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Nikko Asset Management

FOR INSTITUTIONAL INVESTORS ONLY

Investment OUTLOOK 2022

Our investment teams across asset classes and geographical regions present their views on the outlook for the year ahead

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Global Investment Committee's
2022 Outlook

Positive for Risk Assets

By John Vail, Chief Global Strategist

According to our Global Investment Committee, which concentrates on the intermediate term-view regarding developed markets for pension funds and other long-term investors, 2022 looks to be a challenging, but positive year for risk assets. We believe that the G-3 central banks will become more hawkish, and such pivots can often cause potholes and at the very least headwinds, but we trust that policymakers can traverse their new course successfully overall. With the main point being that even if they tighten somewhat more than commonly expected, they will remain very accommodative and should not prevent the global economy, and thus, corporate profits, from growing firmly ahead.

> Of course, the virus remains a constant threat, but risk markets will not likely over-react to such unless lockdowns become widespread

which we think can be avoided now that vaccines can alleviate much of the danger. Thus, the greatest risks could well be geopolitical ones. We admit to "crossing our fingers" about such risks, believing, as we nearly always have over the past decade, that countries usually avoid crisis behaviour and concentrate on the welfare of their economies; however, the situations in the Ukraine, Iran and to a somewhat lesser extent, issues involving China, are now more dangerous than ever.

Meanwhile, we continue to expect the US to enact a moderate fiscal package in 2022, with Europe and Japan also increasing fiscal stimulus, which will be quite powerful for GDP growth. For Europe and Japan in particular, deep consumer fears shifting toward optimism should be particularly pronounced, with business confidence also boosting capex to a large degree, especially to solve supply chain issues and improve climate-related mandates. Moreover, Japan's economy should, in particular, benefit greatly from continued global tech demand and a rebound from hampered auto production. However, due to electricity rationing/pollution curtailment in China through the end of the Paralympics in March, we expect that country to remain challenged for a while. As for specific forecasts, GDP for the US, Eurozone, Japan and China should approximate consensus growth of 3.9%, 4.2%, 2.6% and 4.7%, respectively, in CY22, but these numbers are, of course, boosted by low base effects. Consensus for China is actually a bit higher than our forecast, but such includes many stale estimates (with the trend clearly falling in recent weeks) and the major global brokerage houses' estimates are closer to our forecast.

Over the year ahead, we expect that China will be able to wade through the current troubles, although it will continue to be quite rocky at times. The country has changed direction and such transitions can be very difficult, although often rewarding. Clearly, the real estate industry could not continue to be relied upon to provide rapid economic growth forever. Decreasing the gearing-risk of the property companies certainly makes sense, as it will curtail overall financial industry risks, but such will create additional potholes in what is an extremely opaque and complicated, yet important system. The leadership there likely wishes they had started these efforts earlier, but this process has been years in the making and they seem intent on maintaining the course, confident that they can prevent systemic risk and a major negative wealth effect by consumers and corporations. A key question is whether a large number of vacant apartments will be either rented out or sold. Although the former would reduce rents, matching the common prosperity theme (and coupled with a major government drive to build rental housing), the latter might depress property prices too much. Meanwhile, the regulatory crackdown on various sectors aims to reduce inequality and veer the culture away from trendy (usually foreign, including Asian) and gaming cultures. Growth in the social media sphere will be moderately curtailed for an indefinite period, but will still likely grow nonetheless. Meanwhile, China is promoting super-high technology fields so as to achieve self-sufficiency in semiconductor production equipment (which will be extremely difficult, as no country has ever achieved such).

> It will also seek to boost other areas where it already has achieved prowess like AI, systems integration and the medical industry.

It will also likely try to keep as much foreign business involvement as possible (as long as such does not get political), as such will be needed to support the economy.

Meanwhile, global inflation should remain stubborn in the months ahead at even higher YoY levels, and with commodity prices, excluding oil, rising moderately further, but after the 1Q, global inflation should decelerate. As for our Brent forecast, we expect it to return to USD 71 in June and USD 72 in December, but clearly the Iran question looms large, both geopolitically and as regards global oil supply. Given our forecast, we expect that US headline and core CPI measures for the next two quarters will remain high on a YoY basis, although much less so, at 4.0% and 3.3%, respectively, in June (approximating consensus) and both at 2.7% in December. On a 6-month annualized rate, both should decelerate to around 2% by June. Housing rent should continue upward, but new and used car prices should decline fairly soon as production resurges. Lastly, corporations still seem to have huge pricing power and use shortages to rationalize price hikes that are higher than needed to maintain current profits, but the Biden Administration will likely criticize price hikes (or product shrinkage) and oligopolistic practices much more sharply, while keeping the pressure on OPEC to increase production. Alleviation of labour and logistical bottlenecks will also likely reduce price pressure.

Based on this backdrop, our fixed income and equity teams established targets that, once again, forecast good performance for global equities, with moderate weakness for global bonds. For bonds, given the hawkish stance of central banks and quite strong economic growth coupled with sharply reduced Fed purchases, many readers likely think our forecast of only mild increases in bond yields is too rosy, but many bond investors will likely assume that inflation will decelerate, and will also worry about virus scares, occasional disappointing economic data, geopolitical flare-ups and other problems during China's transition. For US 10-year Treasuries, we expect a gradual increase to 1.8% next December, while 10-year Bunds and 10-year JGBs should hit -0.15% and 0.15%, respectively. Regarding forex, due to continued high interest rate differentials, we expect the USD to rise gradually to 117 vs the yen, and to 1.09 vs the euro.

Given this backdrop, G-3 earnings growth should continue to be strong and boost their equities in CY22. Although "less dovish" central banks will be a headwind for investment sentiment, increased fiscal spending and the global vaccine-driven economic and corporate earnings recovery should more than offset such. Indeed, a major positive factor should be 4Q earnings announced in January and February and, if, as we expect, they exceed consensus, analysts will have little choice but to be even more enthusiastic in their CY22 forecasts (which they have been surprisingly reluctant to do so far). Thus, although PE ratios look high now, the upside to CY22 earnings estimates will likely make valuations much less expensive. One other thing to note is that EPS growth was artificially high in CY21 due to releases of bank credit reserves, which should disappear in 2022, thus making 2022 EPS growth look artificially low, but on an underlying basis, it should be very sturdy.

Aggregating our national forecasts from our base date of December 3rd, we forecast that the MSCI World Total Return Index in USD terms will rise 5.3% through March, 7.8% through June and 12.3% through next December. We expect positive returns in each major region, with Japan's the highest among the regions:

In the US, the SPX's PER on its CY21 EPS estimate is now about 22, which remains, by historical standards, very high. Its CY22 PER is also a bit high at about 20. However, there are clear reasons for such: fixed income yields are low (and bond returns should be disappointing ahead), buybacks are rebounding sharply and earnings growth should exceed the already strong consensus view. The wild valuations among some speculative stocks have moderated, which is encouraging, but remain very high. Although such will likely worsen ahead, Democrats have seemed unwilling to disturb Wall Street or to criticize corporate price hikes, likely hoping for asset revaluation to aid the economy and, thus, their political approval rating. Government intervention, especially among major tech stocks, is also likely to be a moderate headwind. In sum, we expect the SPX to rise to 4,742 (4.9% total unannualized return from our base date) at end-March, 4,831 at end-June (7.2% return) and 5,014 next December (11.9% return) from our base date.

European equities have recently underperformed those in the US in USD terms, with the weak euro being the main factor, but Europeans' confidence in their intermediate-term economic future has greatly improved. The Euro Stoxx PER, at 15.7 times CY21 EPS equates to its historical average (CY22 PER is about 14.9), and similarly to the US, we expect CY22 EPS to be revised upward. The market's high dividend yield should also continue to attract domestic and global investors. Thus, we expect the Euro Stoxx index to rise to 515 at end-December and FTSE to 7,700, which translates to a total return for MSCI Europe of 12.0% from our base date through December. As for "known unknowns," it will be interesting to see how the markets react to Germany's political shift to the Left, and how fast the ECB will need to pivot away from its ultra-dovish stance.

For Japan, despite the plunge in COVID-19 cases and deaths, the rebound in consumer optimism was lower in late 2021 than expected, but looks to rally ahead despite concerns about new variants and the upcoming flu season. The auto sector, which is a major portion of the stock market and economy, has suffered more production troubles than anticipated, but the situation has already sharply improved and should continue to do so greatly after November. Furthermore, Japan has low political risk and structural reform is continuing, especially in digitalisation and alternative energy, while existing and future fiscal stimulus should also boost economic growth. TOPIX's PER is now only 14.1 times its CY21 EPS consensus estimate, which is much lower than other regions, and here too, CY22 EPS estimates will likely be marked up, so its PER of 13.2 on such looks particularly attractive. Thus, we highlight Japan as a market that should outperform after its recent slumber. Other items that will boost the market are increased share buybacks, strong global GDP growth and the significant alleviation of component shortages in auto and tech production. Notably, the market's dividend yield, at 2.1%, remains attractive, even by global standards. Indeed, we expect domestic investors to return to the equity market in large fashion, based upon dividend income, and lead the TOPIX to 2,310 by next December for a total return of 16.0% from our base date. As for the Nikkei, it should hit 33,000. These returns are obviously very attractive for both Japanese and global investors.

Developed Pacific-ex Japan MSCI: clearly, this region is heavily affected by the various troubles and transitions in China. Although the Biden Administration has maintained Trump's tough actions on China, it will likely seek to retain current trade relations and accept the multipolar global construct. In fact, there is a major chance that it will eliminate some of Trump's tariffs fairly soon. However, China's recent boycott of Western firms that have expressed human rights concerns ratchets up the trade pressure, as do other tensions with global democracies, including relations with Taiwan. Australia's relations with China remain very poor, but the country is benefitting from strong global demand for commodities like metals, LNG and coal. Hong Kong's stock market, which is dominated by PRC firms, was hurt by several of China's regulatory developments, as well as Hong Kong's own troubles including the continued dearth of tourists. However, vaccines and increased global tourism will eventually help these two economies ahead. In sum, we only expect modest gains for Hong Kong over the next six months, with a much better rebound after that. Meanwhile, Australia looks very strong to us, leading to the region's MSCI index in USD terms to have a total return of 15.3% through 2022 from our base date.

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In sum, the global economy should match the consensus for strong growth, thanks to vaccinations, continued fiscal stimulus, acceptable global geopolitical conditions, and continued low interest rates despite increasingly hawkish central banks. Such, via increased corporate profits, should allow equity markets to perform very well ahead, with impressive returns in each region, particularly in Japan. Meanwhile, we expect continued poor returns for global fixed income in USD terms. In conjunction with this positive forecast, however, we will be watching geopolitical risk very closely and advise our readers to do so as well.

2022 Global
Multi Asset Outlook

Gauging long-term growth prospects

By the Multi-Asset Team

Long-term prospects for growth remain on firm footing

The year 2021 was marked by the ebb and flow of COVID-19 waves as well as rising inflation, which was partly a manifestation of supply chain bottlenecks, but also partly a function of rising demand as stimulus continued to be ample. Meanwhile, the Federal Reserve (Fed) has shifted its policy to target average inflation, meaning that it is willing to let inflation overshoot in the short term on the premise that the long-term average will fall closer to its 2% target. With inflation printing at the highest levels in 30 years, coupled with a somewhat unknown determinant of what portion is transitory, markets are left to speculate on a very uncertain path to policy normalisation.

The removal of extraordinarily easy policy is always prone to increased volatility, but the bottom line for final demand and growth is whether policy remains accommodative. It does remain accommodative, and it is likely to remain so for some time. Still, given the distortions in the rates markets, it is less clear which risk assets will pay off in the coming 12 months. The US yield curve is abnormally flat, implying a fast pace of near-term rate hikes. At the same time, low long-term rates suggest disappointing long-term growth under the same premise that the Fed will need to raise short-term rates quickly, thereby stifling growth.

Rates markets ordinarily work well for predicting imminent Fed policy changes. But current speculation is far into the future, and trying to see what's ahead in such conditions could be akin to looking into a crystal ball. Our central premise for more than a year is that long-term rates should rise. That it did in the first quarter of 2021, quite abruptly, feeding the reflation trade while punishing tech and other rich high-quality names. But after the US Treasury (UST) 10-year yield lifted from 0.91% to 1.74% in just one quarter, long-term rates lost their head of steam—trending down to 1.43% at the time of writing.

Still, we believe long-term rates should end higher before the Fed is done with their tightening cycle some time from now. Inflation looks to be less transitory than the Fed originally speculated, but it seems unrealistic to think that inflationary pressures are so endemic that it requires the Fed to deliver a crushing blow to the economy through an accelerated tightening cycle. Under this premise, the gradual rise in long-term rates should be beneficial to reflationary assets at the expense of secular growth where valuations look expensive.

A pivotal question on risk assets is what happens to the US dollar. Reflationary growth suggests a weak dollar, but if real rates in the US rise faster than in the rest of the world, this dynamic is a tailwind for the currency and a headwind to reflationary growth.

Of course, COVID-19 can change all the above, as we recently experienced—the volatility spike that closely followed the discovery of the Omicron variant was compounded by a Fed still convicted to accelerate the removal of quantitative easing. But very interestingly, this spike in volatility was not met with a concomitant lift in the dollar, which is rare. Over long time horizons, the dollar is not cheap, and it just may be stuck in a range set in 2015 after lifting over 20% due to the last Fed taper.

The bottom line is that while markets are speculating beyond normal limits of policy visibility in light of still high inflation prints mixed in with bouts of new COVID waves, the world is still learning to live with the virus and policy remains accommodative, which is supportive of risk assets. Importantly, China has turned dovish after a harsh year of regulatory crackdowns while maintaining tight policy. While finding the near-term inflection points for opportunity and risk will remain difficult, it seems the long-term prospects of growth have a reasonably firm footing.

The following are some of the key themes that we are currently monitoring for 2022:

- Path of Fed normalisation: Given the above-described challenges of rates markets perhaps going over their skis in terms of predicting future actions by the Fed, it is nevertheless important to understand the direction of rates, the dollar and ultimate impact on sentiment which can feed back into final demand. At present, we still see the Fed reducing stimulus gradually. That said, a fast step "autopilot" scenario reminiscent of Fed Chair Jerome Powell saying "we're a long way" from the neutral rate back in October 2018 when markets were beginning to crumble is a potential downside risk.

- Watch the dollar: Our long-term view is that the dollar should get weaker as global demand and growth improves, but the course to that endgame follows the uncertainty of the path to Fed normalisation. If the Fed remains firm in its resolve to remove easy policy to the extent that it threatens global demand—in effect, supporting the dollar—we suspect that the Fed would eventually back off as it did in December of 2018. Our base case is that the dollar will generally weaken, following the normalisation of global demand and growth.

- Resolution of labour market supply: Between the hesitancy to return to service-based jobs where human contact (and potential virus exposure) is a constant, and other late baby boomers opting to retire sooner, some dislocations in labour supply are bound to be lasting. If the productivity does not keep up, (yes, companies are investing, but are they investing enough?) will real wages rise to the extent that the Fed would feel compelled to tighten policy more quickly? If we learn to live with the virus and fear levels subside, extra supply can fill the gap, but this remains a critical question.

- The government response to COVID-19: We often say, "the world is learning to live with the virus", which is a euphemism for suggesting that new restrictions are generally expected to be lower than the last as people just get on with their lives. We were a bit taken aback when the discovery of Omicron with its headline-grabbing "more than 30 mutations" was enough to cause governments to restrict travel and in some cases implement local mobility restrictions, despite high vaccination rates. These actions appear less to be learning to live with the virus, but so far, our assessment is that draconian responses to any new variant will be limited.

- Geopolitics: We still believe that risk of a geopolitical flareup significantly affecting the markets is remote given the Biden administration's pragmatic approach to smoothing a path in dealing with China. Tensions are far from appeased, but likely gone are the days when a tweet can set off a firestorm of markets quickly recalibrating the extent of the potential damage. What about Russia? Ructions with Russia seem high at the moment, but the timing is inconvenient given the greater focus on China and the teetering energy crisis in Europe if all guns come blazing. While we suspect this recent crisis will find a normal resolution, it remains an important watchpoint.

- Politics: Needless to say, politics are increasingly divided in the US and in other nations. Mid-term elections are approaching in the US, and many analysts suggest that the Republican Party may regain some of its force in the House and/or the Senate as is often the case when the White House switches parties. Oddly, this dynamic is generally bullish for equity markets as efforts to bring more significant change are stymied and status quo is usually best from a market perspective.

On balance, amid significant uncertainty, we remain constructive on growth between: (1) the world learning to live with the virus as high vaccination rates outweigh the benefits of returning to restrictions on the latest variant, (2) China easing, which will lift global demand at the margin and (3) the gradual removal of easy policy where central banks are showing and are justified in remaining patient on inflationary concerns. The risk to this outlook is mainly the path of Fed policy, the normalisation of labour markets and how conducive governments are to return global sentiment to a normal path of learning to live with the virus.

Asset class outlook

Equities: The outlook for equities continues to be positive, given the still easy policy and the ongoing recovery of final demand. Still, markets are edgy, as always when the Fed's path toward removing easing policy is uncertain. This is the harder part of the cycle when equities have already returned to healthy valuations. The challenge will be finding the appropriate exposures depending on the pace of reflation and the direction of rates and the dollar. However, there are opportunities that extend outside of these rote mechanics—including in China equities. Given the tight policies in China—regulatorily, fiscally and monetarily—easing at the margin is a big plus in light of attractive valuations.

Sovereign bonds: In the developed market space, bonds still look expensive given our projections on growth and the more likely higher terminal cash rate as the Fed begins to lift rates. We like China bonds, particularly given the shift to easing there. We also like emerging market local currency bonds due to the fast pace in their markets to tighten to keep up with inflationary pressures, unlike those of developed markets. The wild card here is the dollar, as dollar strength will not be kind to emerging market local currency bonds. Even so, we like the risk-return payoff, and we stand ready to hedge currency risk if the dollar returns to strength.

Credit: Global credit usually makes sense when policy is still easy and growth is improving. The spread is tight, so the relative attractiveness of the asset class is less than it was in 2020, but the trade still makes sense until policy and/or demand looks tight. Of course, given the policy uncertainty and the relative tightness in spreads, volatility for this asset class is also likely to be elevated through the policy normalisation process.

Commodities: The asset class is a natural hedge to inflation risk, while also benefiting from improving demand. Performance over 2021 has been clouded by relatively tight China policy and bouts of dollar strength. Looking forward, easing in China is a tailwind for commodities, albeit not with the same strength as more aggressive easing campaigns in the past. The direction of the dollar is less certain but given our long-term bearish view on the dollar and improving global demand, we remain bullish to commodities.

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We maintain a constructive view of risk assets but are cognizant that the path toward realising gains will be more delicate as we traverse the course of the Fed and other central banks removing their easy policies. The dollar should ultimately weaken given its still relatively rich valuations and the return of global demand, but its course is likely to be wobbly, adding to periodic risk off pressures. We prefer China bonds for their superior yield and defensive characteristics, particularly as the People's Bank of China begins to ease. We also like emerging market local currency bonds for their attractive yields and advanced state of tightening, but with the recognition that bouts of a strong dollar might require hedging. Credit is still interesting for the yield pick-up but less so for spread compression. Commodities also look attractive for their inflation hedging characteristics and positive beta to China easing and returning global demand.

2022 Global
Equity Outlook

Disruption sharpens the focus on Future Quality

By the Global Equity Team

The initial discovery of the Omicron variant was met with fairly sensational reporting by some of the world's media and this fed through quickly into investor sentiment (it is ironic that "media control" is an anagram of the words Delta and Omicron). This was even before the true nature of this variant of the virus is properly understood. Our hope is that it follows most other pathogens and becomes less virulent even as it becomes more adept at spreading. It is encouraging in this regard that the case fatality rate for the Delta variant was much lower than less transmissible earlier variants.

It is probably true, however, that even if Omicron had not surfaced it was probably about time that investors were again reminded of the volatility that resides in markets, despite the mollifying impact of endless liquidity injections by central banks. The Federal Reserve (Fed) finally ditched the word transitory from their own characterisation of inflation but this does little to change the formidable challenge facing them. How does the Fed remove the liquidity injections to which investors have become so accustomed (fuelling rampant speculation in asset prices), without denting confidence too badly—with inevitable repercussions for real world economic activity?

China is ahead of the US in terms of normalising monetary policy, complemented by other central government initiatives. If they can eliminate the excesses evident in residential real estate without doing any more widespread damage, then the starting point for future economic growth should prove more sustainable, in our view. Our search for "Future Quality" companies in China is often frustrated by valuation. There are fewer quality growth Chinese companies (with proven track records of delivering high cash returns on investment). As a result, there is a scarcity premium attached to the companies that do. Hopefully a period of monetary tightening will remove some of this overvaluation.

Arguably it is easier, in our view, for a control economy like China to implement these changes, compared to countries where politicians are often motivated by prevailing popular public opinion. The problem is that the public may not always be great at thinking longer term. For instance, restricting the supply of overseas workers appeals to a cross-section of the population (and we are not saying that integration is without significant challenges). Will these restrictions really lead to greater opportunities for the local populations though? It certainly seems that there may be some short-term pain to reckon with—well before any long-term gain, in terms of broader employment opportunities for future generations.

The US Infrastructure Bill finally passed the US House of Representatives and has been seen as a huge win for anything construction related. Share prices have been very strong across the construction materials and building products sectors in anticipation. No one doubts the wisdom of spending more money on improving the crumbling US infrastructure, but it is probably fair to ask how quickly the concrete will get poured? Where will the construction workers come from that will be needed to turn these theoretical dollars into real economic activity? No one appears to care now, but they might… According to the US Bureau of Labor Statistics, there are 1.5 million construction labourers in the US. These people are not sitting at home waiting for an opportunity to work at present (not many people are, if the US unemployment rate of just over 4% is to be believed).

By way of comparison, there are three million registered nurses (RNs) in the US. The availability of RNs has been a major issue for two of our Future Quality companies in recent months (LHC Group and Encompass Health). We do not believe, however, that these businesses are powerless in the face of the cost pressures facing them at present. Telehealth, increased use of (faster to train) nurse practitioners and greater use of automation will all help. This addresses an important component of Future Quality companies, their ability to adapt faster than peers to a changing environment.

The recent market volatility has forced some investors to address underperforming stocks, "If I didn't own it already, would I buy it today?" is often a useful mantra. If the answer is "no" then it is likely only a fear of admitting you got it wrong or some other emotional attachment that is making you hold on. If the answer is "yes", however, then we believe that one should be ready to take advantage of short-term factors to buy more.

We will not hide from the fact that this means tolerating underperforming shares from time to time—as long as we remain convinced about the long-term investment case. We won't hide these investments from our clients either in favour of the more comfortable conversations that come if we only talk about outperformers. We continue to believe that we do not want all of our ships sailing in the same direction. That means foregoing some short-term return for smoother, better returns over longer time periods.

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2022 Asian Equity Outlook

Well positioned to navigate tightening

By Ashwin Sanketh, Senior Portfolio Manager, Asian Equities

Summary

- We believe that Asian economies are well positioned to navigate monetary tightening in the US. Government finances are healthier, as are corporate balance sheets. Most Asian economies are digitising faster than their western peers, while consumption is set to receive a meaningful boost from economic reopening.

- In China we prefer domestically focused quality companies in areas with a more favourable policy backdrop, such as the environment, industrial upgrade and innovative healthcare. In India, areas such as healthcare, the new economy, private sector banks and real estate appear attractive.

- Within South Korea and Taiwan, we see opportunities in integrated circuit design, software, clean technology, content creation and industrial automation.

- As for the ASEAN region, we favour Indonesia and the Philippines, and believe that the ongoing reconfiguration of supply chains will continue to benefit Indonesia and Vietnam.

> "When your mother asks, 'Do you want a piece of advice?' it is a mere formality. It doesn't matter if you answer yes or no. You're going to get it anyway.", said American humourist Erma Bombeck.

This piece is a bit like that.

Following a collective failure to predict the events of 2020, and modestly better success in anticipating some of the events in 2021, here is the latest instalment of our annual outlook. In 2021, I tried to read books from different genres in the hope that dabbling at the intersection of subjects would lead to epiphanies and insights that will make for a better investor. For instance, I learnt that it is apparently legal to be naked in Spain—anywhere, anytime. I also learnt that all mammals have seven cervical vertebrae i.e. bones in the neck (yes—you, the giraffe and the dolphin!). Also, that you are more likely to get a computer virus from visiting religious internet sites than adult sites. However, the crystal ball appears no less opaque; but I've elicited a few laughs and more than a few raised eyebrows at social gatherings.

I also learnt that a mega yacht exchanged hands for USD 650,000—which seems ridiculously cheap considering it has four storeys, two helipads, several lounges, a dance floor and a jacuzzi. So, what's the catch, you ask? The Metaflower, as the yacht is called, was sold by investor and developer Republic Realm in the most expensive NFT (non-fungible token) deal in the Sandbox metaverse, a virtual world built on the Ethereum blockchain. In plain-speak, it's not real!

It is hard enough to identify, understand and assess drivers of businesses and valuations IRL (an acronym for "in real life"—in case you too are a tech dinosaur), let alone attempting this in the virtual realm. But that's what the metaverse will force us to do in the coming years. It suffices, for the purposes here, to note that the metaverse is a digital universe, in every sense. For example, is a mall located on the digital equivalent of the Champs-Élysées as "valuable" as another equally large one located on the digital equivalent of Park Avenue? IRL, they're subject to different tax regimes, different interest rate environments, different cultures and different demand patterns. In the virtual world, they're more similar than they're different because the "weather" can be designed, and it will be equally easy to own/rent a "space" on virtual Champs-Élysées as it will on a virtual Park Avenue. And what really is "demand" in the early days of the metaverse? Will it be a case of "build it and they will come" or will it be a case of supply meeting existing demand?

As if that wasn't enough of a curve ball, the average half-life of a public company is about a decade (as noted by Michael Mauboussin a few years ago), implying that the investable universe is continually in flux. The eight largest stocks in the S&P 500 Index at the time of writing are also the eight largest stocks in the Nasdaq Index—all tech giants. The same is true in China, where seven of the 10 largest stocks in the MSCI country benchmark started off as tech businesses. This is as much a reflection of their dominance, as it is of the world's general shift "online". And all these companies are meaningfully different today than they were a decade ago. Morphing into "platforms", which resulted in stronger competitive moats, has now invited regulatory scrutiny, because governments are wising up to the fact that monopsony (the platform is the only buyer for all companies further up the supply chain) is just as bad as monopoly. And this is as true in the West as it is in the East.

Thus, the primary challenge facing investors—distinguishing between a company's fundamentals and the expectations implied by its market price—is growing increasingly difficult. Nonetheless, we are duty-bound to prognosticate, and prognosticate we shall.

We believe that Asian economies are well positioned to navigate monetary tightening in the US. Government finances are healthier, as are corporate balance sheets, allowing countries to calibrate their response to ground reality. Most Asian economies are digitising faster than their western peers, either because they have no choice, and/or because they have no legacy infrastructure investments to encumber them. Digitisation is deflationary; it also boosts productivity. Consumption is set to receive a meaningful boost from economic reopening even as a demand rebound in the West is supportive of Asian goods exports. As things stand, real rates are expected to remain at low levels in the US compared to those in Asia through 2022, pointing towards stable foreign exchange rates—historically another headwind for USD returns in "risky" Asian equities. Markets in the region are attractively valued compared to developed peers relative to the growth they offer. Foreign ownership is also at decade lows.

Citizen Kane?

Recently, US Commerce Secretary Gina Raimondo stated that the US wanted to slow down China's rate of innovation by working "with…European allies to deny China the most advanced technology so that they cannot catch up in critical areas like semiconductors". Also, China imports more than two thirds of its energy needs via oil and natural gas imports. To reduce external dependency, the Chinese government has decided to develop the requisite intellectual property and energy resources domestically. However, this requires investment and time, translating to slower, albeit better quality, growth in the coming years. To make that more palatable for the population, while ensuring a third term as president, Premier Xi Jinping has put forth an agenda of "common prosperity"; that it is a phrase that was used by Mao Zedong in the 1950s, and Deng Xiaoping in the 1980s, is telling.

Citizen Kane, hailed as one of the greatest pieces of cinema to come from Hollywood, is at once a metaphor for isolationism (evidently, a successful one!), and an example of the nexus of media and politics with one influencing the other. Both, or perhaps neither, may apply to today's China.

The move by China to tackle the three big mountains ("三座大山")—property, healthcare and education—has forced a fundamental rethink of the risk premium implicit in investing in Chinese equities. The handling of the Evergrande default is seen to have revealed the state's reluctance to condone profligacy, at the corporate level as well as by the banking sector, while instituting measures to reassure investors that reliance on excessive leverage will be penalised. Thus, we prefer domestically focused quality companies in areas with a more favourable policy backdrop, such as the environment, industrial upgrade and innovative healthcare.

That investing in the Hong Kong equity market no longer warrants a section unto itself, with the territory's market reduced to a footnote in the China section, is reflective of the realpolitik.

The Best Exotic Marigold Hotel

A comedy-drama with an ensemble cast, the Best Exotic Marigold Hotel is a tale of a group of retirees lured by promotions for the recently reconstructed Marigold Hotel in India and are surprised when they arrive to find the establishment in disarray. The characters come to terms with the past, deal with change and eventually come out happy.

Quintessentially, this is the story of investing in Indian equities—there's the lure of a better times to come ('this time will be different"), there's the realisation of ground reality (the "Hindu" rate of growth), there's change (of governments, of economic conditions, of central bankers), and there's eventually a happy outcome notwithstanding the bumpy route (~13.5% annualised USD returns over the past two decades).

This time perhaps is different after all. The ingredients for change are present in the reforms the government continues to push through. The production-linked incentive scheme introduced in November 2020 has some teeth, and gaining momentum. Earlier this year, the government also raised foreign investment limits in the insurance industry; announced plans to create an asset reconstruction company to manage bad debts of Indian state-owned banks; and revealed a new disinvestment policy that would focus on privatising state-owned enterprises in non-strategic sectors. The scrapping of retrospective taxation laws was also a step in the right direction. Should the walk follow the talk, the economy is well positioned for the next decade even if traction on these reforms isn't smooth. Thus, areas such as healthcare, the new economy, private sector banks and real estate appear attractive.

Run Lola Run

As COVID-19 has run longer than many had anticipated, it has transformed what is "normal" for work, social interaction and recreation—with digital means replacing physical means to an unprecedented (I realise this word is overused—apologies!) extent. This in turn means that technology has never been a greater part of our lives, and if early murmurings about the metaverse are anything to go by, it will be the very fabric of our lives, literally and figuratively.

That semiconductor technology, and the attendant supply chain, will be essential to making this possible is a given. The networking, computation, virtual platforms, content and hardware that this entails translates to enduring growth, and hitherto unimagined areas of application. Both Taiwan and South Korea will remain critical therein. Absent an insider in the Communist Party's Politburo, talk of China taking military action against Taiwan, the US response given President Joe Biden's reaching out to Taiwan, and the resulting fallout, are entirely in the realm of speculation—possibilities with low probabilities. Time is therefore better spent identifying companies in this ecosystem that will be invaluable regardless; we find such opportunities in integrated circuit design, software, clean technology, content creation and industrial automation.

Wag the Dog

Thailand, thanks to continual political histrionics and its poor handling of COVID-19, offers lacklustre prospects, in our view. Malaysia fares no better, for more or less same reasons.

Singapore's zero-tolerance policy vis-a-vis COVID-19 has become a case of the perfect being the enemy of the good, in our view. However, the progressive opening of the economy, albeit slowly, is a sign that there is growing acknowledgement of the economic imperative.

When Joko Widodo was first elected president of Indonesia some seven years ago, there was hope that he would usher in a new era of growth for the country. The embers of that hope had nearly fizzled out by the time the Omnibus laws were passed in 2020. Fortunately, the rise of the digital economy, no thanks to the government, has captured investor attention, as it has in the Philippines. For this reason, and notwithstanding political ennui, Indonesia and the Philippines offer attractive investment opportunities, relatively speaking. The ongoing reconfiguration of supply chains will continue to benefit Indonesia and Vietnam, in our view.

The last word...

As yet another year goes by, and various events force a re-evaluation of our outlook, it is worth remembering American writer Dale Carnegie's words, "today is the tomorrow you worried about yesterday".

Season's greetings, best wishes for 2022, and happy investing!

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2022 China Equity Outlook

Focusing on new market leaders

By Eng Teck Tan, Senior Portfolio Manager

A review of 2021

For equity investing in China, 2021 was a year of split fortunes, with multiple indices taking different paths. It was a painful year for offshore investors whose indices are predominantly determined by the MSCI China index, which had declined 18% as of November 2021. On the other hand, onshore investors focusing on stocks in the Shanghai and Shenzhen exchanges had a bumper year in relative terms.

However, by most measures, 2021 was a year of extremism. Mid-caps outperformed the large caps (CSI500 Index easily out-performed the CSI300 Index), sector factor investing (renewables and electric vehicles stocks had outsized returns) became crucial to outperformance and traditional cyclicals (property, steel and shipping) faltered after a strong start. Fortunes definitely favoured the brave who did not stick to the conventional path and moved into uncharted territories in China's different segments.

The year had begun in the aftermath of a shock government cessation of Ant Financial's IPO late in 2020, which triggered selling of Chinese internet stocks. The selling was short lived and many Chinese internet stocks reached all-time highs in Q1 2021. However, investors were unprepared for the government's attempt to balance social goals and economic growth. The resulting implementation of numerous regulations was targeted towards not only the digital economy but also what China feels are the cause of some social ills: the "Three Mountains" of high costs in education, healthcare and property prices.

We believe that investors had definitely underestimated China's determination towards curbing monopolistic behaviours within the digital economy, protecting data privacy and upholding social commitments. The MSCI China Index (which has more than 40% of its components in internet stocks) was among the worst performing indices globally at one stage, while the predominantly internet focused NASDAQ Golden Dragon Index experienced an even steeper decline. The government was also much more focused on trying to bring down leverage across the corporate sector with significant focus on the property sector. Economic growth has lost significant momentum due to these measures with Q3 2021 GDP slowing down to 4.9% from 7.9% in Q2. Economic data has been mixed as well, with strong exports growth being mitigated by mediocre consumption figures while infrastructure spending was stable.

In the start of 2021, there were hopes that China-US relations would become more cordial after Joe Biden took over the US presidency. Minor progress appears to have been made since Biden came into power but tensions still linger. Huawei CFO Meng Wanzhou did return to China, but Sino-US relations didn't exactly warm as Xinjiang and Hong Kong continued to dominate headlines while Washington added more Chinese technology companies into its restricted trading list. Issues over Taiwan as well as Chinese companies listed in US are also sources of tension. Taiwan remained a hot topic as China repeatedly warned Taipei not to push the independence agenda; Chinese companies could be delisted in the US unless both US and Chinese regulators can reach a compromise over access to the listed companies' audit records. These issues are likely to remain contentious for years to come.

Is China still investable?
A resounding yes

With a flurry of negative headlines dominating in 2021, investors were constantly questioning whether China is still investable. We would like to highlight a few important points in this debate. Firstly, every two to five years, this question emerges whenever China is viewed negatively. Investors seem to constantly neglect the fact that China, despite its massive size, is still an emerging economy that is constantly evolving. The government is also constantly implementing reforms. However, history has shown that investing when the negatives are overwhelming has been extremely rewarding, such as during the anti-corruption campaign in 2014, the trading suspension scandal during 2015-2016 and the China-US trade war in 2019.

Secondly, it is important to note that China tends to initiate reform, implement regulations and fix economic glitches (in the current case high property leverage) when the country is in a position of strength. The economy has been relatively strong since China recovered from the COVID-19 pandemic earlier than other countries. Employment has been robust and exports are at its strongest ever. Such supportive factors allow China to fix what they view as potential headwinds to future growth.

Thirdly, in term of investing, investors tend to forget that China's market leaders change every five to eight years, sometimes even earlier. Telecom was the dominant sector (more than 50% of indices) in the early 2000s, subsequently taken over by the banking and commodities sector in the mid-2000s followed by the consumer sector in the early 2010s. And since 2015, the internet sector has dominated every investor benchmark and portfolio. As such, the internet sector has been an easy win for the last five years and investors may have become complacent, neglecting their search for other winners. The internet sector could be peaking but there are still many growing sectors worth investing in China, in our view.

Onshore stocks, and focusing on the right indices and sectors will be key

Our current view is that China continues to have very attractive investment opportunities. But we believe that onshore stocks and focusing on the right indices sectors are the key to outperformance and significant alpha.

Investors in China with the flexibility to position their portfolios generated significant alpha in 2021. Onshore stocks have significantly outperformed offshore stocks and we believe that their outperformance will continue. Onshore stocks have much more structural growth sectors that are expected to drive China's economy in the next decade. Together with domestic investing merits (such as household portfolio allocation and low penetration of mutual funds) we expect onshore stocks to eventually dominate the portfolios of those investing in China.

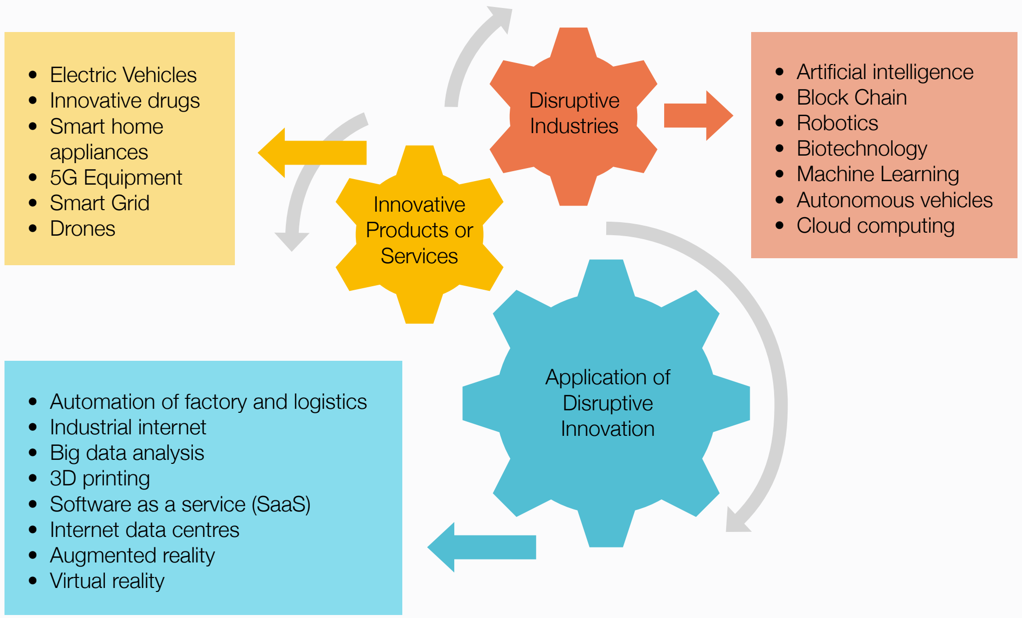
As we have been advocating for many years now, the right indices are also important in determining investor portfolios. In our view, an index that has a more favourable tilt towards onshore and mid-caps is a good way to pivot for investors who want to invest in China. Generally, offshore China indices tend to be dominated by one or two sectors while onshore indices are more diversified due to the size of the markets. For example, the market cap for onshore China indices is in excess of USD 10 trillion, spread over more than 4,000 companies; on the other hand, the market cap for offshore China indices is only USD 2.5 trillion, spread over approximately 1,000 investable companies. As new market leaders emerge in China, the indices comprised mostly of the old market leaders might languish until the new leadership stocks (which currently represent less than 10% of indices) catch up.

Lastly we maintain our view that focusing on the right sectors is crucial for investing in China. The Chinese economy has reached a size in which the quality of growth, rather than the scale of growth, will be in much greater focus. As a result, significant fine tuning will be required when it comes to capital allocation. This will mean that certain sectors will benefit from China's growth while others end up suffering. Sectoral allocation and subsequent stock picking within sectors will be key to generating the required alpha, in our view.

Structural growth sectors

As negative headlines dominated 2021, investors may have largely overlooked the significant number of positive developments in China. The Chinese government has released many positive directives indicating their vision of the economy. These included initiatives directed towards ambitious renewables targets, the continued opening up of the financial sectors and support for a significant number of industries including, but not limited to, artificial intelligence, big data, software, electric vehicles, robotics, 5G and smart grid. We believe these areas could become the new leaders of China's capital markets, representing investment themes for the next several decades. Our investment thesis is summarised in Chart 1. We also believed that China's significant advantage in manufacturing (the country already accounts for roughly 19% of global manufacturing output, an all-time high) can be further enhanced as it leverages technology and automation to cement its dominant position in new industries while consolidating its market leadership in old industries.

Chart 1: Our investment thesis for China



Thematic	• Supply chain benefits i.e., Shein • Guochao (国潮) i.e., nationalism brands • Amazon platform / exports • 4th Industrial revolution
Carbon Neutrality	• Renewables • Manufacturing process reengineering • New sources of energy • Emission trading
Hardware	• Semiconductors • Advanced manufacturing • Automation • Components

Government pivot also a focal point

Even though "common prosperity" has been effectively enshrined in Chinese Communist Party philosophy (or mission statement), the term probably escaped most investors prior to 2021. As investors get around the concept of "common prosperity" and how it will affect the capital markets, it is important to know that China is not going backwards in term of economic development. What the country is seen trying to achieve is balancing economic growth and social stability. This includes keeping corporate profits and employee welfare on an even keel, allocating capital towards more social goods and increasing labour's GDP share. This is an important philosophy to watch as government policies are likely to be geared towards achieving these goals instead of focusing on the growth at all cost objective. Although the objectives are very broad and difficult to quantify, we believe that if well executed, they could lead to a slower but higher quality, longer lasting growth for China. In the long run, China could be positioned towards gaining a better diversified economic structure.

Risks

China's outlook may appear favourable thanks to its well-executed manufacturing capability and the government's efforts to navigate the economy towards more sustainable long-term growth. However, it is hard to imagine a China investment thesis without any risks.

At the top of the list of potential risks is how is China going to reopen to the rest of the world as it continues to pursue its zero-COVID policy. Most countries are adopting a strategy of living with COVID-19 while China is adamant towards sticking to its zero-COVID stance. This presents a problem as China shouldn't, and wouldn't, be able to continue shutting itself off to the rest of the world without economic consequences. We are mindful that if China does reopen, the country might experience sharp short-term pain.

Another risk is geopolitics, which remains an element with the biggest uncertainty. Events related to Taiwan have repeatedly become a hot topic for investors as a potential conflict between Taipei and Beijing might end up involving the rest of the world. Our base case continues to be that as long as Taiwan avoids a blatant move towards independence, China is likely to stick to its current response.

The third risk factor for the capital markets is the upcoming 20th National Congress in Q4 2022. With such an important event coming up, the government is likely to accelerate its 14th five-year plan, which could be a double-edged sword. Investors will be able to look forward to a clear path of development but their enthusiasm might prove to be excessive, potentially leading to execution risks.

Lastly, the perennial property leverage issue that has been haunting China since 2011 could throw a spanner into the investment landscape. Despite the assurance by the government, the property sector still accounts for a good quarter of the economy and mismanagement in this area could lead to disastrous consequences.

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In summary, we believe that the markets in China present significant opportunities and that it is important to be very selective. Beta is challenging as the leaders which had dominated the markets for the past six years are now struggling while the next market leaders will need time before they become big enough to have an impact. It is important to be mindful of the risks but not get swayed by headlines. We retain a heavier focus on onshore stocks, structural sectors and bottom-up stock picking.

2022 Japan Equity Outlook

ESG to bring Japan to the fore

By the Japan Equity Team

Introduction

ESG initiatives are expected to become ever more important for companies and investors around the world in 2022. We expect many Japanese companies to come to the fore amid this global shift towards ESG, with enhancements in ESG disclosures shedding light on their value creation opportunities amid the current drive towards decarbonisation. Political stability that Japan may offer is another factor that is likely to come into focus in 2022. Japan's new Prime Minister Fumio Kishida will be in a position to solidify and leverage his political capital to push forward his policy agendas; he is also expected to maintain the government's key policy measures including its accord with the Bank of Japan (BOJ) and corporate governance reform. Competition to attain corporate control is also likely to continue increasing in 2022 and benefit long-term investors in Japan. We expect changing corporate culture encouraged by corporate governance reform to drive such competition, as evidenced by the growing number of hostile takeover attempts in Japan.

Climate change to expose risks as well as opportunities

COP26 in Glasgow ended in November 2021 with an ever stronger global message, calling for countries to implement measures to tackle the climate crisis. In line with the global drive towards combating climate change, the US has been reversing Trump-era policies. For example, the Department of Labor recently proposed amendments to its regulations that were perceived to have discouraged fiduciaries from considering ESG factors in their investment decisions.

As developments in the sustainability front intensify, that Japan has the highest number of supporters for the recommendations released by Task Force on Climate-related Financial Disclosures (TCFD) is perhaps a lesser known fact (Chart 1).

Chart 1: Top 5 countries by number of TCFD supporters

Japan	**527**
UK	384
US	345
Australia	125
France	117

Source: Task Force on Climate-related Financial Disclosures 2021 Status Report

The number of supporters for TCFD, together with its total global market cap coverage, has been on the rise since the launch of this initiative in 2017. There are currently 2,616 TCFD supporters with a total market cap of USD 25 trillion. We expect these numbers to only go up and it is natural to think that it would do so in Japan as well. In addition, the reorganisation of the Tokyo Stock Exchange (TSE) scheduled to take effect in April 2022 is also likely to prompt companies to increase climate disclosure. Companies to be listed on the TSE's new Prime Market as a result of the reorganisation will effectively be required to make additional corporate disclosure based on TCFD. Moreover, the Financial Services Agency is now said to be contemplating the application of this rule to the broader public equity universe. In light of these initiatives, some key companies with best practices are already starting to disclose GHG emission reduction targets they aim to reach by 2030 (Chart 2).

Chart 2: Japanese companies' GHG emission reduction targets

	Base year	Scope 1 & 2 GHG emissions	Scope 3 GHG emissions
Kirin Holdings	2019	-50%	-30%
Ajinomoto	FY2018	-50%	-24%
Hitachi	FY2010	-100%	-50%
Azbil	FY2017	-55%	-20%
Nikon	FY2013	-71.4%	-31%
Ricoh	FY2015	-63%	-40%
Asics	2015	-63%	-63%
Yamaha Motor	FY2017	-55%	-30%
Marui Group	FY2016	-80%	-35%
Fast Retailing	FY2019	-90%	-20%

Scope 1: Direct emissions from resources owned or controlled by a company
Scope 2: Indirect emissions resulting from the generation of energy purchased by a company
Scope 3: All other indirect emissions that occur in a company's value chain

Source: Nikkei

We believe that at the moment, the market is not fully pricing in risks and opportunities resulting from climate change. We therefore think that skilled active investors will have opportunities to profit from the market inefficiency as additional climate related disclosure will not only shed light on the additional risks but also on opportunities that can contribute towards creating value.

According to estimates released by Japan's Government Pension Investment Fund (GPIF), the CVaR (Climate Value-at-Risk, which measures the potential impact of climate change on corporate and security values) for Japanese equity is positive at 0.6%, compared to -11.4% for foreign equity under a scenario in which global warming is held at 1.5 degrees Celsius above pre-industrial levels. Such an outcome is a result of patent competitiveness in the automobile, energy supply and chemicals sectors. This means that collectively, there may be more opportunities than risks for Japanese companies as the world moves towards net zero.

In a different study conducted by a data analytics firm astamuse, Japanese companies dominate the ranking in decarbonising technology (Chart 3). We expect new markets to be created that leverage their advanced technologies, which include hydrogen, carbon capturing and electric vehicles; as a result, investors are expected to start pricing in these opportunities into stock prices.

Chart 3: Japanese companies dominate decarbonising technology

Rank	Company	Key technologies
1	Toyota Motor (Japan)	Fuel cell EVs, hydrogen infrastructure, EVs
2	General Electric (US)	Geologic carbon sequestration, high efficiency thermal power generation
3	Mitsubishi Heavy Industries (Japan)	CO2-absorbing materials, high efficiency thermal power generation
4	Siemens (Germany)	Hydrogen/ammonia power generation, wind power generation
5	Hyundai Motor (South Korea)	Fuel cell EVs, hydrogen infrastructure
6	Hitachi (Japan)	Industrial machinery electrification, power semiconductors
7	Toshiba (Japan)	CO2-absorbing materials, hydro power generation
8	ExxonMobil (US)	CO2-absorbing materials
9	Honda Motor (Japan)	Fuel cell EVs, hydrogen infrastructure, EVs
10	Honeywell International (US)	CFC reclamation

Source: Nikkei

Japan as a political safe haven

Former Prime Minister Yoshihide Suga resigned in October 2021 after increasing criticism towards his handling of the pandemic led to a steep drop in his approval ratings. Ironically, following Suga's departure, Japan's inoculation drive continued and the country now has the highest percentage of fully vaccinated people among G7 countries. Furthermore, the number of new COVID-19 cases in Japan has declined to the lowest level year to date as of this writing.

The Lower House election held on 31 October 2021—an event that was expected to determine the direction of Japanese politics in the wake of Suga's resignation—resulted in a victory by the ruling coalition. What is worth noting is that the ruling Liberal Democratic Party won an "absolute stable majority" which effectively allows the single party to not only gain the simple majority in the parliament itself, but also control of all sub-committees of the parliament. This enabled the Kishida-led government to put together the largest ever JPY 55.7 trillion economic stimulus package in November. The package includes financial aid for struggling businesses as well as to low income households. It also introduces more forward-looking measures such as a cash handout program to households with children, travel subsidies for the tourism industry and infrastructure spending for disaster prevention.

In 2022, another key political event, the Upper House election, is scheduled in the summer. At this election, half of the Upper House members will face re-election. In order to retain his party's dominance, Prime Minister Kishida and his cabinet are expected to try and boost economic growth ahead of the election and the first quarter GDP figures to be announced in May 2022 will be in focus (Chart 4).

January	TSE to announce companies' new market segments
February	Beijing winter Olympics
Q1	Toshiba to hold extraordinary general meeting to seek approval for spinoff plan
April	TSE reform takes effect and new markets open for trade
May	Full year earnings season for fiscal year through March 2022
May	Jan-Mar 2022 GDP release
June	Annual general meeting season
Summer	Upper House election
November	US midterm election
November	China's 20th National Party Congress

If the ruling coalition wins the Upper House election, it will dominate both houses of parliament, and it will not have to face another election through 2025. Such an election lull is expected to result in higher visibility and stability on the political front.
On the contrary, there remains much political uncertainty in the US. President Joe Biden faces the November 2022 midterm election with deep divisions not only between the Republicans and Democrats but also within the two parties. Thus, as the US gears up towards the midterm election, Japan could be viewed as a country with a relatively higher level of political stability and lower political risk.

Since Kishida took office in November, the Japanese government wasted no time in reconfirming its accord with the BOJ signed in 2013 whereby they will work together to achieve 2% inflation and sustainable growth. Therefore, monetary policy is expected to remain accommodative, which would be positive for the overall equity market. We also do not expect a reversal in corporate governance reform as the changes seen in corporate culture as a result of the reform appears irreversible for the following reasons: i). market reorganization at the Tokyo Stock Exchange and ii). growing competition for corporate control.

No going back on corporate governance reform

Firstly, the TSE is scheduled to reorganise its market segments within the bourse in April 2022. The current TSE First Section, Second Section, JASDAQ (Standard), JASDAQ (Growth) and Mothers will be reorganised into three new segments: Prime, Standard and Growth.

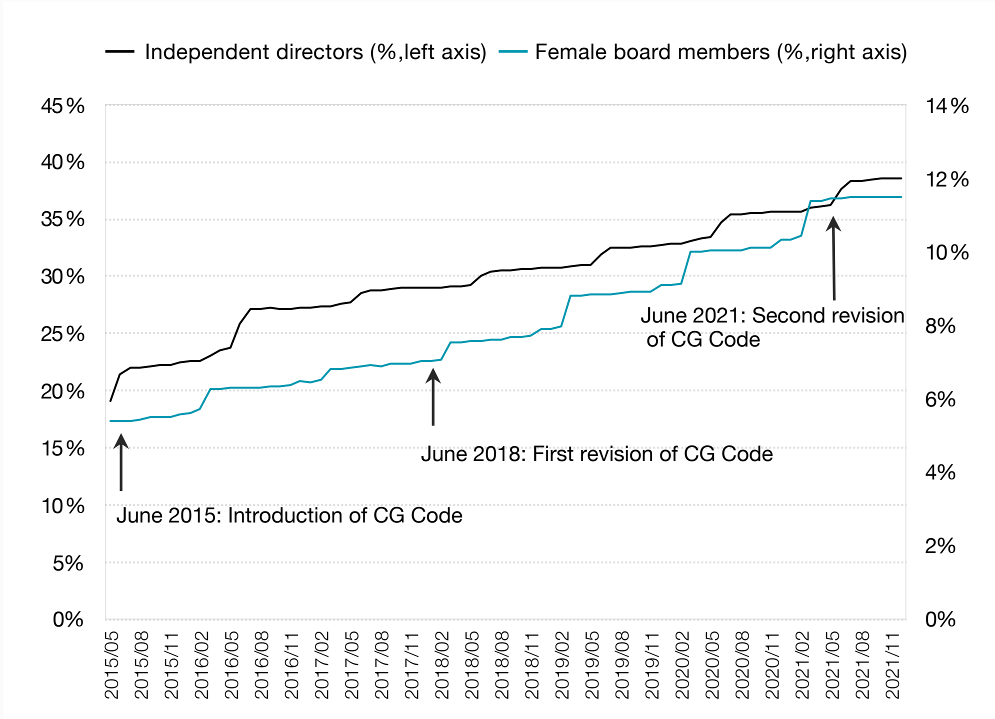
The biggest rationale behind the reform is to enhance the bourse's global competitiveness by ensuring its listed companies have incentive to continue improving their business operations, therefore leading to higher shareholder value and attracting more capital into the Japanese market.

The Prime section will be for companies that can have "constructive dialogue" with investors, the Standard section will be geared towards companies that have sufficient liquidity and possess governance levels that are high enough for investors in an open market and the Growth section will focus on companies with high growth potential.

According to the TSE, there were 664 companies (roughly one-third) on the First Section that do not meet the listing requirements for the new Prime section before they made applications in 4Q2021. These companies unable to meet the listing requirements are faced with two options: either satisfy the requirements for Prime through corporate actions or settle with Standard or Growth (or face delisting if they cannot meet requirements for any of the new markets). For a company to be listed on Prime, it must have tradable shares accounting for over 35% of shares outstanding and have a tradable market cap of over JPY 10 billion. It will also be required to increase the number of independent directors to a minimum of one-third of their board from at least two. The promotion of diversity is expected to open up old school, male-dominated boardrooms to new talent with different perspectives.

In light of these developments, an increasing number of large shareholders are already disposing their shares at the request of companies. In addition, share buybacks by companies have also picked up to ensure that they meet the TSE's new listing requirements. Management buyouts and full consolidation of listed subsidiaries have also increased—thereby unlocking value.
We have also seen a steady increase in the number of independent directors and women on company boards since the Corporate Governance (CG) Code was first introduced in 2015 (Chart 5) and we expect the trend to continue.

Chart 5: Change in the governance structure of TSE First Section companies

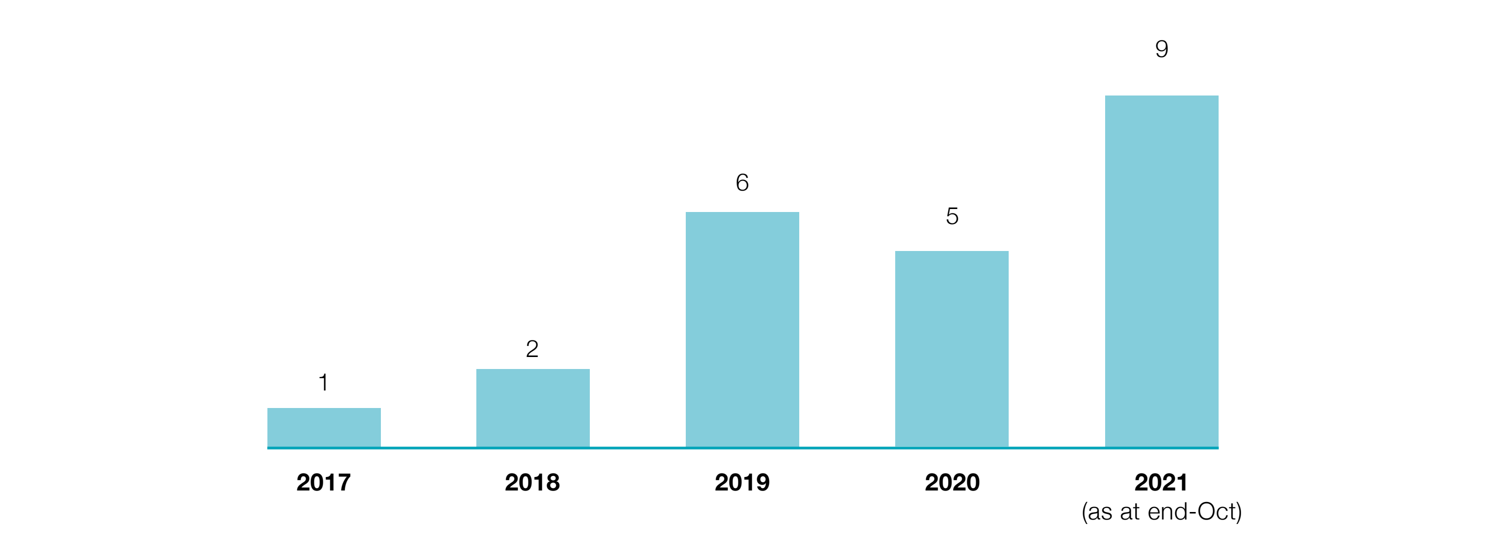


Source: QUICK

Secondly, we think that the government has clearly laid the groundwork with the comply-or-explain rule to provide a level playing field for various investors in Japan. The number of activist investors who consider Japanese market to be attractive has been on the rise (now at 44 in the market including homegrown Japanese activists) and the number of shareholder proposals is growing in tandem. Toshiba's recent announcement to split its business into three segments is also seen as a result of activist investors pressuring the company to remove its conglomerate discount.

On one hand, financial investors (activists) are trying hard to make their voices heard from the standpoint of minority investors. On the other hand, strategic investors are increasingly making proposals to acquire companies outright, often without prior consent by the target company's management teams (Chart 6).

Chart 6: Hostile takeovers are increasing



Source: IR Japan

A recent example is the showdown between online financial firm SBI Holdings and Shinsei Bank involving the first ever hostile acquisition attempt in the banking sector in Japan. In September 2021, SBI Holdings launched a tender offer for Shinsei Bank's shares in an attempt to turn the latter into its subsidiary. In order to fend off the takeover attempt, Shinsei Bank opted to use a poison pill defence and decided to put the proposal to a vote at an extraordinary shareholders' meeting in November 2021.

What is worth noting is that the Japanese government has a stake in the targeted bank (as a result of a bail out in the late 1990s) and it was widely reported that the government agency (which holds the shares) would not support the poison pill measure. We believe this sent a clear message to the capital markets that the government favours competition for corporate control and views it as beneficial for investors and society. Shinsei Bank eventually withdrew the poison pill and cancelled the extraordinary shareholders' meeting; SBI Holdings and Shinsei Bank agreed to integrate and collaborate under a new management team to be decided in early 2022.

Corporate culture in Japan is clearly changing. We view this as a positive development as it allows businesses to be left in the hands of "natural owners" to maximise shareholder value.

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Summary

We expect 2022 to be a year in which Japanese companies and their competitiveness in the sustainability front to come into focus as ESG initiatives continue to grow in importance globally. Another key focal point for 2022 is the political stability that Japan may offer. With the ruling coalition enjoying firm public support, the country could be seen as a safe haven relative to its developed market peers such as the US. Furthermore, we believe that political stability in Japan will ensure the continuation of corporate governance reform, which has been a key element in changing the country's corporate culture. Competition for corporate control could thus intensify in 2022.

2022 Singapore Equity Outlook

Focusing on sustainable growth

By Kenneth Tang, Senior Portfolio Manager, Asian Equities

Summary

- We expect the recovery theme to continue supporting the Singapore economy in 2022. We see broader growth within Singapore's key economic engines in 2022, with a sharper recovery expected in the services sector as the economy reopens.
- Interest rates are likely to rise in 2022 as we see greater pressure from macro policy tightening due to higher inflation and business costs. Inflation might not be as transitory as expected, and rising wages and business costs might pose as a policy headwind in 2022.
- As such, we see a gravitation towards companies with quality of earnings growth and potential defensive growth moats that can sustain and defend returns. With the spectre of rising inflation, we also favour stocks with strong pricing power in an inflationary environment.
- We are positive on alpha opportunities in 2022 and we believe greater bifurcation in growth will lead to opportunities in stock selection. We favour the financials, industrials, consumer and technology sectors and are more cautious on the telecommunications and property sectors.

Looking ahead to 2022

The Singapore economy is on a road to recovery. Although the economy has already rebounded sharply in 2021, we expect the recovery theme to remain intact and continue supporting the Singapore economy in 2022. We see a broadening of growth within Singapore's key economic engines in 2022, with a sharper recovery expected in the services sector as the economy reopens.

Interest rates are likely to rise in 2022 as we see greater pressure from macro policy tightening due to higher inflation and business costs. Inflation might not be as transitory as expected, and rising wages and business costs might pose as a policy headwind in 2022. With rising inflation and wage costs and slowing revenue growth momentum, the outlook for margins and corporate earnings appears more challenged in 2022. We emphasise the importance of investing in quality and sustainable growth franchises, which we believe will outperform in the current macro environment.

Equity returns could moderate from the double-digit returns achieved in 2021. We believe the opportunity in 2022 will come from stock selection and higher bifurcation opportunities in the Singapore market. We favour financials, industrials, consumer and technology sectors most while we view the telecommunications and property sectors with caution.

Singapore poised for continued recovery

Looking back, 2021 has been a good year for the Singapore equity market. The Straits Times Index (STI) returned 12.5% on a total return basis (as of 3 December 2021), which has more than reversed its loss of 8.1% in 2020. A strong revival in trade and manufacturing exports helped catalyse a sharp rebound in corporate earnings in 2021, which together with accommodative policy and attractive valuations, helped drive strong double-digit returns for the Singapore stock market and catapulted Singapore to one of Asia's top equity performers in 2021.

We expect recovery to remain a predominant theme in 2022, similar to 2021, during which the economy, equity markets and corporate earnings all recovered to the pre-COVID levels of 2019. For the year to Q3 2021, Singapore's GDP has already risen by more than 7%, which is higher than its pre-pandemic levels in 2019. What is also impressive about this recovery is that in Q3 2021, Singapore was the only ASEAN-6 economy with real GDP growth (seasonally adjusted) above its Q4 2019 level.

Looking forward, we expect economic expansion in Singapore to build on the 7% year-on-year GDP growth expected in 2021 and rise by another 3-5% year-on-year in 2022, thanks to tailwinds from the region's economies reopening and the normalisation of supply disruptions. We also expect growth in 2022 to become more balanced with services moving more in equilibrium with manufacturing. Manufacturing and export-oriented sectors, undoubtedly the stars of the economy in 2021, could see their growth momentum taper off in 2022 but should remain resilient as global demand continues to be healthy. We believe the service sector should recover and provide most of the incremental growth for the Singapore economy as we head into 2022. Wholesale retail trade, transport and storage and services could surprise positively as the country moves towards a new normal in which COVID-19 becomes endemic. Transport services, traditionally a key contributor to the Singapore economy, could be poised for a strong recovery in 2022 as the travelling resumes.

Growth and quality should start to outperform

In the recently concluded biannual macroeconomic review, the Monetary Authority of Singapore (MAS) said that it is watching closely for signs of inflation, as it sees the risk of inflation becoming more persistent as opposed to a transitory bottleneck caused by the pandemic. This also prompted the MAS to tighten its monetary policy setting in October 2021 to address the rise in consumer prices and inflationary pressure caused by supply disruptions and higher wages.

We see the risk of inflation rising further as we enter 2022. Based on the gap between consumer and producer prices, companies and corporates appear to be bearing a greater brunt of the cost pressure in prices and this could ultimately flow into consumer prices in 2022. Against this backdrop, we believe the MAS is likely to stay guarded against inflation and tighten policy when needed. As the economy gradually reopens, domestic prices pressures could further add to existing supply side pressures caused by supply chain bottlenecks. Should inflation continue to move above 2.0%, we expect the MAS will further tighten at the next April 2022 policy meeting.

Tighter policy is also likely to have an impact on equity markets. Tapering could start at the end of 2021 in the US with the Federal Reserve scaling back on asset purchases until mid-2022. Should domestic inflation be less transitory and more permanent, cost pressure on businesses will inevitably rise, and it would be prudent, in our view, to favour companies with growth and quality. Our belief is that growth and quality typically perform better during times of growth scarcity and when higher interest rates, rising cost drivers and slowing revenue momentum introduce greater uncertainty on earnings.

In 2022, we expect companies with quality and sustainable growth in returns to outperform the broader market, and prefer them over companies that rely purely on cyclical growth, momentum or value. Growth will become scarcer in 2022—investors are likely to pay more for earnings growth visibility and certainty in stock and sector selection. As such, we see a gravitation towards companies with quality of earnings growth and potential defensive growth moats that are able to sustain and defend returns. With the spectre of rising inflation, we also favour stocks with strong pricing power in an inflationary environment. Again, we expect quality and growth moats to feature well in performance during times of inflation.

The return of alpha as growth slows and policy normalises

We expect equity returns to moderate in 2022 following strong double-digit gains in 2021. This is typical when sharp economic recovery phases descend into moderate growth periods typical of a mid-cycle economic expansion. Against the backdrop of rising rates, market valuations are also looking less attractive. This could dampen overall market returns (beta) in 2022 where the market has less room for price-to-earnings expansion and more uncertainty on overall earnings growth.

We are positive on alpha opportunities in 2022 and we believe greater bifurcation in growth will lead to strong opportunities in stock selection. We also believe sectors that offer a more sustainable growth profile at reasonable valuations could attract higher valuations due to scarcity premiums. With this stronger focus on growth and returns, we prefer sectors which offer continued growth in earnings trajectory in 2022, and those that have growth buffers to offset earnings weakness. In this category, we like technology, industrials and consumer discretionary and staples where we see good potential of incremental growth in earnings revisions in 2022.

We like utilities and industrials as we see rising energy prices as a tailwind and the continued push towards sustainability investment as a growing theme. Rising oil and commodity prices should support earnings in select industrials. We also continue to have a constructive view of renewable energy opportunities and transition stories where we identify positive change in a company's sustainable returns.

We are more positive on consumer discretionary in 2022, especially in Singapore companies with exposure to the growth in ASEAN consumerisation. We expect ASEAN consumption to recover in 2022, as we believe the region is poised to play catch up and accelerate faster than most other Asian economies. We also favour consumer staples and see the sector as a good inflation hedge. Valuations are more attractive after the recent price correction and we see better relative earnings growth from higher commodity prices as we head into 2022. We particularly favour companies within the sector in which we identify distinct positive change, such as efforts to improve environmental, social and governance areas of materiality.

We also like technology hardware and see a potential re-rating in the sector once we overcome the current supply chain disruptions. Lockdowns imposed by governments and component material shortages have caused significant impact on the global supply chain, and the alleviation of these bottlenecks through government relaxation and private initiatives to improve supply chain issues should allow tech companies to ride on the broader reopening and the capex recovery in manufacturing and trade. We also believe most of the tech hardware companies in Singapore are trading at attractive valuations, from a historical perspective and also compared to their peers in the region.

We like select financials and believe banks will continue to be a beneficiary of rising interest rates. We also see banks benefitting from financing opportunities with the resumption of trade agreements in the region. While we also like communication services such as e-commerce for their attractive growth proposition in next few years, we are more cautious on their valuations. We have a cautious view of telecommunications due to more lacklustre growth prospects and are also relatively cautious on property and REITs, due to rising interest rates and a tightening liquidity environment.

Corporate restructuring in new Singapore

We remain positive on the corporate restructuring theme in Singapore. In 2022, we expect corporate restructuring beneficiaries to feature more in companies that have embraced innovation to better compete in a post-pandemic economy, as well as companies making positive transitions in their journeys towards sustainability. We believe successful execution in their respective corporate restructurings will raise the potential of overall sustainable returns and provide a re-rating in valuations.

We are more upbeat on reopening beneficiaries in 2022 and expect companies that have restructured to be well-placed for the transition to an endemic new normal. An example would be in private healthcare operators, where companies have stepped up to support government efforts to provide testing and vaccinations, even as their primary hospital business suffered. Today, this restructuring has positioned them well in Singapore's new norm of "test, trace and vaccinate", and the business for healthcare services has doubled from pre-pandemic levels. Also, vaccination rates rising to levels that allow economies in the ASEAN region to reopen borders and resume travel could mean a strong revival of foreign medical tourism in Singapore, as more foreign patients return for elective procedures and the requirements for testing drives continued growth in healthcare services.

The energy transition story in renewables also presents an exciting area of growth and transformation for Singapore Inc. We see this as particularly relevant in the industrials sector, notably in infrastructure and utilities where there are growing opportunities to invest in sustainability. We also favour companies well placed in the energy transition towards renewables, where companies have demonstrated clear and aggressive plans to grow their renewables portfolio through decarbonisation initiatives, tapped green financing and accelerated capital recycling for growth. We also see this expansion in renewable energy happening at a time when ASEAN governments are also accelerating plans to decarbonise. With good execution, we believe this could see companies improving on their sustainable returns and re-rating with higher valuation multiples.

Increased focus on dividend growth

We believe dividend investing remains relevant in a time of rising interest rates and slowing growth. Against the backdrop of growth deceleration in 2022, capital preservation and sustenance of returns will become even more important as a source of returns. We continue to be constructive in dividend investing and expect greater focus on high and rising dividend stocks in the current macro backdrop.

We believe the backdrop of rising yields would not necessarily weaken the prospects of high-yielding dividend stocks, but rather underline the importance of dividend growth. In Singapore, we also continue to find that the spread for dividend yields against bond yields remains attractive, despite rising bond yields. This spread will remain supportive for high-yielding dividend companies. The strategy in dividend investing for 2022 will increasingly focus on dividend growth rather than dividend yields, as we expect dividend growth opportunities could be scarcer amid a rising interest rate environment. As such, we see the potential for companies with high and rising dividend growth profiles to be re-rated with higher valuations during a time where broader earnings growth moderate.

We also see quality and sustainable returns featuring as a key driver of performance in dividend investing. We like selected financials, industrials and technology companies that are well positioned to deliver and increase dividends in 2022. We also see selective retail REITs and logistic REITS outperforming in 2022. We see retail REITs as a beneficiary of the reopening trade in Singapore, and logistic REITS benefitting from Singapore's rising role as a regional manufacturing hub in technology, transportation and financial services.

Key themes of recovery, rates and returns in 2022

In summary, we expect the growth story in the Singapore economy to continue into 2022, where we see a greater contribution from the recovery in the service sector. This continued recovery will also underpin growth in corporate earnings for the Singapore equity market. 2022 will also see the spectre of rising inflation and interest rates. In our opinion, we believe companies with quality and sustainable growth will outperform during a time of slowing earnings growth and rising cost pressures. Finally, against the backdrop of ebbing liquidity and policy support coupled with slowing global growth momentum, we expect overall equity market returns to moderate in 2022. However, we remain positive on alpha opportunities in Singapore. We believe the moderation of earnings growth and tighter policy headwinds will lead to greater dispersion in earnings growth across sectors and higher bifurcation in stock returns. This will favour stock pickers, in our view. We favour financials, industrials, consumer and technology sectors most in 2022.

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2022 Global Fixed Income Outlook

We present our 2022 outlook for core markets, emerging markets and global credit.
By the Global Fixed Income Team

Core markets outlook

Steven Williams, Head Portfolio Manager, Core Markets

Well as it turns out, transitory might not be a thing, with the only thing transitory being the word transitory. With the Federal Reserve (Fed) now expected to double its pace of taper in response to ballooning inflation, we would have expected the bond market to at least sell off on the news. However, the arrival of the Omicron variant brought other ideas. While preliminary data suggest this new COVID-19 variant is more virulent but less severe, we can only point to anecdotal evidence for now, and if its severity remains unchanged, we may face lockdowns in several countries and another pandemic-driven slowdown.

While we would rather likely have only inflation to deal with, this cycle has been anything but typical. We remain optimistic and think the more virulent but less severe viral path will not lead to a dramatic increase in hospitalisations (hopefully, we won't rue these words). With inflation at its highest level in 40 years and this new variant likely not to meet the fanfare, we think the Fed is going to have to accelerate its tapering program to allow itself the option of raising rates by early second quarter of 2022, though the bond market couldn't care less it seems. With the US unemployment rate fast approaching the purported full employment 3.5% level, we do think the Fed will be facing increased pressure to hike rates on multiple fronts. In short, we expect 2022 to maintain the key "covidflation" (we think this should be a thing) story with a now hawkish, rather than dovish, Fed.

The US infrastructure bill was an easy pass with bipartisan support. President Joe Biden's Build Back Better (BBB) bill is unlikely to sway the core Democrat moderates given inflation is running hot. We think any programme will likely be USD 1.5 trillion or less and that is if BBB is passed at all, which is looking unlikely at this point, maybe Biden's luck will change in 2022. We suspect the global supply chain disruptions will eventually run their course with jobs filled, albeit at higher wages. Geopolitical risk looks likely to flare up again with Russia amassing troops on the Ukrainian border; that said, we fail to see this escalating into a multi-country conflict given the previous response to the Crimean invasion.

For Europe, the story is likely going to surround the cessation of the Pandemic Emergency Purchase Program (PEPP) and increase in the Asset Purchase Program (APP) and transition into a more ambiguous goal versus a hard monthly target. Europe, though, seems at a more difficult position relative to the US with growth trending towards zero for core Europe and inflation likely to fall below the European Central Bank's target of 2%. We think Europe will remain an outlier in terms of zero 2022 hikes for developed markets. We think 2023 is even questionable for hikes given current market pricing. In any event, we still like euro-hedged European assets due to their steeper curves given the strong FX carry back into the dollar. The French election in April 2022 will likely set the tone of the political landscape given President Emmanuel Macron is facing increasing challenges from the right with Valérie Pécresse, though polling suggests Macron remains the heavy favourite.

Lastly, in 2021 we saw a greater interest among numerous stakeholders in addressing climate change. Appetite for green bonds, in particular, is mobilising increased capital markets investment to meet climate goals and environmental protection. The success of these instruments reflects the fact that investors are increasingly conscious of the environmental consequences of the decisions that companies and governments make and are ready to exchange financial performance with the assurance of a more sustainable world. We believe that in 2022 more issuers will come to market especially in the US (Mortgages, Loans and Municipals). It might be too early for 2022, but we believe that a Green T-Bill is certainly on the radar for the US Treasury. This would be a true landmark event for the asset class and we look forward to seeing how this progresses in 2022.

Emerging markets outlook

Raphael Marechal, Head Portfolio Manager, Emerging Markets

Search for yields to lead to EM in 2022

Despite the positive sentiment associated with the COVID-19 vaccination campaign, increased mobility, and the promise of a progressive return to fully functioning economies, emerging market (EM) fixed income has fared poorly in 2021. At the time of writing, JPMorgan's index tracking debt issued in local currency is down close to 10% for the year to date in US dollar terms, the main reason being the poor performance of emerging market currencies versus the dollar. External debt indices, both sovereign and corporate, also failed to impress, with a fall in prices offsetting the generous interest payments investors earn from holding the bonds.

However, at the start of 2021, the growth outlook had benefited from massive base effects, rebuilding of inventories and a resumption of domestic demand. It rapidly became clear that there was a mismatch between the size of the global monetary and fiscal stimuli and production capacity, leading to price pressures, aggravated by disruptions in the supply chain.

Facing elevated inflation and the threat of a stronger dollar due to an imminent asset purchase tapering by the Fed, several EM countries decided to embark on a proactive tightening of monetary policy, well before developed economies. Those who did the most to stay ahead of price pressures were clearly rewarded by currency outperformance. At the other end of the spectrum, the Turkish lira was one of the worst performers, pressured by President Recep Tayyip Erdogan's demands for lower borrowing costs, despite Turkey's rampant inflation. Monetary policy divergence was a key theme for us throughout 2021, creating many alpha opportunities and dispersion in rates and FX.

Another key theme during 2021 was the political shift taking place in Latin America. After a few years of conservative right-wing leadership, most countries in the region are now contemplating a change. The reasons for this are numerous: discontent with economic performance, rising inequalities, mishandling of the COVID-19 crisis and a return to fiscal austerity after the largesse experienced during the lockdowns. Peru initiated the change when Pedro Castillo was finally confirmed as president-elect, after being cleared of fraud allegations. Similarly, we could see another leftist, Gabriel Boric, win the runoff vote in the Chile presidential elections in mid-December, although his lead is narrowing. Colombia's conservatives are also under pressure ahead of a 2022 vote after their highly unpopular tax reform. Brazil is also facing an election in 2022, with a galvanized left looking to replace right-wing President Jair Bolsonaro. Indeed, former Brazilian president Luiz Inacio Lula da Silva is energised by the wind of change blowing across Latin America and is already preparing for a potential return to the driver's seat.

Outlook

2022 may continue to prove challenging for EM asset returns as growth could moderate and with the Fed expected to start its hiking cycle. Growth is expected to remain above trend, though perhaps not as robust as it was at the start of the cycle in 2021, driven by strong base effects following the re-opening of economies. With the Fed likely to be less accommodative, emerging market currencies may continue to face headwinds, at least during the first half of 2022, and a careful selection based on country specifics will continue to prevail over market momentum.

Perhaps more interesting in the short term will be emerging market rates. They have already moved significantly higher in 2021 and, given that hiking cycles are already well underway in several emerging economies, they could prove to be a pillar of strength for local debt at the start of 2022, before currencies are able to strengthen against the dollar later on in the year. At this stage, emerging market central banks have essentially removed all of the COVID-19 emergency easing during the course of 2021. There will be additional tightening next year as restoring positive real yields will be key to currency stability and will provide an extra insurance against the Fed's moves. Nonetheless, as we approach the end of this tightening cycle, we expect opportunities to increase duration in many emerging economies to become increasingly obvious as the end of Q1 2022 comes into view. Some emerging market rate curves are already inverted—a testimony of well anchored long-term inflation expectations and very prudent central banks.

In addition, let us not forget that base effects in food and energy are likely to exert a drag on inflation pressures during 2022. If we also factor in a progressive lifting of COVID-19 restrictions, an easing of labour force shortages and supply bottlenecks, we conclude that positive surprises on inflation are very likely during 2022. Finally, concerning timing, previous episodes of Fed hiking cycles have shown that emerging market local rates have tended to rise when Fed hikes are priced but begin to fall on their actual delivery. However, the dollar tends to remain strong as hikes are delivered, making emerging currencies a good investment proposition later in 2022.

Concerning emerging markets external debt, the mid-cycle environment is not as disruptive even with Fed tightening, given the constructive backdrop for growth and current accounts. Current accounts are expected to marginally deteriorate as they converge back toward their pre-pandemic levels. This is mainly due to a marginally less favourable terms of trade for commodity exporters and a recovery in emerging market domestic demand.

Risks

An obvious risk to the outlook is the emergence of new COVID-19 variants with the ability to get around vaccine defences. This risk is well known, though, and shouldn't have the same surprise and disruptive effect as the virus variants early on in the pandemic. Similarly, many market participants appear afraid of the taper tantrum being replayed. Again, this is unlikely, in our view, because the Fed has been very careful not to take investors by surprise.

Moreover, many emerging economies have carefully built up buffers in the form of foreign exchange reserves and more resilient debt profiles, with less reliance on foreign currency debt or short-term borrowing. Concerning growth, the main challenge could come from a disorderly rebalancing of the Chinese economy and/or domestic policy mistakes in the form of a premature withdrawal of fiscal and/or monetary policy support. Again, the RRR cut at the start of December reminds us that the Chinese authorities are pragmatic and that they are ready to make a pause, if needed, on the path toward "common prosperity".

With deeply negative real yields (sometimes even negative nominal yields) in developed economies, foreign investors will continue to look for assets with attractive valuations; we believe they will have little other choice but to continue increasing their allocation to EM debt.

Global credit outlook

Holger Mertens, Head Portfolio Manager, Global Credit

Looking back on 2021

Tight valuations have been a popular topic for global credit markets recently. After multiple years of relentless spread tightening, the credit market now looks expensive. Nevertheless, as we look back on 2021, we see that the valuation situation once again didn't stop the credit markets from outperforming most developed government bond markets. Even the resurgence of COVID-19 in the form of the Delta variant and skyrocketing inflation numbers failed to push the global credit market out of its narrow trading range. After successfully passing these two challenges in 2021, we expect the market to remain rangebound and again outperform government bonds in 2022. Potential risk scenarios include policy errors by global central banks followed by more aggressive monetary tightening and a significant resurgence in COVID-19 cases over the coming months. We might experience some spread widening if either of these situations materialise, but we also expect strong technical factors to push spreads back into their narrow trading range. Regarding the technical situation, we see the lack of yields in fixed income markets as a major driver for fund flows into the global credit market. In particular, US credit still offers attractive income which cannot be found in the government bond markets, and Asian credit may also retrieve some its losses from 2021.

However, after 2021, during which "Beta" was the driver of performance and global central banks pushed up the entire credit market, we expect 2022 to test the skills of investment managers in finding the right opportunities.

For 2022, we will make full use of our quantitative and qualitative skill sets to build our portfolio around four key investment themes.

Four themes for 2022

1.BB-rated credits

The team currently prefers BB-rated credits over AA/A-rated credits. Already in the last couple of months, we have seen a group of credits being upgraded from BB into the investment grade market, with one of the most prominent examples being US streaming platform Netflix. We expect this trend to continue; as such, 2022 could become the year of upgrades with issuers' credit matrices fully recovering from the pandemic. For higher rated companies, the prospects could be much gloomier. A global push for higher corporate tax rates is increasing the costs to maintain an A or AA rating and we expect a growing number of companies to opt for a more cost-efficient BBB rating.

2.ESG

While we expect ESG to be a strong performance driver, ESG means more to us than just chasing green bonds. We implement ideas only if we expect them to provide our performance with a meaningful advantage. For example, in 2021 we saw some Real Estate sector bonds experiencing double-digit declines in prices due to poor corporate governance. Avoiding such situations supports stable results and highlights how ESG, in particular good corporate governance, matters.

3.Small or even negative correlations

The portfolio management team is constantly searching for ideas where the correlation of performance outcomes is small, or even negatively correlated, to the rest of our portfolio. An example is China's policy banks: their total returns have very little correlation with the rest of the portfolio. Recently, China's policy banks delivered positive total returns while inflation angst drove most developed markets into negative returns.

4.China offshore credit market

We expect investment opportunities to arise again in the Chinese offshore credit market (which was subject to a sell-off in 2021) given their attractive valuation levels. While spread diversion in most credit markets is low and therefore bond picking is difficult, the situation in China is different. The recent sell-off has opened an interesting opportunity for experienced credit analysts to be rewarded for in-depth credit research.

In addition to our four investment themes, other factors are crucial as well, such as portfolio construction. It is important not just to generate ideas, but to effectively factor them in to the portfolio. We aim to spread ourselves equally across our themes and refrain from concentrating on just one or two. This strategy has stabilised our alpha generation over the last few years. Furthermore, using the most liquid instruments in the credit market, including CDS indices, has enabled us to change our portfolio positions—even during periods of high volatility when liquidity normally dries up.

We expect the combination of well-researched investment ideas and systematic portfolio construction to benefit the Global Credit Strategy in 2022.

We expect the combination of well-researched investment ideas and systematic portfolio construction to benefit the Global Credit Strategy in 2022.

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2022 Asian Rates and FX Outlook

Regional recovery expected

By the Asian Fixed Income team

Outlook for 2022

We expect global economic growth to persist in 2022 but at a more moderate pace. In the US, strong domestic demand and further fiscal stimulus are seen supporting GDP growth. The US Federal Reserve (Fed) commenced tapering asset purchases in November 2021, as it expects the economy to keep improving, particularly after supply chain issues are resolved. The Fed could end its asset purchases around mid-2022 and then begin hiking rates as the pandemic subsides—a scenario that is seen to have been largely been priced in by global markets. We see expansion in Europe sustained by continued increases in vaccination rates and mobility.

In contrast to the Fed, the European Central Bank (ECB) is seen keeping its monetary policy loose, with ECB President Christine Lagarde recently declaring that inflationary pressures continue to stem from transitory factors linked to the reopening of the economy.

After leading the global recovery in 2021 we expect China's growth to slow in 2022. Admittedly, the Chinese government's decision to tighten policies in a number of sectors has heightened concerns towards how much growth could slow. To soothe the concerns of businesses and investors, the People's Bank of China (PBOC) has vowed to ensure a "healthy property market" and policymakers have directed banks to somewhat loosen lending to the property sector. We take these as signs that the government stands ready to announce incremental and targeted loosening to ensure decent GDP growth.

Meanwhile, the recovery in Asia ex-China is likely to improve significantly in 2022. Countries have abandoned their zero-COVID strategies and transitioned to "living with COVID", slowly reopening their economies and borders amid rising vaccination numbers. Singapore, where more than 85% of the population is now fully vaccinated, has expanded its vaccinated travel lane scheme to more than 15 countries as of mid-November 2021. In South Korea, more than 70% of the population is fully vaccinated, and the government has eased a range of restrictions. Close to 50% of Thailand's population is fully vaccinated; since November 2021, the country has stopped quarantine requirements for vaccinated visitors from more than 60 specified countries. We anticipate these developments to boost private sector confidence, providing an important tailwind for Asian ex-China growth in 2022.

Heading into 2022, we retain our preference for mid- to high-yielding bonds. We expect Indonesian bonds in particular to be supported by low domestic inflation and their attractive real yield. In China, the PBOC is likely to keep liquidity stable in the near term through its open market operations (OMO) and medium-term lending facility (MLF) operations, while preserving policy cushions such as interest rate or reserve requirement ratio (RRR) cuts as a last resort—and only if economic fundamentals deteriorate significantly. Government bond issuance should remain manageable while local government special bonds for infrastructure investment will likely increase. Meanwhile, we expect low yielding countries to be more sensitive to US rates.

On currencies, we expect the US dollar to resume its ascent against most regional currencies when US rates re-adjust higher and the Fed starts raising rates. The performance of Asian currencies will likely depend on varying degrees to factors such as the impact of oil and commodities on the current accounts of regional economies, the extent of success in the further reopening of borders and the outlook for economic growth. Overall, Asia's strong fundamentals should keep regional currencies relatively resilient.

In our view, the biggest downside risk to global markets is the continued imbalance between supply and demand, causing inflationary pressure to last longer than the markets had previously assumed. This could prompt the Fed to tighten earlier than anticipated. Meanwhile, another sharp spike in COVID-19 cases during the winter season is another potential risk that could delay the normalisation of economic activities. Other idiosyncratic factors include political developments (such as presidential elections in South Korea and the Philippines) that could affect policy direction.

Chart 1: Asian real rates (%) – 5-year yields vs CPI

Source: Bloomberg, as of 25 November 2021.

Individual Country Outlooks

China

We expect growth by China to slow in 2022 after it led the global recovery in 2021. The Chinese government's policy-tightening drive has led to growth concerns, but the PBOC has vowed to ensure a "healthy property market" and policymakers have directed banks to somewhat loosen lending to the property sector. We take these as signs that the government stands ready to ensure decent GDP growth.

China's consumer price index (CPI) inflation picked up in October 2021, but it remains at a relatively low level. Looking ahead, favourable base effects as well as higher commodity costs could drive CPI inflation higher, although weak overall demand is likely to limit the rise. In contrast, producer price index (PPI) inflation—which hit a record high of 13.5% in October 2021—could moderate due partly to fading base effects and foreign production capacities resuming as more countries set aside COVID-19 restrictions.

The PBOC is likely to keep liquidity stable in the near term through its OMO and MLF operations, while preserving policy cushions such as interest rate or RRR cuts as a last resort, and only if economic fundamentals deteriorate significantly. Overall, we believe the central bank's policies will lean towards easing.

Government bond issuance should remain manageable while the amount of local government special bonds for infrastructure investment will likely increase. Chinese government bonds are seen benefitting from slower growth, continuous foreign inflows—boosted partly by their inclusion to the FTSE World Government Bond Index (WGBI) in October 2021—and manageable supply. Meanwhile, the renminbi (RMB) has been well supported, backed by the country's large trade surplus. Moving forward, we expect relatively strong net export performance and continued inflows to support the RMB, although demand for the currency could be partially offset by rising regulatory uncertainty and the widening China-US interest rate differential.

South Korea

Relative to its peers South Korea's GDP growth stayed resilient in 2021, thanks largely to strong exports. GDP growth is likely to moderate in 2022 but remain at healthy levels; capacity expansion in response to the global chip shortage could be tempered by slower Chinese growth and the normalisation of pandemic-related tech demand. Since November 2021the government eased a range of restrictions and adopted a gradual reopening plan with more than 78% of its population fully vaccinated. We expect mobility to increase in light of these developments and support private consumption expenditure. Separately, upcoming presidential (March 2022) and local (June 2022) elections could provide South Korea with fiscal policy tailwinds.

The Bank of Korea (BOK) was the first central bank in the region to begin normalising monetary policy, raising interest rates by a total of 50 basis points (bps) in the latter half of 2021. The BOK was seen to have tightened the policy rate to ensure financial stability and address rising inflationary pressures. We expect the central bank to stay on the path of steady and gradual normalisation in order to avoid any policy missteps. Notably, the BOK will undergo leadership changes as incumbent Governor Ju-yeol Lee's term expires in April 2022.

In 2022 we expect South Korean bonds to move with a higher correlation to US Treasuries (USTs) compared to their regional peers. Meanwhile, the South Korean won could underperform as the country's growth momentum slows and its trade surplus narrows.

Malaysia

GDP growth in Malaysia is likely to accelerate in 2022, as domestic activity normalises and borders reopen. The government successfully accelerated its COVID-19 vaccine roll out, with over 77% of the population fully vaccinated as of November 2021. Consequently, policymakers are preparing to treat COVID-19 as an endemic and fully reopen economic sectors by December 2021. Vaccinated travel lanes with neighbouring Indonesia and Singapore were opened in November 2021, while plans are underway for the country to reopen its borders to other international tourists by 1 January 2022.

Going forward, we expect upward pressure on inflation as economic activity picks up in tandem with the easing of border restrictions. Nonetheless, any move towards higher prices is likely to be gradual, allowing Bank Negara Malaysia (BNM) to remain on hold in the first half of 2022. We maintain that the central bank is more likely to keep its current accommodative stance for an extended period to support the nascent economic recovery.

We approach 2022 with a constructive view on Malaysian rates. Supply is likely to remain heavy, as the 2022 budget remains expansive, with the government pencilling in a fiscal deficit of 6.0% of GDP. That said, we see BNM's prolonged pause, together with relatively higher real rates, more than offsetting the pressure stemming from supply risks. Separately, we expect still-elevated commodity prices to benefit the ringgit.

Lastly, we are mindful that political developments in Malaysia are likely to continue to be a risk to investor confidence. We note that general elections—which are due to be held on or before July 2023—may be called as early as the second half of 2022.

Singapore

Within Asia, Singapore has led the way in both reopening and normalisation efforts. Although there have been delays to domestic reopening as daily infection cases rose quickly, the government's overall strategy of treating COVID-19 as an endemic remains intact. More than 85% of Singapore's population is now fully vaccinated, and the country has expanded its vaccinated travel lane scheme to more than 18 countries. For 2022, growth is likely to slow, with expansion by Singapore's tourism and consumer-facing sectors tempered by moderation in China's economy.

Inflation has risen sharply in the second half of 2021. Core inflation may stay robust in the near term after reaching 1.5% in October. We expect inflationary pressures to be supported by an improvement in labour market conditions and high energy prices. As core inflation prints remain elevated, the MAS could further tighten its FX policy, allowing the Singapore dollar to remain attractive against its regional peers.

While we expect Singapore Government Securities (SGSs) to retain a higher correlation to USTs, SGSs could outperform USTs on the back of ample domestic liquidity and the attractiveness of the Singapore dollar.

Thailand

Thailand's economic recovery has been slow so far, due to the economy's heavy reliance on international tourism. Heading into 2022, growth is expected to rebound, reflecting the aggressive border reopening that started in November 2021. That said, tourism arrivals are unlikely to return to pre-pandemic levels anytime soon, as China's COVID-zero approach inhibits the flow of Chinese tourists. Meanwhile, vaccination progress has greatly improved. Close to 57% of Thailand's population is fully vaccinated, with several key tourism cities having reached higher figures of full vaccination coverage. This should support improvement in private sector consumption.

Headline inflation has crept higher of late, but it remains well within the central bank's 1-3% target range. The acceleration has been driven partly by rising fuel prices. Core inflation, which excludes energy and raw food prices, has remained weak, as demand-pull inflation pressures remain muted. The government has announced measures to reduce domestic costs, including an extension of the cap on diesel prices, which should provide some anchor to overall inflation in the coming months.

Bank of Thailand (BOT) has kept monetary policy accommodative, and it continues to emphasise the need to support the economic recovery as a policy priority. At its most recent monetary policy committee (MPC) meeting, the central bank's policy statement still sounded cautious regarding the overall economic outlook, although it did say that downside risks to growth have decreased. We expect the BOT to leave policy rates unchanged for some time, so as not to derail the recovery momentum.

The government raised the public debt limit to 70% (from 60%) of GDP in September 2021. In addition, it unveiled a substantially higher bond issuance target of Thai baht (THB) 1.1-1.3 trillion for FY2022 (from THB 847 billion for FY 2021), prompting the Thai government bond yield curve to steepen. With this behind us, UST direction is expected to remain the main driver of Thai government bonds. Separately, the direction of the Thai baht could, to a great extent, be determined by the increase in tourism receipts.

Political risk remains low. Anti-government protests have been held, but they have been largely under control. Politics will be closely watched in 2022 as political activity could pick up with next elections due by early 2023.

India

India's economy staged a remarkably strong comeback in 2021, following a devastating second wave of COVID-19 infections. The V-shaped recovery was driven largely by growth in private investments and consumer spending. Meanwhile, in October 2021 India crossed the one billion mark for the number of vaccine doses administered, and it expects to achieve its target of inoculating the entire adult population with at least one dose by the end of the year. The rising vaccination rate, easing of travel restrictions under the pandemic and the release of pent-up demand are expected to be the main drivers of growth recovery in 2022.

Elevated inflation is likely to persist in 2022 on the back of robust domestic demand. Sticky core inflation, along with stronger signals of demand recovery, are likely to reinforce market expectations of monetary policy normalisation. So far, the Reserve Bank of India (RBI) has maintained its accommodative stance, but it has taken steps to withdraw its extraordinary policy support via declaring an end to the government securities acquisition programme and undertaking larger variable reverse repo rate operations. Against a backdrop of strong growth and elevated inflation, a rate hike by the RBI appears imminent. That said, we believe that the RBI will follow a gradual path as it normalises monetary policy, to temper risk of policy missteps. Meanwhile, we expect the rupee to be vulnerable to further sharp moves in oil prices.

Separately, five state elections are scheduled for early 2022, including in the most populous state of Uttar Pradesh. Current opinion polls suggest that Prime Minister Modi's Bharatiya Janata Party is set to retain power.

Indonesia

As with the rest of Asia ex-China, we expect Indonesia's recovery to improve significantly in 2022, as the government transitions to living with COVID, slowly reopening its economy and borders amid rising vaccination numbers. As of November 2021, about 33% of the country's population was fully vaccinated. The government expects this to increase to 50% by the end of 2021. Bank Indonesia (BI) expects full year 2021 GDP growth to register between 3.5-4.3%, while the finance ministry sees growth at 4%.

Inflation is likely to remain low, allowing BI to keep interest rates unchanged for a while, barring a major risk-off sentiment in markets. At its most recent meeting, the central bank declared that policy rates are likely to remain low for another year. That said, we do not expect the interest rate differential between Indonesia and the rest of the region to widen unduly, and we anticipate BI to eventually adjust the policy rate as it balances supporting the economic recovery against the risks of rising inflation in the latter half of 2022.

Indonesian local government bonds (IndoGBs) have stayed relatively resilient despite the weakening by USTs. An accommodative monetary policy, low inflation, strong demand from local financial institutions and positive bond supply technicals were key factors that supported demand for Indonesia bonds. We hold a constructive view on IndoGBs going into 2022, supported by low domestic inflation and their attractive real yield. For now, foreign positioning remains relatively light. Any improvement in overall risk sentiment could trigger increased foreign flows into the emerging market debt space, which would bode well for IndoGBs. Separately, the outperformance of the Indonesian rupiah against its regional peers may persist in the coming months, supported by the country's trade surplus generated by elevated commodity prices.

Philippines

GDP growth in the Philippines surpassed expectations in the third quarter of 2021 as private consumption growth surged on the back of pent-up demand following lockdowns in the previous months. As of November 2021, close to 40% of the population was fully vaccinated. With infections also declining markedly, the government relaxed some local restrictions on movement, although the country remains effectively closed to foreign tourists. Moving forward, we anticipate the rebound in GDP growth to reflect recovery in private consumption (supported by increased mobility) as well as increased infrastructure spending by the government in the run-up to the national elections in 2022.

Overall inflation has surpassed the Bangko Sentral ng Pilipinas (BSP)'s 2-4% target for most of 2021, and it could stay relatively elevated in response to higher demand as economic conditions normalise. Even as it warned of risks to inflation in the coming year, we expect the central bank to take a gradual approach to monetary policy normalisation, prioritising monetary policy support for now to ensure a sustained recovery. That said, we believe that of the region's central banks the BSP is likely to be among the first to deliver rate hikes should second-round effects suggest inflation could stay elevated for longer.

We approach 2022 with a cautious view on Philippine rates, given the negative real rates; we also have a subdued view on the peso. We are cognizant that the country's external position remains strong thanks to resilient remittance inflows. However, we expect import growth to further recover in 2022 on normalising economic activity. This could weigh on the country's current account position and the currency in turn.

The country is holding its general elections in May 2022, when registered voters will choose, among others, a new president. Currently, there is no clear front-runner among the candidates. Despite the uncertainty in outcome, we do expect the elections to be relatively clean, with limited incidents of violence. Heading into the May elections, we expect the Philippine peso to become more volatile.

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2022 Asian Credit Outlook

Growth momentum seen reviving

By the Asian Fixed Income team

Summary

- The macro backdrop and robust corporate credit fundamentals remain supportive of Asia credit spreads. As such, we expect growth momentum of many Asian economies to gather pace heading into 2022. Overall corporate credit fundamentals are expected to remain robust, with earnings growth staying strong—albeit at a slightly slower pace compared to 2021.

- We expect progress on vaccine rollouts, the gradual reopening in several countries and still-supportive fiscal and monetary policies to reinforce the positive backdrop.

- We favour Asian high grade (HG) credits over Asian high yield (HY) as 2022 gets underway, with a slightly more defensive bias pending key catalysts in the form of policy changes in the China property sector. If such changes materialise, there should be scope for higher returns from spread compression within Asian HY. Within HY, we prefer strong BB-rated China real estate credits. Within Asia investment grade (IG), we retain a preference for BBB-rated credits where we see scope for spread compression against the higher quality segments.

- The key downside risks to Asian credit in 2022 include a deeper China economic slowdown, more aggressive monetary policy tightening in the US and developments around the new Omicron variant.

2022 Asian Credit Outlook

Fundamentals

Macro

The spread of the Delta COVID-19 variant through much of the second and third quarters of 2021 weakened domestic demand and accentuated supply disruptions across many Asian and global economies, slowing the recovery momentum which had emerged after the initial coronavirus wave in 2020. However, as we approach 2022, a tentative improvement in the COVID-19 situation across many Asian economies reinforces our view that the setback to growth is likely to be temporary—although we continue to closely monitor developments surrounding the spread of the new Omicron variant. Progress on vaccine rollouts, the gradual reopening across most countries in line with the transition to a "living with COVID" strategy and still-supportive fiscal and monetary policies are expected to lead to a revival in growth momentum in 2022.

We expect the recovery in 2022 to be driven by the services sector, as the sectors hardest hit by the pandemic—such as air travel, leisure and entertainment, accommodation and dining out—revive from the deep slump suffered in 2020 and 2021. Manufacturing activity is expected to remain at a decent level. However, its growth rate may moderate as 2022 progresses due to already-strong growth registered in 2021 and goods exports growth potentially normalising in 2022. While external demand should stay robust, some moderation may occur as the shift from goods to services spending gathers pace globally. This is likely to be a second half story as the clearing of order backlogs and still-firm commodity demand are seen supporting export growth in the early part of 2022. Domestic demand, particularly private consumption, is seen strengthening through the year as mobility restrictions ease further and households become more comfortable engaging in contact-intensive services. Private investment demand is expected to gather momentum as business confidence and consumer outlook improve, and as the current supply chain bottlenecks prompt new capital expenditure across industries including semiconductors, industrial equipment and renewable energy.

In terms of country performance, we expect some divergence across Asia, at least at the beginning of 2022. In China, real gross domestic product (GDP) growth is expected to remain weak in the first half of 2022 before recovering in the second half. Since mid-2021, the Chinese government has embarked on a series of regulatory and credit tightening measures across various sectors, notably real estate, technology and private education, as it pursues "Common Prosperity" and macro deleveraging goals. These policies have exerted downward pressure on economic activity, leading to a sharp growth slowdown in 2H 2021. High commodity prices, manufacturing and power generation curbs to meet environmental goals and sporadic virus outbreaks amid a zero-tolerance COVID strategy have added to the headwinds facing the economy. Although the government has begun to acknowledge these headwinds and has sent signals of possible loosening in monetary, credit and fiscal policies, the drags on economic activity is likely to persist into early 2022 before recovery takes place in the second half of the year. The broad thrust of the structural reforms and regulatory measures aimed at strengthening the long-term resilience of the economy is unlikely to be fully reversed, however, meaning the recovery in China may not be as strong as in previous easing cycles. In India and Southeast Asian economies, strong catch-up growth is expected through 2022 as the economies shift to a living with COVID strategy and gradually reopen amid rising vaccination coverage after the Delta wave disrupted recovery momentum in mid-2021.

We expect monetary policy to remain accommodative in most Asian economies, although some divergence is likely. The more advanced economies, such as South Korea and Singapore, have already begun tightening monetary policy. However, there is room for central banks in other Asian countries to maintain an accommodative stance for longer to support the nascent recovery given still benign domestic inflation as the output gap remains negative. Likewise, fiscal policy is likely to remain supportive of growth as most countries will continue to run sizeable budget deficits. However, given the fiscal capacity expended through the last two years, governments will have to balance that against the need to achieve fiscal consolidation and debt sustainability over the medium term.

We expect the sovereign credit ratings of most Asian economies to remain stable in 2022, except for Sri Lanka, which faces near-term external repayment risk due to depleted foreign exchange reserves and multiple domestic economic headwinds. The risk of India's sovereign rating being downgraded to below investment grade has significantly receded with growth recovery, reduced risks in the financial sector and the country's external strength. Nevertheless, India's high debt levels remain an area of weakness which the government will need to address in time.

Credit

With economic recovery regaining momentum and credit conditions still supportive, we expect overall Asian corporate credit fundamentals to remain robust across most countries and sectors, although some divergence is likely. Revenue and earnings growth should stay strong, although we expect the pace to moderate slightly from 2021. Financing costs may begin to edge up towards the end of 2022, but they are likely to remain low historically with interest coverage ratios staying high. Overall debt levels, gearing and leverage are not likely to pick up meaningfully as many sectors, in particular the China real estate sector, remain focused on deleveraging and managing liquidity; furthermore, only fundamentally strong Asian high-grade companies are likely to be active in mergers and acquisitions and capital expenditure.

Commodity prices are likely to remain elevated given recovering domestic demand, supporting earnings in upstream industries such as oil & gas and metals & mining, while at the same time exerting some downward margin pressure on downstream manufacturing and services industries. As household incomes and financial prospects remain fragile in the early stage of the recovery, consumer goods manufacturers and retailers in Asia may not be able to pass on higher costs to end consumers as much as their developed market counterparts, resulting in still compressed margins—although their earnings growth may be supported by volume recovery from a low base.

We expect tourism-oriented service companies such as airlines, airports, and mall and hotel operators to experience strong growth in 2022 due to the reopening of borders and low base of comparison. China real estate developers may continue to face soft sales at least in the early part of the year and liquidity pressure could continue to impact the weaker developers in this space. However, there have been tentative signs of Chinese authorities stepping in to stabilise funding access and market sentiment to prevent an overcorrection that could lead to systemic risks. The industry consolidation and sector-wide deleveraging to meet regulatory requirements will benefit the stronger and better quality developers in the medium term. Chinese technology companies may also experience slower growth and margin pressure due to the government's regulatory measures, although the credit metrics of most companies in this space remain strong.

Asian banks can expect higher net interest margins on rising interest rates, with delinquencies having been less than anticipated despite the reduction of loans under moratorium. Moreover, most Chinese and Hong Kong banks have manageable exposure to the China property sector and remain well capitalised. Indian banks' asset quality looks set to stabilise on the back of an improving operating environment. Broadly, the outlook is positive for the banking sector with more businesses conducted through digital channels. This is a positive change which will have lasting positive impact for the sector.

We expect to see greater differentiation between Asia HG and Asia HY, as well as within Asia HY, in 2022. On the HY side, the differentiation within sectors will likely continue in 2022. In the near term, weaker developers within the Chinese property sector are likely to continue to struggle due to a loss of confidence from multiple stakeholders. In the medium term, we expect the sector outlook to improve, driven by urbanisation and household formation. We prefer to take a cautious view of the sector as the stronger, higher quality developers will benefit more directly from any easing of government policies. Similar to 2020 and 2021, credit metric trends for Chinese HY industrials are expected to be more credit specific, although tighter onshore credit conditions may exert pressure across the sector. Tight liquidity may also put pressure on select HY companies in Indonesia and India, especially those facing near-term refinancing needs.

We may see more fallen angels in the China HG property sector in 2022, but outside of this segment, we expect to see lower cases of idiosyncratic fallen angel cases compared to 2021. We expect the Asian HY corporate default rate to range between 3.0% and 3.5% in 2022, although much depends on the developments around several highly distressed China real estate companies and the timing of any default events.

Valuations

2021 has seen a significant divergence within Asia credit, with Asia HY spreads widening significantly due to weakness in the China HY real estate sector, while Asia HG spreads have continued to tighten despite some volatility through the year. Asian HG spreads currently sit at 169 basis points (bps), about 47 bps tighter than at end-December 2020. Meanwhile, Asian HY spreads are at 809 bps, about 191 bps wider than at end-December 2020. HG spreads have pushed below their historical mean levels post Global Financial Crisis, while HY spreads are meaningfully above those levels.

The spread differential between Asia HY and Asia HG, currently at 640 bps, is significantly above the last five-year average of 375 bps, which makes Asia HY very attractive at first glance. However, there is significant dispersion within Asia HY and the current spread level reflects the wide spread of certain distressed China real estate credits which carry high default risks. While there is certainly scope for Asia HY to tighten on both an absolute basis, as well as relative to Asia HG, such potential can only be realised with a significant turnaround in the China HY property sector, which in turn is contingent on a more material loosening of regulatory and credit policies on the sector.

Within Asia HG, BBB-rated pickup over A-rated is currently at 90 bps, having widened from the end-2020 level of 84 bps, and above the last five-year average of 77 bps. We thus continue to prefer BBB-rated over A-rated credits for the spread pickup amidst robust fundamentals and see China BBB-rated credits as offering good value.

Chart 1: Asian High-Grade Spread

Source: J.P. Morgan, Bloomberg, as of 23 November 2021

Chart 2: Asian High-Yield Spread

Source: J.P. Morgan, Bloomberg, as of 23 November 2021

Technicals

The technical backdrop for Asian credit is likely to remain subdued in the early part of 2022 before becoming more constructive as the year progresses. With the US Federal Reserve (Fed) having initiated the tapering of asset purchases and potentially poised to begin hiking interest rates in the second half of 2022, the demand for emerging market (EM) debt is likely to be lukewarm at the start the year with investors adopting a more cautious risk stance. Fund flows thus far, however, do not point to any 2013-style taper tantrum, and as more of the developed market monetary policy normalisation is priced in, fund flows into EM may turn more positive. The weakness of the China real estate sector has also dented investor sentiment towards Asia credit to some extent, although most of the outflows may have taken place in 2021. Any meaningful easing of property sector policies in 2022 could result in a sharp return of investor inflows given attractive valuations. In addition, we expect the demand from regional pension and insurance funds to remain robust through the year. Gross supply is likely to be roughly similar to that of 2021 at around USD 350 billion. A large part of the gross issuance will be for refinancing, leaving net issuance at a manageable level of around USD 50 billion. Chinese property USD bond issuances are likely to be limited at least through the first quarter of 2022, although there could be more opportunistic issuances by IG companies to lock in the historically low yields, as well as to fund selective merger and acquisition activities.

Strategy

The macro backdrop and robust corporate credit fundamentals remain supportive of Asia credit spreads. While we continue to monitor developments surrounding the latest Omicron COVID-19 variant, we believe that progress on vaccine rollouts, the gradual re-opening in a number of countries and still-supportive fiscal and monetary policies should revive growth momentum heading into 2022. We expect overall corporate credit fundamentals to remain robust, with earnings growth staying strong—albeit at a slightly slower pace compared to 2021. Asia corporate leverage and interest coverage are expected to remain manageable overall, although some divergence across sectors is likely.

Asia HG spreads have tightened to historical levels, and any further tightening from here will likely be modest. We retain a preference for BBB-rated credits where we see scope for spread compression against the higher quality segments. We expect US Treasury (UST) yields to have an upward bias as elevated inflation and an improving labour market nudges the Fed along the path of monetary policy normalisation. The rise in UST yields could offset the positive impact from any credit spread tightening, resulting in low-single digit positive returns for Asia HG in 2022, with carry again being a prominent driver.

Asia HY spreads are wide both on an absolute and relative basis, and we believe that there is scope for meaningful total and excess returns from spread compression. However, for this to materialise, a key catalyst in the form of significant loosening in the China property sector policy would be required. Although there have been tentative signs of authorities stepping in to stabilise credit access and market sentiment to prevent an overcorrection that could lead to systemic risks, the measures so far may mainly benefit the stronger developers. In the meantime, weak sales and liquidity pressure could continue to impact the weaker developers, potentially leading to more distress or default events. We are therefore inclined to start 2022 with a more defensive bias, preferring strong BB-rated China real estate credits, while awaiting more concrete policy easing measures. Given such a view, we also have a preference for Asia HG over Asia HY to start the year.

The key downside risks to Asian credit in 2022 include a deeper China economic slowdown, which could challenge the country's macro stability and growth outlook and in turn negatively affect the rest of Asia. Aggressive monetary policy tightening by the US and other major economies in response to prolonged elevated inflation is another downside risk. These risks could lead to a moderation of excess carry, which would be negative for EM credit technicals. Furthermore, economic recovery from the COVID-19 pandemic may suffer a setback due to the emergence of new variants that could reduce the effectiveness of vaccines. Meanwhile, despite some recent positive developments, US-China tensions continue to simmer in the background with Washington adding more Chinese companies to its restricted trade list, citing national security reasons and foreign policy concerns.

Sector Outlooks

Financials

Market conditions are expected to normalise in 2022 for banks as well as non-bank financial companies (NBFIs). The upside for the stronger banks, particularly those in Singapore and South Korea, is that there has been fewer than anticipated delinquencies despite the reduction of loans under moratorium; in addition, another supportive factor is the very low allowances which may result in better-than-expected earnings. The banking sector can also expect higher net income margins should interest rates rise. On the flipside, normalisation could also mean the easing of bank deposit inflows on the back of flush liquidity and lower growth in mortgage loans which do not attract comparatively as much capital costs. While the concern at present for the Chinese and Hong Kong banks is their exposure to mainland China's underperforming property sector, most banks have manageable exposure in the low double-digit percent handle and are well capitalised except for a handful of the joint stock banks. For the Thai banks, which have significant exposure to the tourism industry, asset quality may modestly weaken as support measures unwind. While the potential laggards are banks from the Philippines, where sluggish business confidence and private consumption continue to pose challenges to asset quality, it is worth noting that the country's economic growth in 3Q2021 was better than expected. In India, risks relating to the deterioration of asset quality have receded, and asset quality looks set to stabilise along with greater credit growth driven by an improving operating environment. Broadly, the outlook is positive for the banking sector and we think it worthwhile to observe the capital structure of the larger players with strong fundamentals. We see minimal non-call risk for these bonds. We also saw both banks and NBFIs conduct business through digital channels in 2021; in our view this is a positive change with a lasting impact on business performance.

In India, we prefer non-gold NBFIs as we expect strong growth on returning demand as infections subside. The gold NBFIs on the other hand are unsurprisingly susceptible to gold prices falling and leading to a smaller asset base. In China, asset management companies (AMC) could be poised to stage a comeback with the completion of the revitalisation of state-owned asset manager Huarong. Elsewhere, a travel surge would benefit the non-life insurers as travel insurance has become essential since the pandemic. More countries are also making it mandatory for inbound visitors to have travel insurance that covers pandemic-related medical expenses.

Real Estate

The Chinese property sector has seen heightened volatility in recent months. The sector's short-term fundamentals have been significantly impacted by tighter government policies, which have simultaneously hit property sales and reduced credit to developers. This has driven several weaker developers to default or to extend the maturities of their debt, while secondary market prices of other developers' bonds have dropped.
In the near term, we expect sales and liquidity to remain muted, and many of the weaker developers may continue to struggle due to a loss of confidence from multiple stakeholders. In the medium term, we expect the sector's outlook to improve due to the following factors:

- A gradual easing of government policies restoring developers' funding access
- An improvement in balance sheets and less reliance on shadow banking as developers have been required to deleverage under government regulations
- Relatively stable underlying demand for property driven by urbanisation and household formation

We expect that the stronger, higher quality developers will benefit more directly from any easing of government policies. In addition, the timing and magnitude of government policy easing, which remains key to restoring funding and confidence to the sector, is relatively uncertain. As a result, we prefer to take a defensive view of the sector and favour investment grade and BB-rated property firms while we have a more cautious view on B-rated property firms.

Infrastructure & Transportation

With vaccination rates increasing globally and border restrictions being eased, we expect the credit fundamentals of the Asian aviation sector and related infrastructures to stabilise and gradually improve in 2022. We expect Asia to catch up after significantly lagging the recovery in the US and Europe. With the increasing establishment of vaccinated travel lanes ("VTLs") and the easing of quarantine requirements, a stronger recovery pace could be expected for both leisure and business travel simply thanks to the region's pent-up demand.

As for the seaport operators, most companies within our coverage have demonstrated a high level of resilience to external shocks despite the pandemic, as observed from the robust throughput volumes seen in 2021 thus far. We remain constructive on Asian seaport operators in 2022, while actively monitoring for any escalation of geopolitical disputes between China, US, EU, and Australia, which could weigh on trade throughput volumes.

Technology

In the past, leading Chinese internet companies enjoyed spectacular growth due to their monopolistic positions. However, domestic regulations were intensified in 2021 as the government aims to improve market practices on the grounds of fair competition, data security and consumer privacy. We expect tightening of regulations to continue in 2022, resulting in increased competition. In addition to the regulatory environment, we believe that the expected slowdown in macroeconomic activity in some key advertising sectors will result in weaker business growth and lower profit margins for most internet companies. Despite these challenges, most Chinese internet bond issuers have very strong capitalisation and low leverage. Due to their strong credit profile, we believe these companies are well positioned to weather the near-term operating volatility and sector downturn, and we are neutral in our view on the sector.

Consumer hardware companies were resilient performers in 2021 and their credit profiles improved. The resilient performance was driven by changes in consumer demand and the shift towards remote work amid the pandemic. Going into 2022, as the world progresses into an endemic phase, we expect performance within hardware companies to diverge. Some companies are poised to retain strong growth momentum as we see demand for their products—arising from permanent structural changes in consumer behaviour—driving supply conditions to their tightest in many years. We therefore maintain a favourable outlook on these companies. However, other companies are likely to experience weaker growth as front-loaded, pandemic-driven demand may fade due to weaker consumption and higher raw material input costs. In addition, some companies are also being hit by chip shortages and supply chain disruptions and we expect these challenges to continue into 2022. We have a cautious view of companies with less diversified supply chains and limited access to raw materials as we believe they are more prone to business interruptions.

Utilities

During the second half of 2021, we saw global natural gas shortages and record surges in coal prices resulting in power shortages in some of the world's largest economies and a loss of profitability for thermal power producers. With fuel costs still at elevated levels, we expect such conditions to last well into the first half of 2022. Furthermore, we expect thermal power producers (particularly those using coal) to be weighed down over the medium term by higher regulatory costs and capital spending as they cope with the transition to a low carbon economy.

Within the utilities sector, we have a less constructive view of thermal power producers and have a favourable view of renewable power companies, given the tailwind the latter are likely to receive from the global transition toward cleaner energy sources. Our cautious view towards Asia Pacific thermal power producers is underpinned by elevated thermal fuel costs, higher capital spending, higher regulatory costs and lastly, tighter funding conditions—especially for coal-reliant power producers.

Telecommunication

We expect the industry consolidation observed recently in some Asian telecom markets to continue in 2022. Roaming services are expected to gradually resume as countries reopen their borders. Thus, we see a gradual recovery in revenue and earnings for most Asian telecom operators in 2022. Capital expenditure could remain high due to 5G roll outs and further investments into the broadband network made to meet increasing data consumption. However, we expect most telecom operators to keep their prudent and disciplined capital spending approach, and we thus maintain a stable outlook on their overall credit profiles. We are broadly neutral on the sector.

Oil & Gas

Crude oil supply-demand dynamics are seen supporting prices in 2022. Oil supply is expected to remain tight into 1Q2022 and then gradually ease towards the remainder of the year. The supply of oil is expected to increase gradually based on an agreement reached by OPEC+ members in July 2021, leading to an eventual normalisation of oil prices. Demand for oil is expected to reach pre-pandemic levels in 2022 as economies recover and travelling resumes.

In the medium- to long-term, we believe that global decarbonisation efforts will dictate the outlook for oil prices. This will likely place a lid on oil majors' hydrocarbon investments aimed towards continued exploration and production activity. As notional demand for oil is expected to be inelastic in the initial years, supply-side dynamics are likely to be the main driver of oil prices. In such a scenario, we expect oil prices to remain high and well supported.

Asian oil & gas companies in the upstream segment are expected to enjoy strong profits in 2022 thanks to higher prices and volume recovery. As for the companies in the downstream segment, we also expect their profitability to recover as refining margins improve from a low base. As a result, we believe that credit metrics will remain strong. Asian national oil companies will continue to enjoy strong government support. Despite the structural shift away from fossil fuels, these companies are still expected to be of high strategic importance in ensuring energy security to their net oil importing nations for many years to come. We are neutral on the Asian oil & gas sector.

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2022 New Zealand Fixed Income Outlook

Boxing on into 2022

By Fergus McDonald, Head of Bonds & Currency

Boxing on into 2022: A financial markets perspective

For a nation that prides itself on punching above its weight in all we do, 2021 has seen us bobbing and weaving against the ropes somewhat, as we've fought the economic impact of an enduring COVID-19 pandemic. We may have been down in some places, but we're certainly not out.

The blows we've taken have been felt keenly by the bond and equity markets, which after years of delivering strong returns to New Zealand investors have this year underperformed their global counterparts. However, while the NZX has waned, private equity has waxed with many companies, particularly in the tech sector, attracting global interest.

Our export sector continues to underpin our recovery—not least through our dairy industry which, despite its many criticisms, has this year poured billions of dollars into New Zealand's economy to help make up for the lost output from international tourism, education and hospitality. Add in our still buoyant commercial and residential property markets, and from a macro level we can see that total economic activity has held up well. The question on all of our lips though, is will this continue?

Red flags near and far

To look forward, we still need to look back. In the past New Zealand has been able to rely on a growing population to add momentum to its economic growth rates. But with immigration having been stalled by the pandemic, and the increasing likelihood of more Kiwis looking offshore for opportunities or feeling less inclined to return home, at least in the short term, we look set to remain handicapped by a countrywide skills shortage. Without this growth potential, I believe we'll see the official cash rate (OCR) peaking earlier than the Reserve Bank of New Zealand (RBNZ) and financial markets are currently pricing.

There are also global threats to New Zealand's economic wellbeing that have been signalled this year. The US is starting to tighten its monetary policy—a move that will likely slow the world's largest economy and the largest buyer of consumer goods. China's growth rate is also likely to slow, which has implications for our export sector and therefore our overall prosperity. Given that it's our top export destination, China's aging population and falling birth rate remains a longer-term concern.

Life gets in the way

So called "black swan" events that impact global economies, like the COVID-19 pandemic, are unpredictable but also increasingly less unexpected. Natural disasters that are still termed "one-in-a-hundred-year" phenomena seem to now occur with far greater frequency than their nomenclature suggests; while developments as varied as Brexit, armed conflict, the GFC and nuclear meltdowns continue to offer regular reminders that we don't need to rely on Mother Nature to put ourselves on the back foot. We also can't ignore the impact of the possible emergence of further COVID variants.

With the first economic policy response from central banks to such events being to cut interest rates, my point here is that life has this uncanny knack of simply getting in the way. So, while the RBNZ is forecasting raising the cash rate by 2.6% by the end of 2023, it may not get the chance to push it this high if, indeed, life gets in the way again.

Housing

We all know of the negative impact rising mortgage rates have on the housing market. But this is by no means the only headwind the sector now faces—particularly in our biggest centre, Auckland. In the year to June 2021, Auckland's population actually fell for the first time on record, as immigration was strangled by the pandemic and an increasing number of Aucklanders reacted to it by heading for the provinces. Another example of life getting in the way.

The corollary of this is that 2022 will likely see more developers put their plans on hold as demand for new builds decline. I expect the pace of house price growth to reduce and then plateau, which will take some of the heat out of both the sales and construction sectors.

More than just a numbers game

Supporting the country's wellbeing through economic growth isn't all just about numbers. Nurturing the feeling of inclusive-ness; providing a good education for our children; letting families grow up in healthy homes in safe neighbourhoods; having a well-resourced health sector; providing the elderly and needy with dignity and support; and even supporting the business community in times of crisis are all things we can and should strive to achieve.

These things take money. Some of them, a lot of money. That's why having economic settings that support healthy business and export sectors and encourage an environment that provides jobs and income for all New Zealanders matters.

Creating the right economic settings for our emerging tech and innovation sectors to thrive is central to our future well-being. The economic and employment impact of the New Zealand tech sector over the last decade has been huge. Rocket Lab, Xero, Weta Digital, Zuru … these are all home grown businesses attracting huge global investor attention while providing Kiwis with highly paid work and the opportunity to further develop and enhance their talents.

Alongside our tech sector, let's not forget that there is also the upside potential of the down-trodden hospitality, tourism and education sectors coming back to life as 2022 progresses. If this bounce back is to occur, it will add significantly to the strong performance of the export sector that has helped sustain New Zealand income levels over the dark days of the pandemic lockdowns.

But let's end with some numbers nonetheless

With the caveat that if the last two years have shown us anything, it's surely the folly of making predictions, I'll stick out my neck sufficiently to say that inflation, the OCR and long-term bond yields will all peak in 2022. Long-term bond yields are likely to peak before the OCR tightening cycle is complete, and I'm picking that the CPI will likely reach its highest point by mid-2022. Pending no further extended lockdowns from other COVID variants, I'd expect the Delta variant rebound to have lost its momentum by September, at a time when house prices are stalling and migrant numbers remain low. Collectively these influences will reduce the pressure for interest rates to rise further.

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