Elston

Elston Insights

11th January 2022

2022 outlook: key themes

- Adapting portfolios for inflation
- Income generation in a negative real yield world
- Positioning portfolios for climate transition

2021 in review

Our 2021 market roundup summarises another strong year for markets in almost all asset classes except for Bonds which remain under pressure as interest rates are expected to rise and inflation ticks up.

Listed private equity (shares in private equity managers) performed best at +43.08%yy in GBP terms. US was the best performing region at +30.06%.

Real asset exposures, such as Water, Commodities and Timber continued to rally in face of rising inflation risk, returning +32.81%, +28.22% and +17.66% respectively.

2022 outlook

We are continuing in this "curiouser, through-the-looking glass" world. Traditionally you bought bonds for income, and equity for risk. Now it's the other way round.

Only equities provide income yields that have the potential to keep ahead of inflation. Bonds carry increasing risk of loss in real terms as inflation and interest rates rise.

Real yields, which are bond yields less the inflation rate, are negative making traditional Bonds which aren't linked to inflation highly unattractive. Bonds that are linked to inflation are highly sensitive to rising interest rates (called duration risk), so are not attractive either.

How to navigate markets in this context?

The big three themes for the year ahead are, in our view:

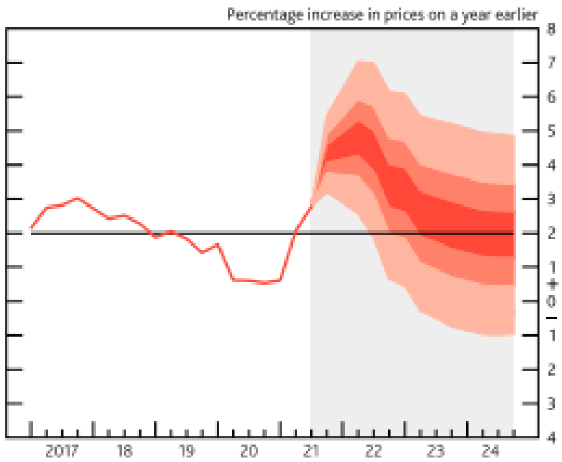
1. Adapting portfolios for inflation
2. Income generation in a negative real yield world
3. Positioning portfolios for climate transition

We explore each in turn, as well as reviewing updated Capital Market Assumptions for expected returns from different asset classes.

1. Adapting portfolios for inflation

The UK may pass peak inflation ~6% in coming months, afterwhich it should moderate, but will likely remain higher than pre pandemic levels.

Fig.1. Potential paths for UK inflation from 2022



The fan chart depicts the probability of various outcomes for CPI inflation in the future. It has been conditioned on the assumptions in **Table 1.A** footnote (b). If economic circumstances identical to today's were to prevail on 100 occasions, the MPC's best collective judgement is that inflation in any particular quarter would lie within the darkest central band on only 30 of those occasions. The fan chart is constructed so that outturns of inflation are also expected to lie within each pair of the lighter red areas on 30 occasions. In any particular quarter of the forecast period, inflation is therefore expected to lie somewhere within the fans on 90 out of 100 occasions. And on the remaining 10 out of 100 occasions inflation can fall anywhere outside the red area of the fan chart. Over the forecast period, this has been depicted by the light grey background. See the box on pages 48–49 of the May 2002 *Inflation Report* for a fuller description of the fan chart and what it represents.

Source: Bank of England

The rising cost of living as inflation surges is all too apparent and it will get worse in coming months before it starts getting better. Investors need to consider how to adapt portfolios to be inflation-resilient. Aside from inflation-linked bonds which carry duration risk, we explore two other focus areas:

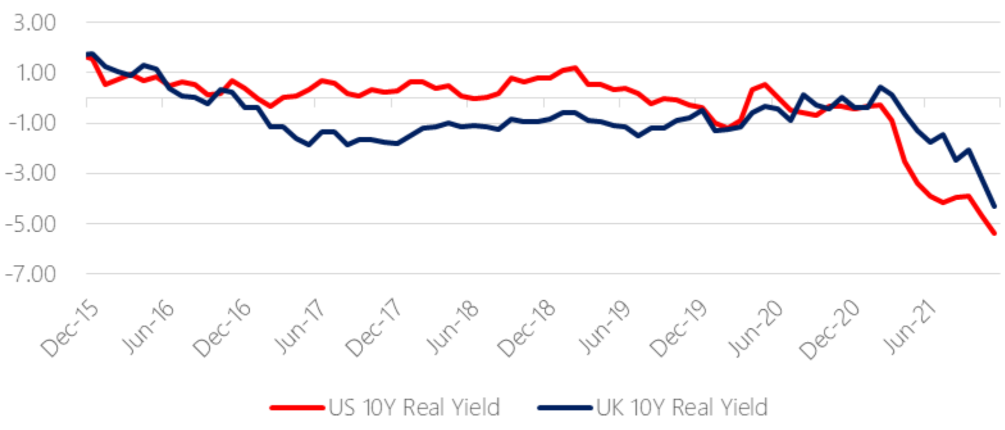
a) liquid real assets: a ready-made basket of assets that are driving or resistant to inflation, such as property, infrastructure, commodities, water, timber, industrial metals and more.
b) value-biased equities that have been out of fashion since the financial crisis and are making a come-back because of their cash generative ability: the so-called "rotation" trade, and it still has room to run, in our view.

Both real assets and value-factor equities tend to outperform during higher inflationary regimes.

2. Reality gap: Income generation in a negative real yield world

Generating income against negative real yields is a challenge. It's hard to create income yield from bonds when there isn't any available in traditional fixed income. In real terms (adjusted for inflation), yields are negative meaning you are being asked to pay income, not generate it…

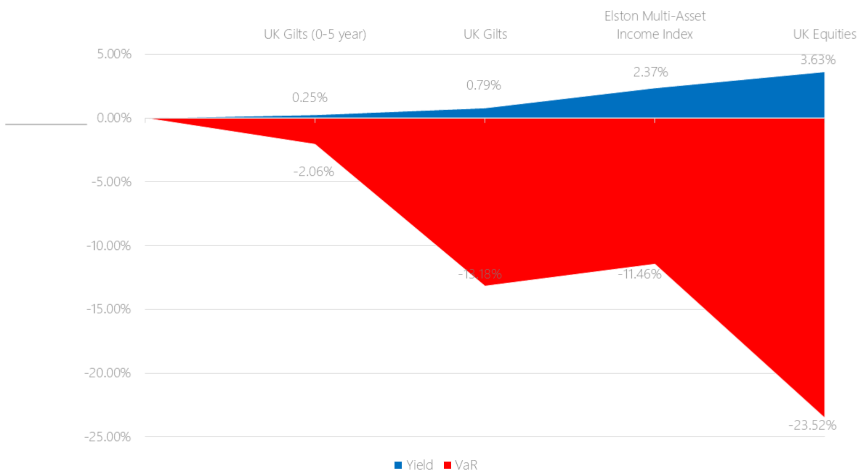
Fig.2. Negative Real Yields



Source: Elston research, Bloomberg data

In place of bonds, we see a role for Equity Income and Multi-Asset Income as alternative ways of generating an income stream, but this comes at a cost: the higher level of capital at risk.

Fig.3. Yields vs downside risk (Value at Risk)



Source: Elston research, Bloomberg data as at end Dec-21

3. Positioning portfolios for climate transition

The scale of changes to the economy, industry and energy infrastructure is colossus if we are to meet the targets that the Net Zero emissions targets that the UK Government has signed up to (Paris Agreement).

Strategies for mitigating climate risk from a portfolio perspective could include:

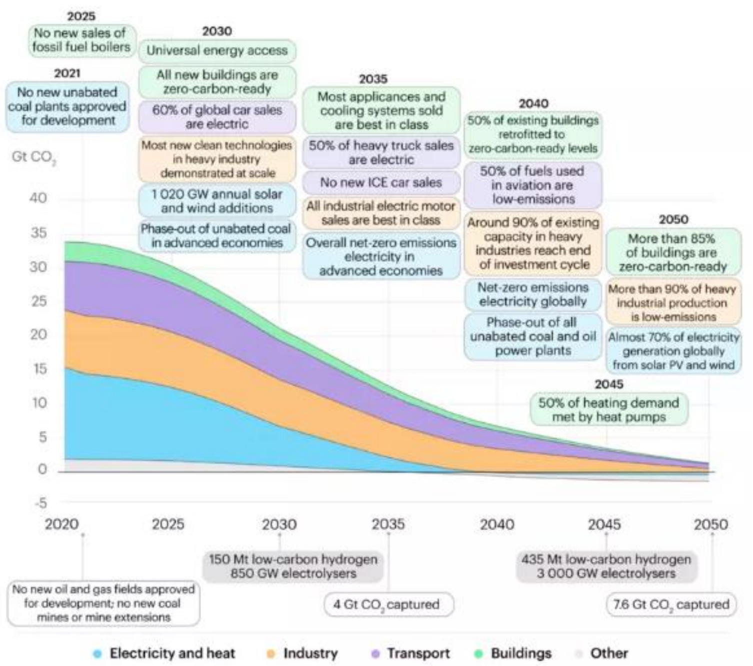
a) Reduce exposure to Carbon intensive companies;

b) Allocate to companies that are putting their business on a path to Net Zero; and

c) Enable the transition to Net Zero by companies actively enabling climate solutions.

Climate transition will prove highly disruptive between old and new technologies. This creates both risks and opportunities.

Fig.3. The path to Net Zero

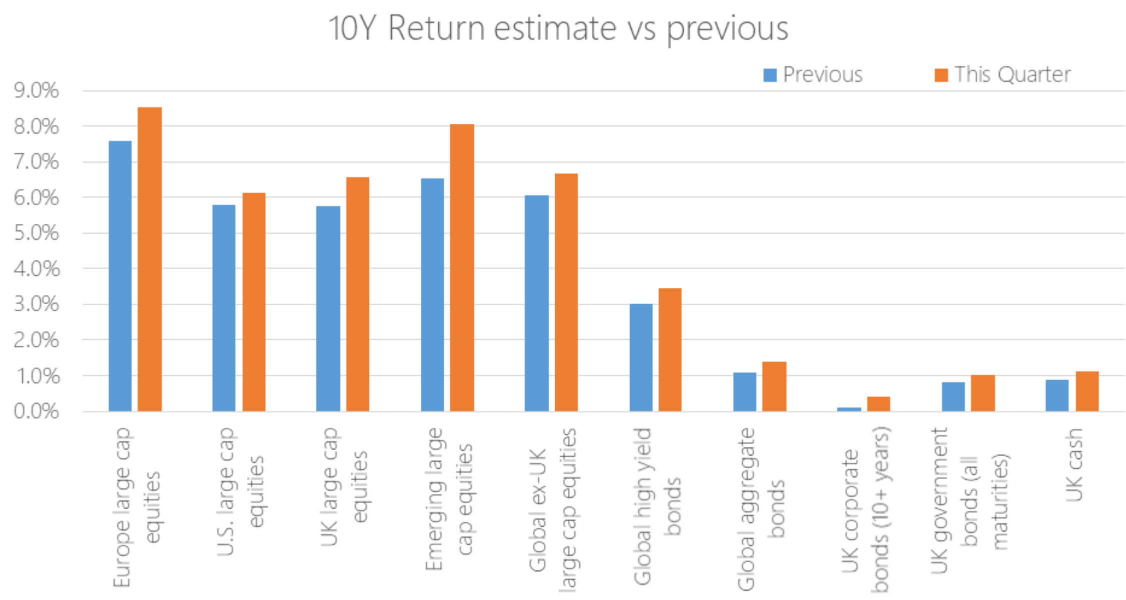


Source: IEA

Capital Market Assumptions

Capital market assumptions are a useful framework to consider forward looking expected risk and reward. Long-term (10 year) estimated returns for different asset classes – and how they have changed since last quarter, are presented below.

Fig.4. Capital Market Assumptions



Source: Elston research BlackRock Investment Institute, Capital Market Assumptions. For GBP investors, 10 year term. As at respective report dates

Summary

For our full 2022 outlook, [please join us on Wednesday 26th January at 10.30am for our 4q21 Review & 2022 Outlook webinar].

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