GLOBAL LONG-TERM UNCONSTRAINED

MARTIN CURRIE

2022 INVESTMENT OUTLOOK

DECEMBER 2021 FOR INSTITUTIONAL, PROFESSIONAL AND WHOLESALE INVESTORS ONLY

2022 OUTLOOK – KEY POINTS

A supportive backdrop for equity markets driven by a prolonged positive economic cycle – although the Omicron variant has the potential to disrupt

We believe that economic momentum should remain supportive in the medium term. This is partly related to supportive policy initiatives, notably the infrastructure programmes that have been announced globally but not yet deployed. Given the magnitude of these programmes, and the longer duration of their deployment, we are of the view that we are facing a more prolonged positive economic cycle, which should remain supportive of equity markets.

With the higher equity valuations and a strong 2021 for equities globally, we expect 2022 to be a year of lower returns and higher volatility for investors.

Monetary policy normalisation will bring continued volatility and will maintain the bull-bear debate between growth and value.

The Omicron Covid-19 variant has the potential to disrupt both economic momentum and monetary policies, should it lead to renewed significant lockdown measures.

2022 will confirm whether inflation is frictional or structural

Inflation will remain an important talking point in 2022, with the bull-bear debate continuing into summer when we believe inflationary pressures will subside. Wage inflation remains the important measure to watch as it has the potential for a more long-lasting impact. We believe stagflation is a low probability given the supportive economic backdrop, although the Omicron variant has the potential to increase this risk.

Focus on companies with consistent growth profiles after a strong year of recovery

Lower earnings growth is expected in 2022 following the strong 2021 recovery. There is a risk of margin pressure from the higher frictional inflation, emphasising the need to focus on companies offering consistent growth profiles, these have superior pricing power and therefore lower downside risk to their margins.

Sustainability will remain an area of focus in the post pandemic recovery

Following the COP26 summit, we will see an ongoing trend towards more sustainability, given the ongoing need to deliver on the ambitious and necessary net zero targets. As this sustainability focus continues, it will bring more regulatory requirements and a higher cost burden notably on the most polluting and high carbon emitting companies and industries. It will also bring a higher level of investment into green initiatives and solutions driving momentum in innovation and increasing potential opportunities for long-term investors.

Thematic opportunities remain plentiful in a world transitioning towards sustainability

Our three mega-trends, (i) Demographic Changes, (ii) Future of Technology, and **(iii) Resource Scarcity**, provide us with opportunities to capture long term structural growth themes, which are well aligned within a world transitioning towards a more sustainable future. Demographic Changes are about Sustainable Living, Future of Technology is about Decarbonisation, and Resource Scarcity is about Climate Change. Within these megatrends, there are thematic opportunities with supportive structural growth prospects in:

- Infrastructure across green energy, energy efficient buildings, electric transportation, 5G telephony, and healthcare; and
- Technology in cloud computing and cyber security, robotics and automation, and quantum computing.

Many risks for investors in 2022

There are many risks that investors need to take into account as we enter 2022. A loss of momentum in infrastructure spending is an important risk, given the impact of such spending in helping economic growth. Monetary policy mistakes are another risk, which could unnerve investors and bring more volatility in terms of style rotations between growth and value as yield curves shift around.

Other risks include:

- corporate tax rates increasing, putting downward pressure on earnings
- localised pandemic relapse risks putting pressure on economic momentum and further exacerbating supply chain disruptions
- stronger and more prolonged frictional inflationary pressures, leading to more pronounced margin pressure for corporates; and lastly
- geopolitical risks, with tensions potentially becoming more open notably in terms of China versus Rest of the World.

Finally, we predict an ever more disruptive decade continuing to affirm itself in 2022. There are many risks of disruptions for existing business models, in a rapidly transitioning world, but the increased investments and innovation enabling a faster transition towards a more sustainable world will create many areas of opportunity for long-term investors.

2022 OUTLOOK

Macro-economic outlook remains supportive notwithstanding the Omicron variant, we expect a more prolonged positive economic cycle in the medium-term

Whilst leading indicators have lost momentum of late, we believe this is related in some instances to the impact of partial lockdowns and supply chain bottlenecks. We believe that economic momentum should remain supportive in the medium term. This is partly related to the supportive policy initiatives, notably the infrastructure programmes that have been announced but not deployed yet. Given the global magnitude of these programmes and the longer duration of their deployment, we believe that we are facing a more prolonged positive economic cycle, which should remain supportive of equity markets.

The Omicron Covid-19 variant could provide some cause for concern on the pandemic battle front, potentially disrupting economic momentum. It remains unclear at this stage whether this will be a significantly different variant that could challenge the vaccines' efficacy and push economies into renewed lockdowns.

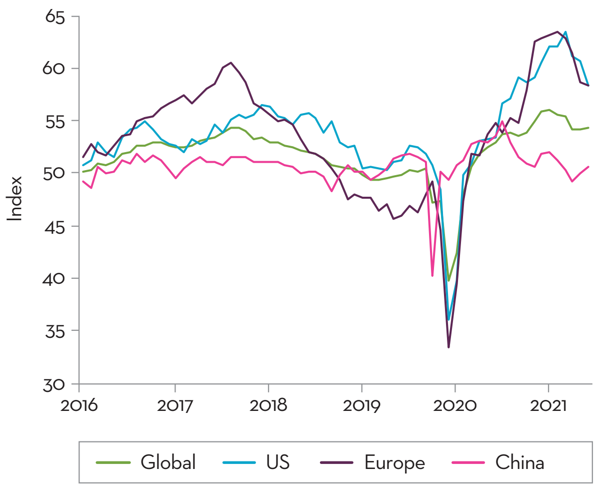
Supply chain and logistics bottlenecks will persist into H1 2022, fueling frictional inflation and putting pressure on margins

Supply chain and logistical bottlenecks have been a headwind for economic momentum in 2021. We expect these bottlenecks to persist into the first half of 2022 and to be at risk of further exacerbation by the Omicron variant. This is likely to continue to push companies to increase their investments in robotics and automation, and to continue to diversify their production bases in the medium term. Nearer term, these bottlenecks are also further fueling the frictional inflationary pressures that we saw in 2021.

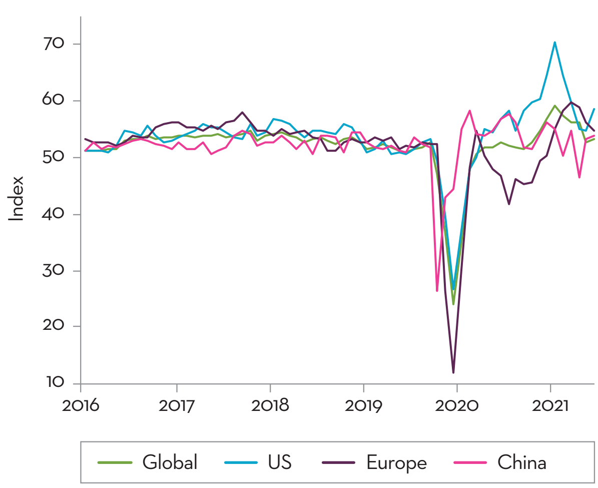
Economic cycle will move from recovery to expansion, favouring companies with consistent earning profiles

2021 was a year of recovery, which led to an extremely supportive economic and corporate earnings environment. We believe that we are now moving from the recovery to the expansion phase of the economic cycle, assuming no major disruption from the Omicron variant. This is typically accompanied by a broadening of leadership in the market, with an important emphasis on supportive earnings momentum. We believe that this should favour companies with consistent earnings growth profiles, rather than deep cyclical profiles, which have done well during the recovery phase. The Omicron variant, should it prove to be of significant concern, has the potential to push the economic cycle back into slowdown, so it will be important to reassess the macroeconomic backdrop as the situation evolves.

Manufacturing PMIs



Services PMIs



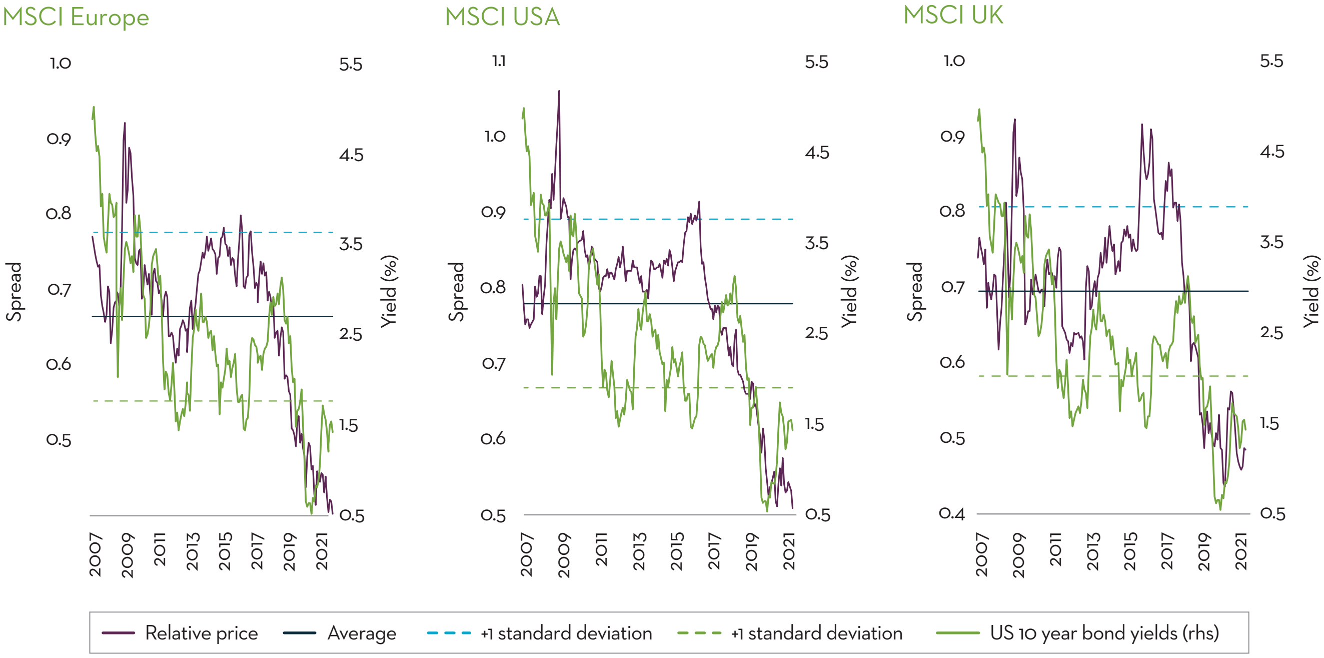
Source: Martin Currie, FactSet and OECD as 30 November 2021. PMI: Performance market indicator.

Monetary policies are normalising but still supportive for equities, with the potential to drive market volatility and leadership between growth and value styles

As we move from recovery into expansion in the economic cycle, monetary policies typically shift from being accommodative to normalising. We expect this to be followed by interest rate increases over the next two-three years, which in turn typically leads to some increased volatility in equity markets as markets speculate about the speed and magnitude of the tightening cycle. We believe that central banks are not late in tightening and therefore the risk of very aggressive tightening is low. The market will however have a healthy bull-bear debate between those who think that they will need to tighten more aggressively and those who think that the tightening is premature, based on the belief that growth remains fragile. Movement in yield curves and the shape will be important focal points that will drive both market volatility and intra-market volatility in terms of style leadership between growth versus value. For our part, we believe that we are moving into a period of monetary policy normalisation rather than over-tightening, and therefore believe that the equity market should be able to digest the shifting interest rate expectations without too much downside risk.

The Omicron variant could have the potential to disrupt monetary policies, and delay the move towards normalisation in interest rates. If the Omicron variant leads to more stringent lockdown measures it may significantly disrupt economic momentum by delaying the implementation of monetary policy and the normalisation of interest rates.

Value versus Growth spread versus US 10-year Treasury bond yields



Source: FactSet as at 30 November 2021.

2022 should confirm that inflation is transitory and we believe stagflation is a low probability, but bull-bear debate to remain until the summer

Inflation will remain an important talking point in 2022, fueling a bull-bear debate that could last until the summer. At this point we believe it will become more apparent that monetary inflationary pressures from this year will subside, following economies normalising, and supply chains and logistical bottlenecks easing. Wage inflation remains the important measure to watch, given that this has the potential for a more long lasting impact on inflation expectations.

We are conscious that there has been increasing talks of stagflation risk, given the higher inflation and loss of momentum in economic leading indicators recently. However, we believe that this remains a low probability scenario, given the supportive economic backdrop that we mentioned earlier.

The Omicron variant could increase the risk of stagflation. Should it prove to be a difficult variant to tackle with existing vaccines more stringent lockdown measures could be imposed, which would impact economic momentum negatively and would exacerbate supply chain and logistical disruptions, thus fueling higher frictional inflationary pressures.

Geopolitics to increase focus on China and the 'Cyber Cold War'

Geopolitics are likely to remain an important talking point, with a growing focus on China's territorial claims in the South China Sea. The second half of the year brings the focus on China President Xi Jinping's likely third term, which could open the way to him being President for even longer. This could unleash a more pronounced territorial ambition around Taiwan, which could in turn lead to a flare up in cross-border tensions and an increase in geopolitical risk that the market is currently not pricing in.

Cyber security attacks could also lead to an increased focus on the digital Cold War that is at risk of escalating. All in all, geopolitical risks are lurking, something we believe that investors should increasingly focus on.

Earnings growth is likely to be modest in 2022 after a strong recovery year in 2021

The year 2022 will face many headwinds, not least the more demanding base effect of 2021, and the inflationary pressure weighing on cost bases for corporates. The recovery in 2021 was stronger than expected, fueling a highly supportive positive earnings momentum and upgrade cycle, with 2021 earnings growth expectations moving from +21% expected at the start of 2021 for the global market to c.+46% at present*.

The current consensus estimates for earnings growth year on year from 2021 to 2023 are shown in the table opposite. Our top down forecasts for the MSCI World assume +46% for 2021E, and +6% for 2022E, which are now broadly in line with consensus*.

Estimated earnings per share calendar year on year growth

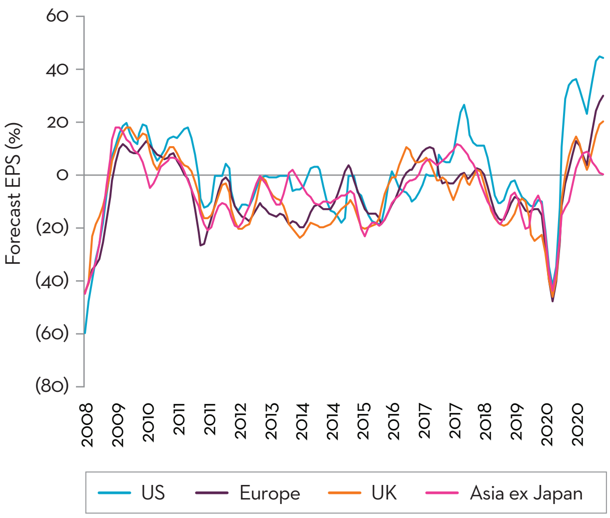
	2021	2022	2023
MSCI AC World	46%	6%	8%
MSCI AC World ex-USA	49%	5%	7%
MSCI North America	44%	7%	8%
MSCI Europe	57%	3%	6%
MSCI Europe ex UK	51%	3%	7%
MSCI UK	83%	1%	3%
MSCI AC Asia Pacific ex Japan	31%	8%	12%
MSCI AC Asia ex Japan	34%	9%	10%
MSCI Japan	47%	12%	7%

*Source: Martin Currie and FactSet as at 6 December 2021.

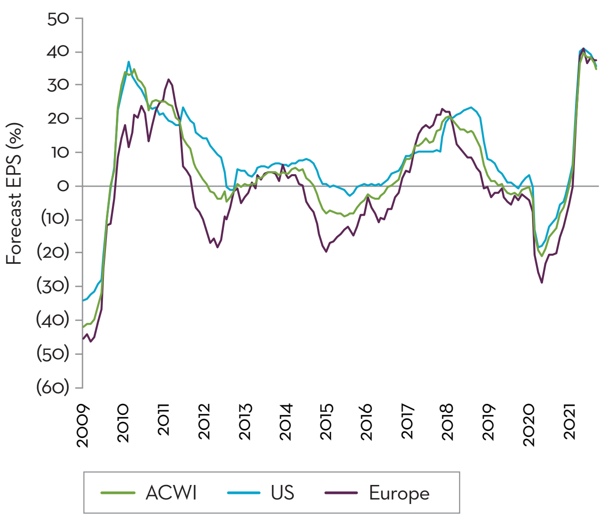
We are focusing on companies with earnings support and consistent growth profiles

Given the lower earnings growth expected in 2022 and 2023 we believe that companies with steady, consistent, and superior earnings growth profiles will constitute an attractive area for investors. Additional downside risks to earnings could come from rising corporate tax rates, which remains a likely scenario in our view, given the need to part fund what have been highly expansionary fiscal policies since the Covid crisis began. Our estimates for the corporates that we cover already anticipate a three-percentage point increase in corporate tax rates worldwide. Further downside risk could come from stronger and longer lasting inflationary pressures compressing corporate margins. This could be exacerbated by the economic impact of the disruption from the Omicron variant.

Earnings momentum



Forecast Earnings per share growth NTM



Source: FactSet and MSCI as at 30 November 2021.

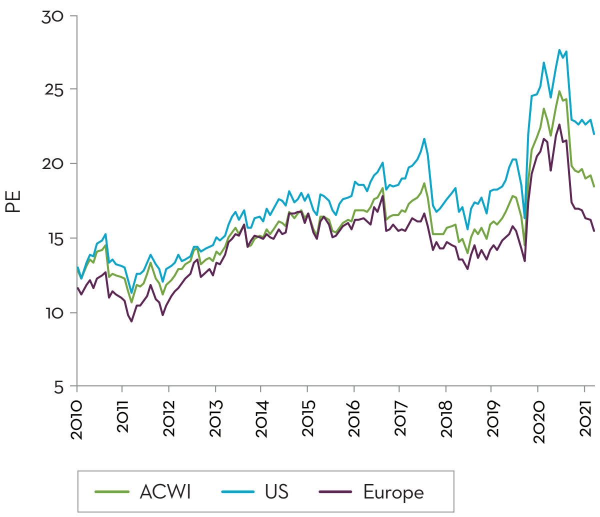
Pricing power will become a key differentiator between companies in 2022, as margin downside pressure increases on companies with weak pricing power

With inflationary pressure having built up with more speed and magnitude than expected in 2021, we believe risks are building on corporate margins in 2022 in a way not that apparent in 2021. Indeed, with the cyclical recovery coming through stronger than expected in 2021, a large proportion of companies have been able to compensate for the underlying margin pressure with the help of the operational leverage from a faster recovery in revenues. As revenue growth in 2022 moderates we are expecting operational leverage will not be there to help absorb the margin pressures coming from rising input costs and higher wages. This will be particularly acute in some sectors employing low-skilled labour where wage inflation pressures are highest. We therefore predict that 2022 will see more differentiation between corporates with genuine pricing power, which will be able to protect their margins, and corporates which lack pricing power and that will face margin pressure. In this environment, stock picking focused on strong franchises will be an important focal point.

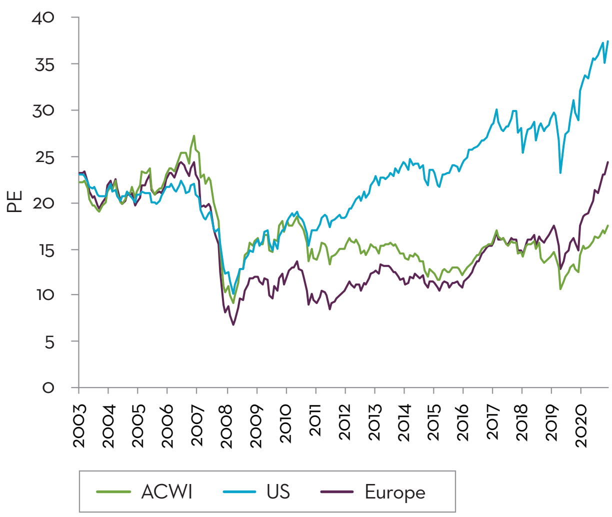
Valuations are less supportive versus history but still attractive against bond yields, stock picking and a valuation discipline will be paramount

Given the strong equity market returns in 2021 equity valuations are less supportive than historic levels, as we enter 2022. Based on cyclically adjusted price earnings (PE), Asian equities appear to have the most support, followed by EU equities, whilst US equity valuations are more demanding. However, equity valuations are generally still attractive in terms of earnings yields versus bond yields. We remain positive on equity markets globally, although expect a lower return potential in 2022 for equity investors. Importantly a focus on stock picking and valuation discipline will be critical for investors, given the more elevated valuation levels. In terms of style leadership, the growth versus value valuation spread remains elevated, which could lead to more style volatility, notably as monetary policies transition from accommodative to normalised. Earnings growth consistency and positive momentum, however in a lower earnings growth environment, will be an important driver of leadership in our view, as explained earlier.

Forward PE (FY1) of given markets



Shiller PE



Source: FactSet and MSCI as at 30 November 2021.

> We remain positive on equity markets globally, although expect a lower return potential in 2022 for equity investors. Importantly a focus on stock picking and valuation discipline will be critical for investors, given the more elevated valuation levels.

Investors should expect higher volatility from markets in 2022

Given the transitioning monetary policies towards normalization this could lead to movement in yield curves. We expect to see higher volatility in the markets depending on whether the market views that central banks are over tightening or still being too loose given the higher inflationary pressures.

In addition to fiscal policies becoming less supportive, further volatility could arise from the ongoing execution risk on some of the announced infrastructure programmes. Supply chain bottlenecks and logistical disruptions could further fuel frictional inflationary pressures, which have the potential to bring additional volatility. The Omicron variant could lead to a disruption in economic momentum, which would also bring more volatility across markets. Geopolitical risks that we discussed earlier could further fuel volatility. Finally, valuation levels being less supportive can also make markets more volatile. All of these factors combined lead us to conclude that a period of higher volatility in equity markets is ahead.

Sustainability will remain an area of focus in the post pandemic recovery with higher costs and higher investment

In the same way as we predicted an increased focus on sustainability in 2021, we believe that 2022, coming on the heels of the COP26 summit, will see an ongoing trend towards more sustainability by corporates, investors, policy makers and society as a whole. This will be fueled by the ongoing need to deliver on the ambitious and necessary net zero targets. As the focus on sustainability continues to sharpen, it will bring with it higher operating costs for corporates, a higher regulatory burden in some industries (notably the most polluting and high carbon emitting areas) and potentially some higher tax structures related to carbon emissions. It will also bring a higher level of investments into greener initiatives and solutions. This ongoing increased investment in climate solutions is likely to drive positive momentum to innovation, opening opportunities for long term investors. At the same time, it will be important to stay disciplined as investors, in order to avoid over-inflated thematic bubbles that could form in these periods of increased investment in specific areas.

Thematic opportunities remain plentiful in a world transitioning towards sustainability

As long-term investors, we believe we are facing an exciting period of increased investment opportunities and strong innovation. A world transitioning towards a more sustainable approach to operating brings opportunities notably in the below areas:

- Green energy
- High speed railway
- Electric vehicles
- Healthcare infrastructure
- 5G telephony
- Cloud computing & cyber security
- Robotics & automation
- Quantum computing

> As long-term investors, we believe we are facing an exciting period of increased investment opportunities and strong innovation.

Several identified above specifically relate to infrastructure and are supported by the sizeable infrastructure spending initiatives that have been unveiled since the pandemic crisis. Some of these are yet to be deployed in any meaningful way. As ever, a structured and disciplined valuation approach in assessing these thematic areas of structural growth will be key to finding attractive opportunities.

AN EVER MORE DISRUPTIVE DECADE CONTINUES TO AFFIRM ITSELF

With the ongoing focus on investing for a world transitioning towards net-zero, innovation rates are likely to continue to increase. With this increase, we expect a continued rise in the disruption risk to traditional businesses. For long term investors, this opens up areas of opportunity, but it also highlights the need to be vigilant in terms of disruption risk, and to ensure disruption risk is assessed in a detailed and structured analytical approach. Equally important is the ability for companies to remain innovative, to both fend off competitive pressures, and to stay ahead of the disruptive trends that could challenge their market positioning.

Potential risks investors need to consider for 2022

Policy mistakes around initiatives – fiscal stimuli and infrastructure initiatives are critical to supporting the economic recovery. There is therefore execution risk to these initiatives which could disappoint the market.

Monetary policies hiccup – we believe the risk on the monetary policy front is not one of acting too late, but one of acting too aggressively and reactively to the higher inflationary pressures that we are going through at the moment. If rate expectations were to increase too rapidly, we could see a rapidly flattening yield curve, which could unsettle markets.

Tax rates increasing – we continue to predict a period of rising tax rates, as a way to part fund the expansionary fiscal policies that have been pursued to recover from the pandemic crisis. Whilst the market should be able to digest such developments, it will put downward pressure on earnings estimates.

Lower long term growth outlook – periods of increased indebtedness have tended to be followed by periods of lower growth, which therefore does not bode well for the long term growth outlook, beyond the current cycle.

Style rotations could remain omnipresent – whilst we expect less violent swings in styles, as monetary policies move firmly into normalising mode, there will still be periods of rotations that could unnerve some investors.

Localised pandemic relapse risk – localised pandemic flare ups, and resulting temporary lockdowns could continue to disrupt both the short term economic momentum, and the supply chains, which could unnerve some investors willing to find signs of an economic cycle reaching exhaustion. We believe that these will be short-lived, and that the medium-term economic momentum remains well supported. The Omicron variant could however bring a higher pandemic relapse risk, should the variant prove to be of significant concern to healthcare authorities, and that would trigger more stringent lockdown measures globally.

Stronger and more prolonged inflationary pressures – we believe that frictional inflationary pressures should ease into the summer of 2022. A more prolonged duration of higher inflation could bring the need for more rapid interest rate increases, which would unnerve investors and could put downside pressure on market levels.

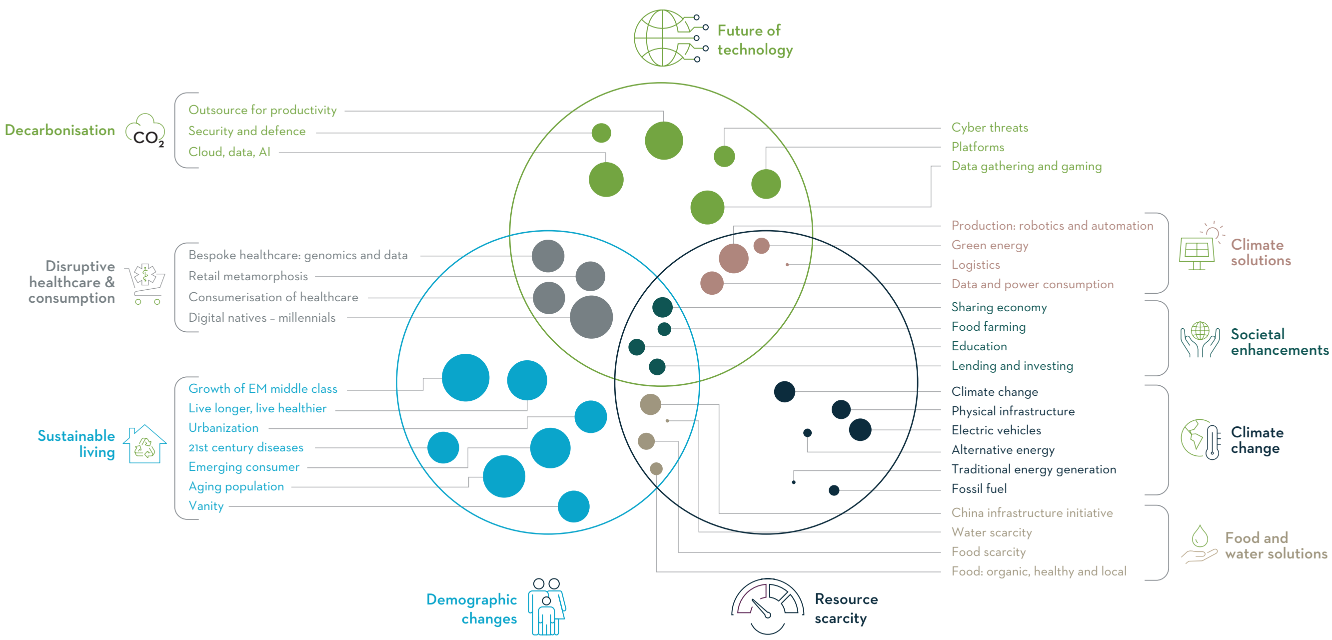
Margin pressure from higher inflation – the higher inflation period could lead to secondary effect pressures on margins in 2022, which will be more apparent than we have seen in 2021, given the lack of operational leverage in what is a lower earnings growth backdrop in 2022.

Geopolitical tensions become more open – if the geopolitical risks that we have flagged continue to simmer, we believe they should be manageable for the markets. However if tensions flare up that lead to higher risks of conflict, notably in the South China Sea, markets would come under significant pressure in our view.

Overall, given the more prolonged positive economic cycle that we predict and the ongoing low rates environment, even if monetary policies are on their way to normalising, we still see a supportive backdrop for equity markets. Given the higher equity valuations however, we expect 2022 to be a year of lower returns for investors, compared to a strong 2021. We believe monetary policy normalisation will continue to bring volatility and will maintain the bull-bear debate between growth and value. The Omicron variant may disrupt both economic momentum and monetary policies, should it lead to renewed significant lockdown measures. The lower earnings growth expectations in 2022 and margin pressure from higher frictional inflation risk emphasise the need to focus on companies with superior pricing power, lower downside margin risk and more consistent growth profiles, in our view. The increased focus on sustainability is likely to speed up innovation rates in sectors focusing on solutions, bringing some attractive opportunities but also risks to companies not able to evolve rapidly enough.

Our research continues to focus on finding undervalued companies operating in industries with high barriers to entry, and that have dominant market positions, strong pricing power and low disruption risk. They will have high structural growth prospects, and the potential to generate high returns over time, with solid balance sheets and compounding cash flows. Finally, they will also need to have a strong corporate culture, quality management and sustainable business models to be well positioned in a transitioning world.

Our three mega-trends, **(i) Demographic Changes**, **(ii) Future of Technology**, and **(iii) Resource Scarcity**, provide us with opportunities to capture the long-term structural growth themes aligned to a world transitioning towards a more sustainable future. Demographic Changes is about Sustainable Living, Future of Technology is about Decarbonisation and Resource Scarcity is about Climate Change. Within these mega-trends, there are thematic opportunities with supportive structural growth prospects, such as the eight medium-term opportunities that we have discussed.



Source: Martin Currie as at 30 November 2021. Representative Martin Currie Global Long-Term Unconstrained account shown.

Wishing our readers a happy festive season, and a healthy and prosperous new year.

Zehrid Osmani

Head of Global Long Term Unconstrained Equities and Senior Portfolio Manager

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