raw materials, labour and transport also began to pinch in other sectors, too. The spectre of stagflation reared its head. To make matters worse, it became clear that China was serious about introducing stricter regulation of the local economy. The stock markets paused once again and interest rates climbed back to their May levels.

Once again, however, corporate results swept away the doubts. Strong growth figures with virtually no pressure on margins drove up share prices in October and November. At the same time, the supply chain tensions appeared to be gradually easing.

Then, just as the champagne had been put on ice, Covid came charging back onto centre stage. While Europe is being tormented by a fourth wave, the world is holding its breath about the new omicron variant. As a result, the stock markets have begun to stutter since the end of November, though without any major correction thus far, and bonds are finding eager buyers.

Summarised in return figures:

The MSCI World AC has risen more than 20% since the start of the year, with American and European shares especially bathing in the rosy glow. Chinese policy interventions and a sluggish vaccination campaign are weighing on returns in the emerging markets. They are also unable to attract many bond investors. It is mainly inflation-linked bonds that are in favour in these markets. Corporate bonds performed better than government bonds, but the low interest rates could still mean that the year closes with a negative return. The increased nervousness on the stock markets in recent weeks showed yet again that bonds, and especially government bonds, continue to play a stabilising role.

Outlook 2022

The omicron wave

In the near term, the omicron virus mutation will generate a good deal of uncertainty. Economists and market players are waiting to hear the verdict of the scientists. Since the initial stock market correction on 'Black Friday', the markets have fluctuated up and down with no clear trend, responding to news reports pointing to more or less favourable developments. KBC Asset Management is currently opting for a cautious but certainly not overly pessimistic positioning. Digital risks could spark off both upside and downside market shocks. We are basing our cautiously positive stance on experiences from the previous Covid waves. Where governments opted in the spring of 2020 to shut down society and the economy almost completely, much more targeted interventions have been employed in recent virus spikes. Schools and industry have largely remained open, for example, while the necessary contact restrictions were targeted mainly at the leisure sectors. The downturn in the economy was accordingly more limited, and often amounted to no more than a slowing of economic growth. This was also due to consumers and producers adapting to the temporary new normal – think of the boom in online shopping, for example. In our baseline scenario we assume a new or continuing Covid wave through the winter months, with a clear but manageable negative impact. The measures taken, the continuing vaccination campaigns and the warmer spring weather to come, will then bring an improvement.

That is not to say that we are blind to less positive reports surrounding the omicron variant. The uncertainty and the risks are high. If the present vaccines prove ineffective, for example, and the virus does not weaken, this could temporarily threaten a deeper economic contraction and usher in a correction, including on the stock markets.

Boom

If it were not for the new Covid variant, and the Covid-related risks present even before it emerged, the title of this article could well have been simply 'boom'. The underlying economic growth trend is robust, something that is also evident from the forecasts by the KBC Chief Economist. Despite the new Covid wave, the growth figures in 2022 are expected to be substantially above the long-term trend. High private savings ratios, production lags due to the familiar problems in the supply chains, extremely low stock levels, the recent strong growth in corporate earnings, the high capacity utilisation rate, high producer confidence, structural investment programmes by governments in Europe and the US, …, it all points to a continuing expansion.

For investors, this means that, partly in the light of the higher inflation and therefore more robust nominal economic growth, once the new Covid wave is under control, corporate earnings will continue to move upwards. Equities remain our preferred asset class, especially for the first half of 2022, all the more so as 2022 is set to be a poor year for bonds, with interest rates in Europe very low or even negative. And if central banks tighten the monetary reins even slightly, there is the additional threat that prices will fall. There Really Is No Alternative.

All in all, the interest-rate risk in Europe should not be overstated. The indications are that, as the year progresses, inflation in the euro area will fall back below the ECB target. An increase in the euro key rate it is unlikely for at least two years. The upward pressure on interest rates will come mainly from the US. There, too, however, as baseline effects and the temporary impact of the reopening of the economy and associated supply chain problems disappear from the year-on-year increases, inflation will once again settle around the central bank's target. The upside risks are however more pronounced there, partly due to the accelerating wage growth and more broadly supported price rises. The Fed will tighten its monetary policy as a precaution. Against the backdrop of the recently revised target function, the normalisation of monetary policy will however be a gradual process. This implies that the discount rates will not rise substantially and will remain negative in real terms. That will also support share prices.

History has shown that a normalisation of monetary policy, once the economic recovery is well entrenched, need not be disastrous for risk-bearing assets. The markets are drawing support from the improved growth outlook. Only when policymakers apply the brakes more firmly later in the cycle will a more cautious approach be appropriate. Valuations do typically reduce, however, something that has in fact already happened in recent months. In other words, share prices rise more slowly than earnings growth. This leads to good but less exceptional stock market years.

Alert to a tipping point

US inflation and its impact on monetary policy brings us to the main non-Covid-related risk with this scenario. Among other things, the recent fall in oil prices, the omicron variant and initially favourable baseline effects will allow the Fed to continue advocating a gradual approach over the coming months. The central bank bought itself some time anyway with its policy decision to first unwind the bond purchase programme . But in the second half of 2022 it should become apparent to what extent the pressure on prices is genuinely reducing. Strongly rising rental costs, a stubbornly low labour participation rate, accelerating wage growth, a GDP gap which is gradually being closed: these are all factors which suggest that there are also upside risks. If the Fed is forced to take more radical steps, it will be time to reduce the portfolio risks.

But that is by no means a foregone conclusion. Strongly rising corporate investments and accelerated digitalisation, partly as a result of the enforced working from home, could reverse the recent downward productivity trend. The second half of the 1990s taught us that strong growth and low inflation then go hand in hand. Will Goldilocks make an entrance once again?

Return to a more cyclical climate

Zooming in on the details of the KBC AM model portfolios, the more mature economy is once again steering us towards cyclical equity sectors. Earlier in 2021 we successfully banked gains in those sectors. Our eyes are also focused on the major investments in infrastructure and ecological solutions which are receiving financial support from governments. Value stocks, including in the financial sector, also warrant an above-average weighting in the portfolio, especially given the anticipated interest-rate rise. This prompts a more cautious approach to defensive sectors and could also be problematic for the more expensive quality and growth stocks.

At regional level, Europe ought to do better in 2022, though we are more cautious for the short term. In addition, the underweight positions in emerging Asia are also being very gradually increased. The Chinese economy contracted in the autumn of 2021. The zero tolerance approach to Covid infections, a stricter climate policy, the after-effects of earlier monetary interventions, and political interventions in the business model of a great many companies (including the biggest real estate developers), led to a fall in GDP. Now, though, there are signs that Beijing is once again opting for a bigger fiscal and monetary stimulus. Sufficiently high growth remains of vital importance for the country's socioeconomic stability. In the past, such a policy reversal has been a precursor to a better stock market climate. The relatively cheaply valued local stock markets could make up some ground in 2022. Despite this, we are building our positions only cautiously. Allowing the property bubble to gradually deflate is not a cure-all, and the anticipated monetary tightening in the US does not play to the advantage of investments in emerging markets.

A phased rotation is in fact a central element throughout our strategy. The uncertainties caused by the omicron variant are too great for us to take any pronounced positions.

Useful ballast

Despite the weaker return outlook, bonds still warrant a place in the portfolio. Strong price gains, for example in July and November 2021, show that bonds continue to play a stabilising role in a portfolio. Corporate bonds are the preferred choice here. In times of rising interest rates, they outperform government bonds, due to shorter terms to maturity, higher current returns and credit spreads which correlate negatively with the risk-free interest rate. The fact that they help lift the current return on the total bond portfolio above zero is an added bonus. Every basis point counts, especially in times when returns are scarce. The bond model portfolio retains a pro-cyclical focus (shorter terms to maturity, corporate bonds), but in moderation. The strongest performance comes from corporate bonds earlier in the cycle, in the recovery phase after the marked widening of credit spreads during the preceding recession. Bonds from emerging markets, for their part, are in danger of coming under pressure as the Fed tightens its policy. Moreover, a number of major debtors are facing specific, local, economic and/or political problems. At current interest rate levels, the primary objective of holding bonds is still to achieve balance in the portfolio. Major risks can then be avoided.

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KBC Group NV
Havenlaan 2 – 1080 Brussels
Viviane Huybrecht
General Manager
Corporate Communication /Spokesperson
Tel. +32 2 429 85 45

Press Office
Tel. +32 2 429 65 01 Stef Leunens
Tel. +32 2 429 29 15 Ilse De Muyer
Tel. +32 2 429 32 88 Pieter Kussé
Tel. +32 2 429 85 44 Sofie Spiessens
E-mail: pressofficekbc@kbc.be

KBC press releases are available at
www.kbc.com or can be obtained by
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