EMBRACING CHANGE

UBP

Union Bancaire Privée

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EMBRACING CHANGE

Investors benefited as economic recovery took hold in the US and Europe in 2021, supported by vaccine-led re-openings.

Consistent with the UBP philosophy, we sought to shield investor portfolios from uncertainties surrounding those roll-outs in early 2021, much like we did successfully in early 2020 as the pandemic began. As these uncertainties faded, our focus on quality earnings as a driver and our timely exit from China equity and bond holdings in the second quarter supported portfolio returns through the summer. Meanwhile our third-quarter addition to bank stocks proved timely as our expectation of a rise in US 10-year yields towards 2% by year-end boosted our financials allocations in the second half of the year.

We expect 2022 to require similar agility on the part of investors as the global economic cycle transitions from the post-pandemic recovery phase to a normalisation phase, similar to the 'mini-cycles' that have characterised economic recoveries since the early 1990s. In such an environment, investors will need to remain nimble in order to enhance the more modest return profiles on offer in both fixed income and equities in the year ahead.

Proactive risk management will be a key in fixed income with coupon-minus returns ahead as US and eurozone risk-free yields rise to levels not seen since early 2019, providing opportunities in alternative income strategies to shield investors from both rising rates and widening credit spreads.

For equity investors, more modest, 8–10% returns in global equities are set to stand in contrast to the 17% returns delivered through end-October 2021.Stock selection will provide an opportunity to augment returns in the new year like in 2021.

Transformation will remain an important narrative, both as a potential catalyst and a headwind for returns. Widespread energy shortages as winter begins in Europe and China should accelerate investment in the green energy transition. Moreover, the tech transformation story will expand with select industrials set to become technology companies in their own right as the benefits of their IT investments spur growth in a traditionally cyclical sector.

China should present renewed challenges as they seek to transform their economic model while at the same time the US turns its attention to containing the world's second-largest economy. As a result, investors will continue to rely on the dynamic, risk management approach that remains at the core of UBP's DNA, helping us maintain our commitment to both preserving and growing our clients' wealth in challenging market conditions just as in bullish times.

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Avoiding the risk of stagflation

Growth is slowing and inflation is climbing steadily due to the serious energy shock in late 2021. Central banks are starting to withdraw monetary stimulus and talking about rate hikes in the near future. The spectre of stagflation is re-emerging, in defiance of economic policy, which will have to be even more finely tuned than in previous crises, with more public spending and central-bank support needed to keep economies growing.

Growth to slow after rapid 2021 rebound

In 2022, the global economy is likely to grow by around 4% after a sharp upturn taking growth close to 6% in 2021. Most economies have made up the shortfall in output caused by the pandemic, with GDP rising back to or already surpassing levels reached in 2019.

The recovery has taken place quickly because of major support from economic policy, i.e. a combination of monetary loosening and fiscal stimulus all around the world. These measures prompted a rapid rebound, firstly in China, then in the US and finally in Europe as various sectors reopened. However, variations in the pace of vaccine roll-outs mean that gaps have opened up between emerging-market and developed countries, and European vaccination rates are the world's highest in late 2021.

The second half of 2021 has been more volatile and economic activity has fallen again in some regions following an upturn in both consumer spending and investment. Supply shortages and bottlenecks have continued to hamper activity, preventing the manufacturing sector from making a full recovery.

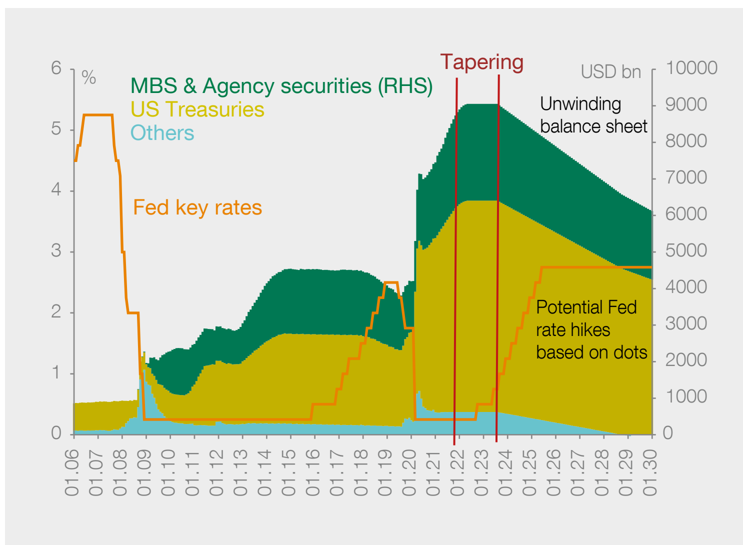
Consumer spending has been the key driver of the upturn and will remain crucial for growth in 2022, especially if households spend all of the money they have saved up during the pandemic. However, problems have emerged in the second half of this year, with real incomes falling because of a sharp rise in inflation and causing consumer confidence and retail sales to decline in some countries. The firm jobs market and falling unemployment should underpin consumer spending, but it is likely to grow at a slower pace in 2022 than in 2021, especially given declining confidence towards

the end of this year. As the recovery phase comes to an end and with elections upcoming in France and the US, the themes of population ageing, pension reform and widening inequality are among people's main concerns.

Adjusting economic policy to fight the spectre of stagflation

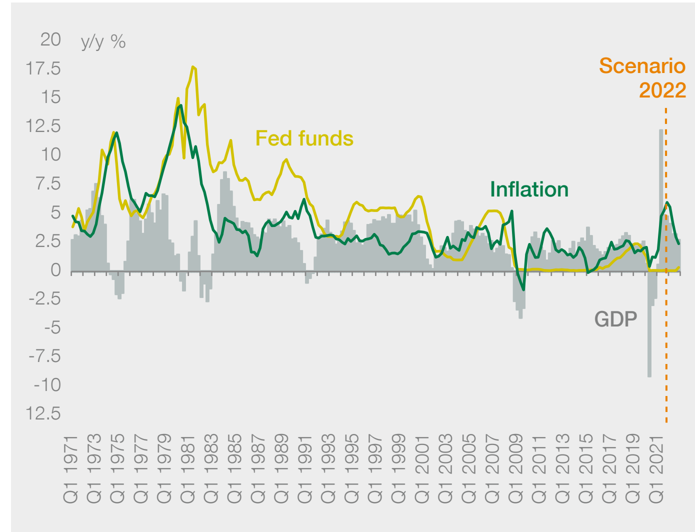
Investment has proven very resilient during the recent difficulties, and has recovered in line with consumer spending in the world's big economies as companies have benefited from support measures and efficient financial markets, with access to cheap and sometimes state-guaranteed funding. This means that capital has not been destroyed as it was in previous crises. However, in late 2021, bottlenecks that appeared during the pandemic remain in place and, together with the prospect of less monetary support in 2022, this could reduce the pace of investment. Public-sector plans adopted this year to encourage infrastructure investment should support the relevant sectors in 2022, as should politicians' desire to reshore production of certain "strategic" goods such as semiconductors and medicines. Overall, in 2022, the economic cycle will be highly dependent on confidence among economic agents and the major role that governments are still playing through their support for certain sectors.

US: FED BALANCE SHEET AND KEY RATES



Sources: Federal Reserve, UBP ETR

US GROWTH, INFLATION AND MONETARY POLICY



Sources: Federal Reserve, BEA, UBP

Economic policy: support being gradually withdrawn

Job support measures have been gradually withdrawn in developed countries in the second half of 2021, and assistance for companies has become increasingly targeted. The US wants to maintain its policy in favour of infrastructure investment and social spending, but disagreements between the two chambers of Congress and within parties mean that final decisions have been delayed and the amounts involved are lower than those mentioned at the start of the Biden administration. Governments in several countries are also considering raising corporate income tax (or taxing digital companies), and raising taxes for high earners to bring down the large deficits resulting from the Covid-19 crisis. In China, tougher regulation of digital platforms and monopolies, but also of the remote education and real estate sectors, has already slowed economic growth. The new medium-term strategy, based on common prosperity, aims to adjust the economy's growth trajectory for the benefit of the middle classes, but relying on large amounts of government regulation instead of just market rules.

In terms of monetary policy, the phase of aggressive economic support is gradually coming to an end. The extraordinary measures introduced during the pandemic will be gradually withdrawn in 2022 and several central banks (in Latin America, Sweden and South Korea) have already raised rates in 2021. Major central banks, except for the Bank of Japan, have announced plans to end asset purchases in 2022 and official rate hikes are starting to appear on the horizon, particularly for the Fed and the Bank of England.

An energy shock and the spectre of stagflation

In 2022, therefore, economies will rely on private-sector demand and an upturn in global trade to continue the expansion that started in 2021. But the global energy shock that has occurred in late 2021 has interfered with existing trends, accelerating the slowdown and fuelling further upside risks to the inflation forecast, which was already high.

Energy and service prices: watch this space

As a result, the risks are that demand could grind unexpectedly and suddenly to a halt, and that inflation could remain at a historically high level eventually becoming unbearable for economic agents but also central banks. The latter, which initially assumed that the spike in inflation will be only temporary, are being forced to admit that it will last longer than expected. This brings the risk of economic policy errors being made at this point in the cycle, leading to disorderly responses between countries and between fiscal and monetary policy.

If these risks are realised, we could see stagflation, i.e. weaker growth, persistently high inflation, and higher nominal long bond yields, which would spell bad news for the countries and companies emerging from the crisis with the largest debts.

The growth cycle remains intrinsically fragile, despite the strength of the recovery seen in 2021. This is because, behind the cyclical rebound, developed countries and China need to combat a long-term trend towards slowing productivity and falling potential growth. Secular factors are still putting a drag on growth, such as population ageing, a workforce with limited skills in terms of new technologies, and slow progress towards new-generation infrastructure. An energy shock, a decline in confidence and real incomes among consumers, and downgraded business investment plans would bring the growth phase to a premature end, leading to a new "mediocre era" to borrow the phrase used by Christine Lagarde, then at the International Monetary Fund, to describe growth in 2015.

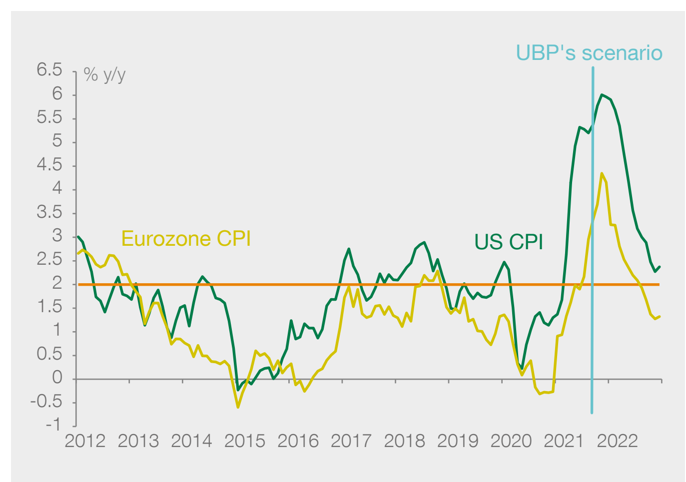
Inflation has risen in 2021 due to the combined impact of higher energy prices, strong demand for goods and services, and rising production and transport costs. The new energy shock facing countries in late 2021 has been caused by economies reopening simultaneously, but also results from years of underinvestment and an energy policy vacuum. But since it is impossible to increase the supply of energy sources in the short term, further price rises seem inevitable and we will have to wait until next March to see prices ease significantly. Ongoing production bottlenecks and price increases for some services (e.g. transport and rent) are adding to the risk of higher inflation, possibly spreading to other sectors over time.

Although the new strategy adopted by the Fed and the ECB means that they will tolerate very high inflation after a period of low inflation, central banks were expecting the surge in prices to prove temporary. However, higher inflation could be with us for longer than central banks are expecting because of bottlenecks, and the difficulties faced by some industries in recruiting staff without raising wages.

Although stagflation is unlikely to be as bad as it was in the 1970s, when economies were less open to competition and indexation systems were in place, it is likely to cause a dilemma for central banks: either accept higher inflation in order to preserve growth, or raise interest rates more sharply than anticipated in order to restore confidence and remove the risk of an upward spiral in prices and wages.

This risk is not the same across all regions. The US and UK seem to be most exposed, due to the strength of the upturn in demand and recruitment difficulties. In Europe and Asia, labour markets appear less stretched and there is less risk of an upward spiral in wages. Monetary policy could decouple from budgetary policy as monetary authorities slam on the brakes: this could bring the end of the growth cycle and create major problems in terms

INFLATION SCENARIO



Sources: BLS, Eurostat, UBP

of public- and private-sector debt, which would quickly become unsustainable.

Investment to boost productivity

The way to avoid this situation is to focus on public-sector investments that boost productivity and on fine-tuning monetary policy. Budget deficits will remain high in large economies next year, but unlike the situation in the 1970s, governments are likely to gamble on directing public investment into new technologies, digitalisation and new-generation infrastructure to address climate issues, thereby extending the growth cycle. Efforts to boost productivity through public and private investment should counteract the secular slowdown seen in recent years and should mean that although inflation is likely to remain high for a few quarters, it should then ease off.

This means that the monetary authorities will have to be nimble in terms of managing liquidity and asset purchases in order to limit potential pressure on nominal interest rates, and gauge any rate hikes carefully in order to delay any rise in real rates. If central banks were to raise interest rates sharply to combat inflation arising from higher energy prices, this would be an error of analysis: a supply-side shock can only be resolved by addressing supply, not by tightening monetary policy. However, central banks and those in charge of economic policy will have to show that they can avoid a second-round effect on core prices and wages, by fine-tuning credit conditions and by injecting liquidity.

To avoid stagflation, economic policy needs to be calibrated in a subtle and careful way, and must be more flexible than it was when emerging from past crises. As a result, any resumption of austerity should be delayed and central banks should maintain their interventionist approach, although on a smaller scale. By adopting flexible policies, authorities should avoid mistakes resulting from persistent laxity or excessive austerity, and allow the growth phase of the cycle to continue.

USD strength lies ahead

We expect the USD bear market to pause, with the greenback rising against most G10 and EM currencies, a significant change to our long-held bearish view. Sterling and the Russian rouble should be exceptions as their proactive central banks allow them to strengthen against the USD in the new year.

In 2022, we expect the USD to appreciate modestly against both G10 and certain emerging markets (EM) currencies. This is a significant change to our long-held USD view, but one we feel is warranted by a hawkish US Federal Reserve, which has led to higher short- and long-dated US yields despite desynchronised growth prospects across major economies and reduced portfolio flows.

The Fed's more hawkish stance means that the USD's interest-rate profile has improved

The Fed's hawkish tilt

The Fed has become more hawkish. It is set to complete tapering of quantitative easing by June 2022, followed by three rate hikes in both 2023 and 2024, in which case the USD will benefit from an improved interest-rate profile against the other major G10 currencies: we see 10-year US yields rising to around 1.7% and even 2% in 2022.

Higher yields

The USD has already appreciated modestly against most other major currencies, with EUR/USD falling to around 1.1550 and USD/JPY rising to around 114.00, and we think there is more to come. Two-year US yields are currently trading at only 0.50%, which is too low considering the Fed's potential tightening between now and 2023. If they rise significantly, this will cause cyclically sensitive currencies (EUR, AUD, NZD, CAD, SEK) to underperform as interest-rate differentials widen. If US 2-year yields rise by a further 25bp, this would be consistent with EUR/USD trading at or below 1.12 and USD/JPY at around 116.00.

Some G10 central banks have become slightly more hawkish, but only Norges Bank will be able to match the Fed's rate hikes. This implies that the USD should outperform most other G10 currencies in the coming quarters.

Desynchronised growth

The recent underperformance of cyclically sensitive high-beta G10 currencies will be compounded by desynchronised growth among major economies. Since March 2020, currencies with a high beta to global growth have outperformed due to a widespread improvement in global economic data and modest USD weakness. However, since June 2021, economic surprise indices in major economies have started to decline and recent policy changes announced in Beijing presage a period of weaker Chinese growth. This has ominous implications for the likes of AUD, NZD and CAD, but also for EUR: lower Chinese growth poses downside risks for the EUR due to the eurozone's substantial exports to China.

Investors have already shifted their stance to reflect this emerging reality. The Commodity Futures Trading Commission's aggregate International Monetary Market futures figures show that they have closed long positions and now even hold small short positions on high-beta currencies. The aggregate USD long position comes to well over USD 25 billion.

The outlook for GBP is more nuanced. We expect the Bank of England to raise its base rate by at least 40 bp to 0.5% in 2022. Consequently, we

see GBP performing well against EUR, but major gains against USD look less likely than before, even though UK/US rate spreads are consistent with GBP/USD trading well above 1.45.

Reduced portfolio flows

Slowing global growth among the major economies will also lead to changes in investor portfolio flows. Portfolio inflows have been beneficial for EUR and CNY over the last 18 months as investors have sought to take advantage of the reopening trade. However, more restricted growth will reduce portfolio flows into cyclically sensitive currencies.

We expect weaker portfolio flows into onshore Chinese equity markets until there is greater clarity from Beijing about the regulatory outlook, although bond inflows should hold up well. The overall shift will be offset by the huge rise in China's trade surplus, meaning that we do not anticipate materially weaker CNY exchange rates. USD/CNY will continue to trade within a relatively tight range in 2022, with the RMB basket rising gradually over time.

However, weaker portfolio flows towards the eurozone will deprive the EUR of any significant upside. Combined with the possibility of underperforming eurozone exports over the coming quarters, this will weigh on the EUR and is one of the main reasons why we have changed stance on the single currency.

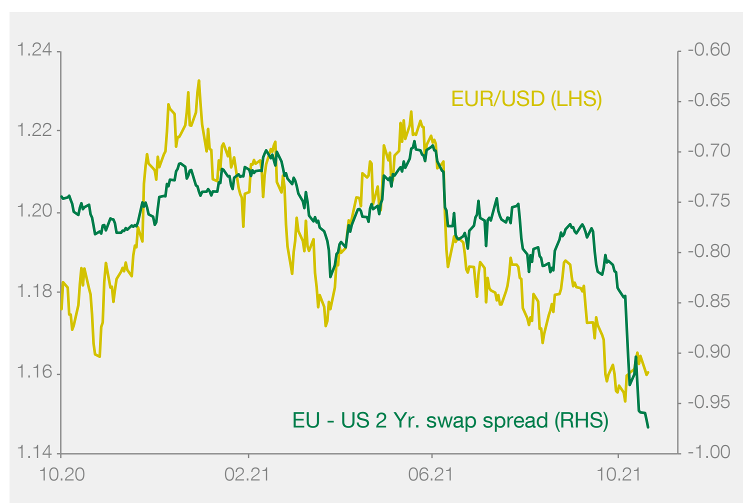
Emerging markets – a mixed picture

Emerging market (EM) currencies tend to underperform when US interest rates rise. However, we think they are less vulnerable than in 2013 because aggregate current-account deficits are in much better shape, meaning that EM economies are less reliant on capital inflows. This will limit the need for aggressive rate hikes, which would stifle growth.

The outlook for EM currencies is nonetheless varied. Countries where central banks proactively raise interest rates will see their currencies do well. We therefore expect RUB to stand out, reflecting high nominal carry and a tailwind from higher oil prices. BRL will also benefit from high nominal carry, although this will be offset by rising inflation in the early part of 2022.

The likes of ZAR, MXN and TRY should continue to weaken, due to high inflation, low investment and central banks that are reluctant to raise rates. In the case of TRY, the central bank is in a rate-cutting cycle, which will lead to a weaker exchange rate and higher FX pass-through inflation.

EUR/USD IS SET TO DECLINE



Sources: Bloomberg Finance L.P.

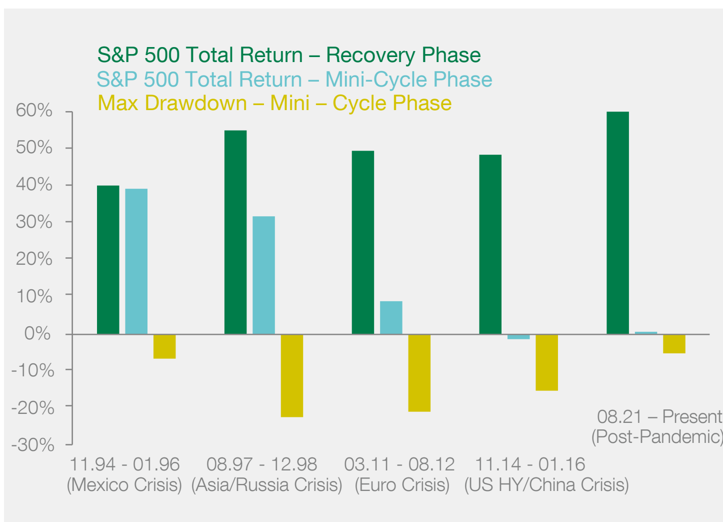
Mini-cycle ahead: opportunity for a "barbell" portfolio

Equity investors should be prepared for a bumpier path ahead as the global economy enters a mini-cycle. Despite increased volatility, investors can expect 8–10% returns in global equities driven by high-quality growth companies combined with a select group of cyclical stocks.

As we expect the global economic recovery to mature in 2022, investors should likewise expect the equity market cycle to mature and progress through a mini-cycle as growth momentum peaks and policy support is gradually withdrawn.

Select industrials offer unique growth prospects, leveraging technology to drive earnings

MINI-CYCLES: EXPECT MORE MODEST RETURNS WITH INCREASED VOLATILITY



Sources: Standard & Poor's, Bloomberg Finance L.P. and UBP

Mini-cycles since the 1990s have shown a number of distinct characteristics. Following consistently strong market performance in economic recovery phases, mini-cycles have tended to be characterised by more modest and increasingly volatile returns. In particular, they have coincided with important, localised credit events including the Mexican crisis (1994), the Asian/Russian crises (1997–98) and the eurozone debt crisis (2011–12).

As a result, after the S&P 500 rallied for over 200 trading days without a 5% correction in 2020–21, equity investors should be prepared for a bumpier path ahead. Encouragingly, though, despite greater volatility, as long as investors steer clear of localised credit events, returns tend to be positive during mini-cycle phases, driven primarily by ongoing earnings growth as the economic recovery matures.

However, unlike in previous mini-cycles, global equities are entering the current one with historically high valuations.

With markets anticipating elevated inflation in 2022, rising bond yields probably lie ahead (see Fixed Income section for more details), which may mean that declining P/E ratios could represent a headwind for equity returns in 2022.

With consensus forecasts showing high-single-digit earnings growth for global equities in 2022, and if we assume modest upgrades to expectations throughout the year, as is typical, we can anticipate 8–10% returns in global equities, admittedly less than the nearly 17% returns seen in the year to October 2021.

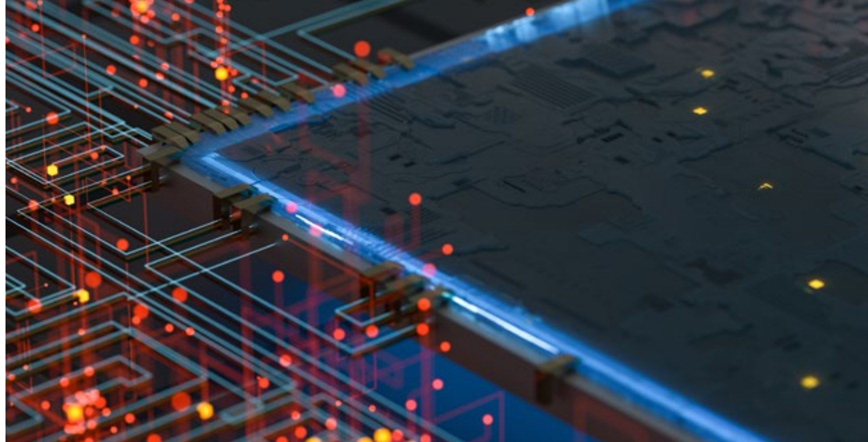
As a result, sector and stock selection will be increasingly important in driving equity returns in the year ahead.

In particular, we believe that the outlook for 2022 presents an attractive opportunity for a "barbell" equity portfolio, exposed to high-quality growth companies combined with a select group of more cyclical stocks.

The former group continues to be a strong foundation for portfolios, due to the very attractive combination of strong balance sheets, significant earnings growth and reasonable valuations found among large-cap, market-leading companies in the technology, communications and healthcare sectors.

Tactically, meanwhile, cyclical stocks will continue to benefit as the economic cycle matures and earnings expectations rise. Indeed, earnings momentum is already pointing in that direction as profit forecasts have risen by 50% for basic materials stocks, 40% for financials and a staggering 180% for energy companies in the US compared to an increase of "only" 24% for the S&P500 and NASDAQ100. Indeed, industrials, although typically cyclical, may offer unique earnings growth prospects as they leverage technology to drive earnings (see box).

Geographically, the US and Europe provide a good balance between growth and cyclical stocks. In contrast, ongoing restructuring and reform in China (see p. 18) represent headwinds for EM earnings growth prospects in 2022, despite historically attractive valuations relative to their developed-market peers.



Embedded technology in global industrials

The technology sector has clearly been one of the winners during the pandemic as lockdowns had consumers and businesses around the world turning to technological solutions to enable them to work and shop from home.

However, the issue of changing how we consume and how businesses deliver services will now give way to that of how traditional industrial manufacturers adopt technology to cope with resource scarcity, increased global competition and growing ESG obligations, not just to survive but to thrive in a post-Covid world.

The transformation of industry will be led by the integration of advanced automation, combining machine precision with human creativity. Data, networking and artificial intelligence will be central to this.

While the global market for industrial automation could reach USD 280 billion by 2026, growing at over 7% per annum in the coming years, emerging industrial automation technologies leveraging the Internet of Things are expected to grow at nearly 10–20 times the rate of GDP growth. Even automated vision and laser technologies are likely to grow at an impressive compound annual growth rate of 13% in the next few years.

This pivot by industrial companies as a response to the pandemic is also supported by transformative fiscal policies being deployed in Europe and China (though still under discussion in the US). ESG and climate-focused regulations will increasingly encourage industrial companies to replace their 20th-century manufacturing facilities with ones that comply with sustainability objectives, with significantly reduced use of energy and production resources due to better planning and organisation, as well as smart maintenance.

Moreover, the pandemic has exposed supply chain fragilities after decades of outsourcing to China, and there is a move to shorten supply lines. This provides an opportunity for industrial companies to develop and invest in domestic 21st-century factories, targeting higher growth and profitability while at the same time reducing the chances of future supply-chain disruption.

While both diversified manufacturing companies and specific automation technology providers should benefit, investors should also look to end-use opportunities including healthcare, semiconductors, broad energy efficiency and e-commerce. In these areas, there is the potential for traditional cyclical industrial companies to be transformed into technology-driven growth companies.

Searching for a new equilibrium in fixed income

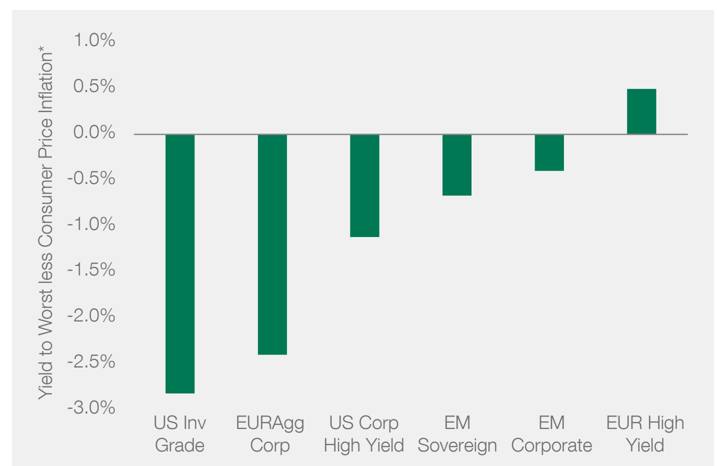
2022 should see long-dated yields normalise in the US and eurozone, with Bund yields above 0% and Treasury yields above 2% for the first time since 2019. This is likely to produce "coupon-minus" returns in the credit segment, with volatile spreads partially offset by the rising rate environment.

If 2020 was a year of economic shock and recovery following Covid-19, 2021 was a year of transition to an as-yet-undefined era for the global economy. 2022 should be the year that the world's economy and fixed-income markets seek to establish a new equilibrium as we learn to live in the post-pandemic era.

Accordingly, the US Federal Reserve and the European Central Bank have both signalled that they will begin to taper the bond-buying programmes that have supported their domestic economies through the pandemic.

We expect this signal to complete the process of restoring the pre-pandemic profiles of both yield curves. With the ECB expected to continue anchoring short rates in the eurozone, German Bund yields, which have been below zero since early 2019, could finally turn positive and rise as far as 0.3%.

SEEKING ABOVE-INFLATION RATES OF RETURN IN FIXED INCOME



Sources: Bloomberg Finance L.P. and UBP

Notes: US credit less US CPI 3-mos MA; EUR credit less EUR area MUICP 3-mos MA; EM credit less US CPI 3-mos MA

In the US, with markets pricing in an initial Fed rate hike as early as December 2022, 10-year Treasury yields could reach 2% for the first time since early 2019 and perhaps as much as 2.5% should Fed rate-hike expectations crystallise between now and 2023.

The Fed & ECB will be seeking a 2013–14-style soft landing for US and German property prices in 2022

Although economic growth is showing signs of faltering as we enter 2022, the pace of recovery is not the only driver of policy and long bond yields. Higher long yields are also important to address central banks' other priority of ensuring stability in the financial system.

With nominal and inflation-adjusted yields having fallen sharply in recent years, US and German residential property prices are now growing at nearly 15% year-on-year. Even adjusting for the low base for comparison at the height of the pandemic, American and German property prices have still risen at a compound annual growth rate of more than 10% over the past two years.

In the US, where the data go back further, there have only been three other periods in which residential property prices have risen at such a rapid two-year pace: in the late 1980s (followed by the US savings

and loan crisis), in 2005–06 (triggering the subprime loans crisis in 2007 and eventually the 2008–09 global financial crisis), and most recently in 2013–14, after which Fed tapering successfully slowed the pace of property price inflation back to its 21st-century average by 2016, although this came amid significant stress in the US high-yield bond markets.

We expect that both the Fed and the ECB will seek to recreate the comparatively soft landing for the financial system seen after 2013–14 and avoid the credit stresses of the two previous US property surges by seeking a more measured rise in long yields.

Credit markets around the world appear optimistic that policymakers on both sides of the Atlantic will achieve this soft landing, with EUR, USD and EM credit spreads near historical lows. Even with the rebound in long-dated risk-free yields, this still means that even risky credit offers little in the way of a premium compared with inflation levels currently seen in the US and eurozone.

As a result, entering 2022, investors should expect "coupon-minus" returns in fixed income, with volatile credit spreads being partially offset by the rising rate environment anticipated in the new year. Short-dated and floating-rate opportunities, for example in the senior loans category, should provide some shelter for investors. However, fixed-income investors should focus on protecting against interest-rate risk as well as some cyclical widening in credit spreads during 2022.

Alternatives to fixed income

With many traditional fixed-income assets delivering sub-inflation rates of return, investors must look beyond credit risk premia and the multi-decade long decline in risk-free yields to both preserve long-term purchasing power and generate sustainable income.

For traditional investors, declining yields have been accompanied by declining bond volatility, creating a favourable environment for buy-and-hold and, in many cases, passive bond investors.

Looking ahead, with yields constrained by the zero lower-bound interest rate policies in Europe and increasingly the US, active credit selection – taking advantage of both long and short opportunities along with periodic spikes in volatility such as that seen in 2020 ¬– should offer investors an opportunity to generate superior returns compared with the buy-and-hold strategy that has served investors well in previous decades.

This active approach offers the additional benefit of reducing sensitivity to directional moves in interest rates and/or credit spreads. This should give investors some shelter from rising rates, as we have seen through much of 2021, or even a widening in credit spreads, common in this phase of the economic cycle.

Beyond this, just as investors originally turned to alternative credit markets to achieve their objectives over the last decade, income-oriented investors will once again need to broaden their net and incorporate illiquidity risk premiums and increased volatility via structured products as a driver of portfolio returns.

Fixed-income sub-sectors like leveraged loans and emerging-market debt have historically had illiquidity risk incorporated into their return profiles, which has served investors well over the past decade. Accordingly, in the same way as investors ventured into these previously new segments, they will once again need to explore additional niche areas where they are compensated for not seeking daily liquidity to boost yields. We believe that areas such as trade receivables, consumer loans, life insurance settlements and even infrastructure and real estate can help to enhance yields and returns for investors in 2022.

Much like leveraged loans and emerging-market debt before them, their novelty allows specialist managers to add meaningful value via investment selection in order to augment the illiquidity risk premium on offer. In addition, like long–short credit strategies, lower sensitivity to wider bond market movements means that these illiquid strategies provide some shelter from the increased interest-rate or credit volatility ahead.

Challenges of the global climate transition

The energy transition currently underway is different. It will be the first in the world's history where the ultimate outcome is to achieve more energy with less carbon, and will arguably involve greater effort in the early years of the transition.

In the past, energy transitions have involved developing technologies that provide ways of accessing more carbon-based energy with less effort, and effectively removing constraints on economic growth arising from the supply of existing energy sources.

Today's energy transition is different. It will be the first where the ultimate outcome is to achieve more energy with less carbon, and will arguably involve greater effort in the early years of the transition.

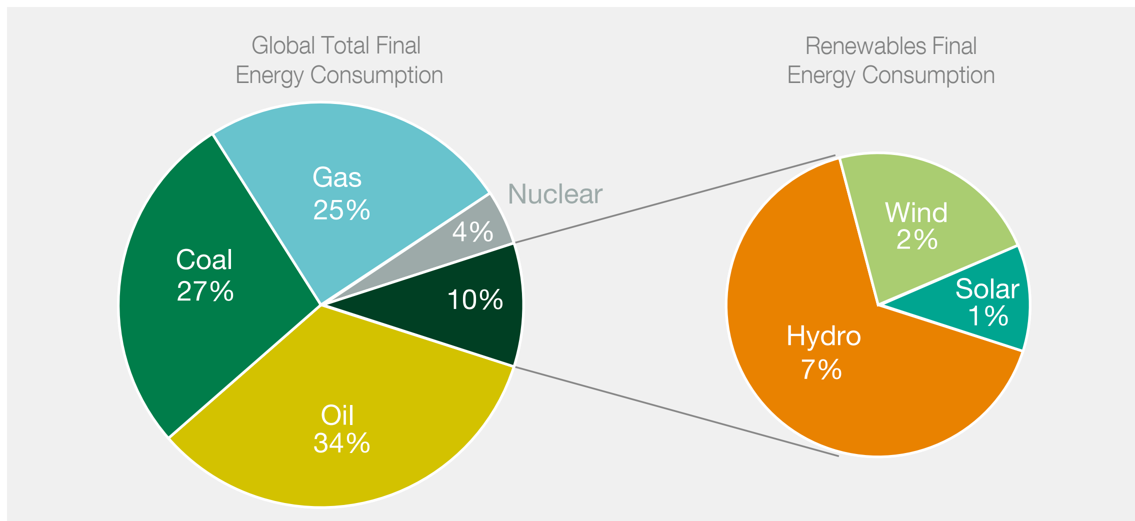
Green energy offers the exciting promise of zero marginal power costs. However, the core technologies for decarbonising the energy value chain – wind, solar, and batteries – currently lack the scale required to replace today's global fossil-fuel infrastructure in full. Solar and wind account for only 3.3% of global final energy consumption and even this modest figure has taken over 20 years to achieve.

Past energy transitions have taken many years or even decades, without the challenges posed by the transformation that lies today. This suggests that the journey ahead will involve more complexity and, as we are seeing in many parts of the world today, greater volatility.

How much complexity and volatility will be determined by how reactive, and hopefully proactive, the global economy is in addressing the future challenges, triggering innovation and creating value in the wake of the value destruction that will be an unavoidable part of the transition.

At the moment, the dominant approach to climate challenges remains reactive. Indeed, estimates by the UN's Intergovernmental Panel on Climate Change suggest that global temperatures are already 1.2˚C above pre-industrial levels, leaving little room before the world exceeds the 1.5˚C warming threshold adopted for the next two decades.

WIND AND SOLAR STILL ACCOUNT FOR ONLY 3% OF TOTAL GLOBAL FINAL ENERGY CONSUMPTION

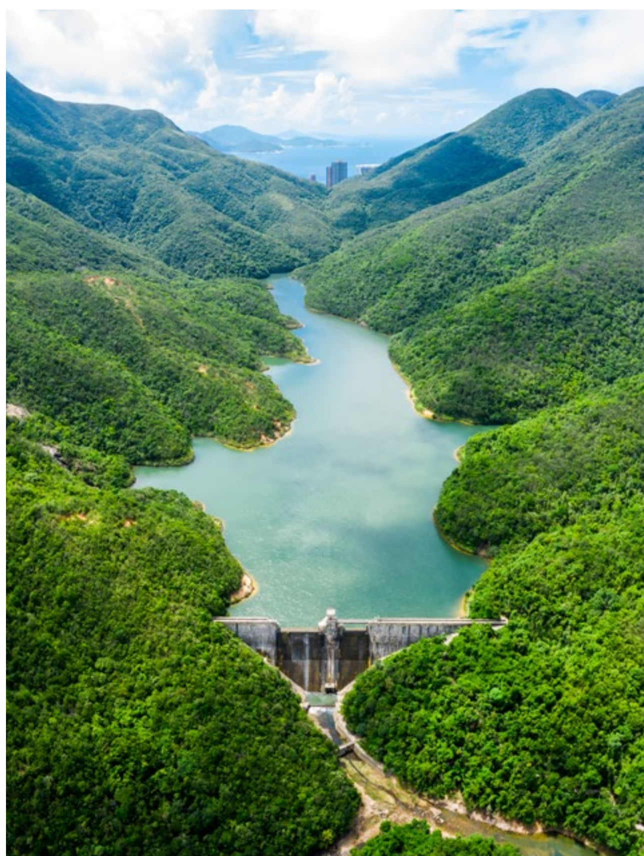


Sources: Ourworldindata.org, BP Statistical Review of World Energy and UBP

For a global economy still seeking to recover fully from the pandemic, the reactive approach, while alarming, is understandable as it presents a lower near-term burden on economies that have been hard-hit in recent years.

However, as events such as extreme weather episodes become increasingly common, markets are responding by factoring in future climate shifts. For example, with hurricanes becoming more frequent and creating extreme flooding across a wider area of the US in recent years, flood insurance rates are set to rise by as much as 77% for the US National Flood Insurance Program's nearly 5 million participants. Similarly, in Europe, banks are increasingly reining in their lending due to climate impacts.

These developments are resulting in reactive infrastructure spending by those affected, in order to mitigate the effects of future weather events. Indeed, for companies geared up for delivering such solutions, these previously one-off opportunities are turning into future annuity streams as this spending becomes recurrent, creating new opportunities for them.



Replacing the current energy value chain could cost as much as USD 50 trillion

Moreover, while the world seeks to replace its carbon-based energy infrastructure, it will require more energy in the near term to achieve the transition and in the meantime, the current energy crisis is forcing some nations to temporarily turn back to high-carbon fossil fuels such as coal. However, the crisis is showing signs of triggering reactive change as consumers look to avoid future disruption by investing in rooftop solar systems, for example, to protect against grid shortfalls should the near-term scramble for fossil fuels continue.

Fortunately, these reactive measures may be accompanied by proactive measures to replace the carbon-based energy system, led by manufacturers using wind, solar and batteries on an industrial scale.

Those that have the capability to build, install and operate renewable assets and the associated infrastructure are set to benefit from decades of growth, although scaling up is not necessarily easy and tomorrow's challenges may be difficult to spot today.

By contrast, those whose business models are based entirely on fossil fuels face potential long-term extinction.

However, this also presents a major opportunity for such businesses to evolve. Many global oil and gas companies are in just such a position. In fact, the current energy crisis will probably help them take action, since they can use the rewards of high fossil-fuel prices to redeploy their traditional oil and gas capex towards renewable assets, potentially making them a key contributor to the energy transformation. If they fail to do so, they face structural decline and the risk of seeing what were once productive, cash-generating assets become stranded assets in the years ahead.

While corporates can take the lead in the global energy transition, and are increasingly doing just that, governments and policymakers will also have an important role to play, even beyond the regulatory pressure they are applying in order to spur the transformation, by de-risking the investment proposition.

To achieve net zero by 2050, some estimates suggest that as much as USD 50 trillion will have to be spent on replacing today's global energy infrastructure, an order of magnitude larger than the investment required to industrialise China in recent decades.

So just as China benefited from falling interest rates to provide cheap funding for its ambitious capital spending plans, policymakers will probably need to ensure similarly attractive financing costs that encourage the private sector to deploy capital and ingenuity on a scale that governments alone cannot achieve.

The landscape has changed

China's pivot to an era of "common prosperity" means that the authorities need to rebalance the economy, adopting a consumer-led growth model. This shift, which began in 2021, has disrupted China's traditional investment narrative, creating both medium-term challenges and strategic opportunities for agile investors.

Since November 2020, regulators have proactively deployed a wide array of policy tools to address structural shortcomings in the economy. These include the role of technology platforms, income inequality, elevated corporate debt and the ostensible fraying of China's social fabric, the result of many years of rapid GDP growth under the "to get rich is glorious" era of Deng Xiaoping.

Faced with these challenges, President Xi Jinping has heralded a new epoch of "common prosperity". Under this new paradigm, the overarching aim will be to attain high-income status by 2025. This ambition requires a substantial increase in per capita gross national income (GNI) from USD 10,610 in 2020. To achieve this, China will look to accelerate reforms to increase the share of labour in GDP and alleviate demographic pressures.

China must walk a fine line between growth and reforms, suggesting a secular slowdown ahead

To succeed with this pivot, China will seek to realign its factors of production towards labour and away from capital. This will be achieved via redistributive measures and by mobilising the private sector. The latter has developed rapidly in the absence of external competition, but established players are now being tasked with generating social value in addition to financial returns, potentially creating a new, more moderate earnings growth trajectory for some.

Tougher regulations aimed at addressing the "three burdens" affecting households – housing, education and healthcare — have also begun to be implemented in the hope that they might spur consumer spending and allow for higher fertility rates to reverse the effects of China's one-child policy on overall population growth. With the 2025 target of becoming a high-income economy in mind, ongoing rapid reform should be expected in 2022, suggesting that the increase in volatility seen in the second half of 2021 will continue until a new, stable foundation is established and investors have fully priced in this new normal.

While investors may see a cyclical reprieve in 2022 following the slowdown in 2021, China will need to walk a fine line between growth and reforms. While 4.5–5.0% growth is needed to achieve high-income status, investors should expect that GDP

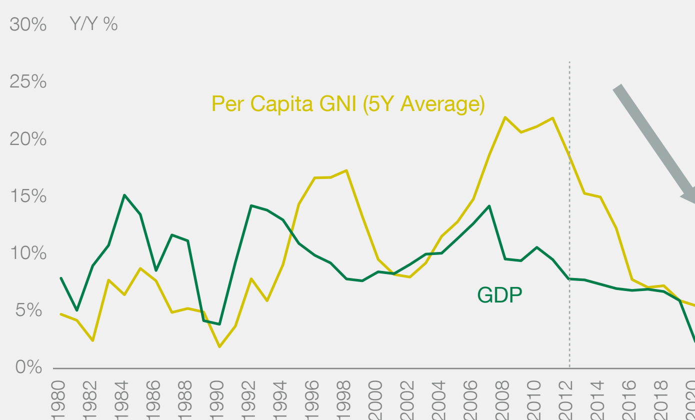
will slow once again to 5.0% in 2022 and gradually trend towards 4.0% by the end of the 5-year period, suggesting a secular slowdown ahead for China.

Against this backdrop, policy can remain tight to allow authorities to pursue structural reform, especially with regard to housing and the overall property market. However, marginal easing will be tolerated to smooth out fluctuations in the business cycle and offset exogenous shocks.

Indeed, with a brewing energy crisis and lingering Covid risks as 2021 comes to a close, additional counter-cyclical measures may be implemented starting from the second quarter of 2022. This should allow greater clarity in early 2022 regarding the future regulatory situation. Even if cyclical and regulatory support emerges, we expect a bottom-up, stock-picking approach – favouring business models targeting both social and financial returns – to be increasingly valuable, even within the Chinese economy's favoured growth sectors.

CHINA: ECONOMY FACES A STRUCTURAL SLOWDOWN

President Xi Jinping was tasked with addressing rising inequality and creating sustainable growth as China entered a period of structural slowdown that started during the 12th FYP (2012–2015)



Sources: International Monetary Fund, World Bank, UBP

Navigating the new landscape in China technology

The regulatory environment for consumer-facing technology companies in China has tightened significantly in 2021. This comes after a decade of robust industry expansion facilitated by a relatively small number of rules. We believe the new era of heightened scrutiny is here to stay, and we are likely to see more measures in 2022 to fulfil regulatory objectives.

Chinese consumer-tech companies will have to navigate the new norms cautiously. Their previous "innovate first, ask questions later" modus operandi is no longer tolerated. The prize of market dominance may be diminished as leaders can no longer expand aggressively or sideline competitors simply by using their scale and financial strength. As firms contend with the higher costs of regulatory compliance and increased expectations of corporate social responsibility, the market may spend early 2022 continuing to "reset" its valuation and earnings outlooks on the large and increasingly mature companies in the space.

As a result, investors should now go in at an earlier stage of the growth cycle to avoid the social costs that mature market leaders must bear. Despite this, as the world's largest digital economy, China continues to yield opportunities for long-term investors in consumer-tech.

Even with 1.01 billion online users, China's 71.6% internet penetration and the "open-mindedness" of new online users to new technology make the country adept at facilitating large-scale roll-outs of consumer innovations in very short timeframes.

It will, however, be increasingly important to be selective in hard-tech due to its heavy R&D and longer horizon for returns, albeit with policy and fiscal support from the government. Artificial intelligence and its application in autonomous driving, speech and facial recognition is an area where China has world-leading technology and can leverage its access to a large data bank to accelerate time to market.

Moreover, clean energy transition and vehicle electrification also tie in with the nation's targets on peaking emissions by 2030 and hitting net zero by 2060, and remain industries where China retains global leadership.

While these themes remain aligned with overarching Chinese policy goals, investors will need to be increasingly focused on company-level as well as industry-level trends and ensure that potentially increased social costs are built into evolving business models to ensure attractive rates of returns.

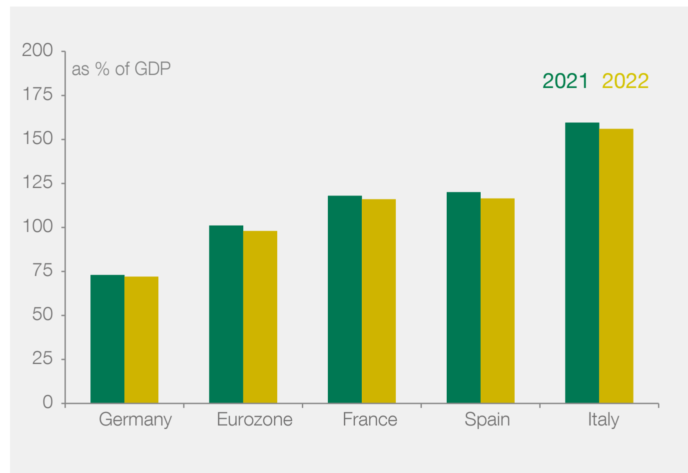
Restoring fiscal discipline in the eurozone

In the wake of the pandemic and applying the lessons learned from the 2012 European crisis, the EU's fiscal policy can no longer limit itself to reinstating the budget deficits and public debt ceilings agreed in the Maastricht Treaty, but must review them or even radically reform them.

To allow European governments to combat the pandemic effectively, the Maastricht rules have been put on hold. Compliance with rules regarding fiscal discipline (limiting the budget deficit to 3% of GDP), public-sector debt (limiting it to 60% of GDP) and the European Commission's oversight (the European Semester gives governments medium-term targets as part of the Stability and Growth Pact) is scheduled to resume in 2023. However, that seems to be too soon and would require countries to adopt excessive austerity. In addition, the European Commission has begun a strategic review of its fiscal governance.

To avoid stagflation, a compromise allowing a highly flexible interpretation of the rules is a minimum requirement and more clear-cut reforms could arise in the wake of the Next Generation EU (NGEU) recovery fund.

PROJECTION OF GROSS GOVERNMENT DEBT



Source: UBP

Highly flexible rules under the Maastricht treaty are a minimum requirement

Moreover, the new environmental targets and necessary expenditure of each individual country mean that the way in which fiscal policy is assessed now appears obsolete. The Stability and Growth Pact's rules are complex and remain largely unenforced because decisions to penalise countries are being delayed. Slow progress in terms of reforms means that fiscal policy is pro-cyclical, making recessions worse but failing to restore surpluses when economies are growing strongly. Fiscal austerity has often involved a reduction in public-sector investment, leading to underinvestment in infrastructure and new technologies.

2022 will bring intense negotiations to redefine the framework of European fiscal policy. Work done by several European organisations has resulted in four themes for discussion, with a range of measures depending on the political will and landscape that emerges in 2022:

1. A review of the criteria regarding deficits (3% of GDP) and debt (60% of GDP). These figures could be raised to take account of the current context, but this would involve the amendment of European treaties.

2. Greater flexibility in assessing the deficit and debt criteria, and greater speed in making adjustments on a country-by-country basis. The analysis is likely to focus on net public spending rather than on complex deficit calculations. By removing strategic investment from ordinary public spending when calculating the deficit, the rules could be loosened without restricting investment.

3. The NGEU fund could be turned into a permanent instrument. The aim would be to develop a European version of the International Monetary Fund to provide a fiscal and monetary response with a customised medium-term convergence target, cyclical aid and the ability to respond to external shocks with its own, permanent resources, based on solidarity and transfers within the eurozone.

4. A greater role for the European Parliament in the budget process.

These changes could emphasise the value of strategic public spending, as well as speeding up the process of changing the eurozone. Resilience against external shocks has been vital in recent years, highlighting the need for co-ordinated fiscal and monetary action. Finally, European debt and the debts of member states must remain sustainable in the eyes of both taxpayers and the markets, having risen over time and during recent crises.

Reshaping the European Union

The European Union has experienced a deep recession during the pandemic but has shown its ability to bounce back and take strong concerted action. The Covid-19 crisis has shown that the EU is vulnerable to several factors: a dependency on emerging-market countries for manufactured goods and medicines, export markets, and insufficient diversification in industry and technology.

Europe's economic and political landscape has been redrawn by the UK's departure from the EU and by the response to the pandemic: the creation of the recovery and stimulus plan (Next Generation EU) creates the basis for a new Union. Monetary union is the cornerstone of the European project. It has prevented the eurozone from breaking up and has allowed new kinds of support (purchases of government and corporate bonds), along with a redefinition of the ECB's inflation target.

The European Union has laid the foundations for the eurozone to work in a new way, with the issuance of common debt and transfers between member-states. Although this collective action does not constitute a genuine fiscal union, it comes alongside national action and opens the way for further reforms. As a result, the eurozone is at a turning point: if there is clear political will, the principles of its actions could be redefined to see greater integration. This latter point was emphasised by the Social Democrats and Greens in the recent German election campaign and it echoes the strategy adopted by France along with fiscal and political decisions made in Spain and Italy.

The eurozone faces major challenges that go beyond monetary and fiscal issues and include greater European co-operation in the fields of healthcare, energy and defence. Finally, European co-operation on climate issues is taking shape.

These new tools could represent a big opportunity for the eurozone. They could have a substantial medium-term impact, increasing potential growth, ending the decline in productivity, and allowing to overcome the challenge of an ageing population. The focus on new technologies is an opportunity but also an obligation given the stated ambitions of the US and China. It would make the eurozone less exposed to external shocks. Finally, in geopolitical terms, a strong, united eurozone would be a response to increasing US isolationism in recent years and to China's growing Sino-centrism.

An American pivot to Asia

Geopolitical tensions are likely to return as President Biden turns his attention to foreign policy in 2022. Trade may see some relief if the US drops certain tariffs to ease supply-chain disruptions. However, the source of pressure may change, due to a continued build-up of US-led multilateral coalitions and restrictions on Chinese access to advanced technologies.

President Biden has unsurprisingly spent much of his first year dealing with pressing domestic matters, including the pandemic response, the US debt ceiling and his signature fiscal programmes, which remain under negotiation in Congress.

However, Biden may seek to focus on foreign policy in his second year, much like his predecessor Donald Trump, who announced his trade war in January 2018, almost exactly one year after taking his oath. Though the specifics of Biden's China policy remain unknown, developments in the second half of 2021 suggest the Biden administration is reviving the Obama-era's "Pivot to Asia", which should take shape more fully in 2022.

Accordingly, investors may see a thaw in US–China trade relations in the new year. With supply-chain disruption resulting in high US inflation, the Biden administration appears keen to use selective tariff relief as a way to achieve domestic objectives. Indeed, with China's purchases of US goods under the Phase One Trade Deal still 40% below target, the US has some cover to ease trade tensions in the months ahead while China may likewise see domestic benefit from increased agricultural supply.

However, progress on trade may belie a broader shift in US priorities. In particular, the US withdrawal from Afghanistan, the deepening of ties among the "Quad" – the US, Japan, India and Australia – and the late-2021 announcement of a trilateral security pact between Australia, the UK and the US (AUKUS) suggest a shift in US focus away from the Middle East and towards a multilateral approach to countering China's influence in the wider Indo-Pacific region, and not just on trade.

> The risk is not imminent conflict but miscalculation by the world's two largest economies

With tariffs an unviable form of leverage, access to advanced technology and to USD capital markets remain key potential strategic pressure points, especially as China seeks to establish its new domestic paradigm (see p. 18 for more details).

Chinese policymakers are not oblivious to these threats. In recent months, Chinese aircraft have conducted manoeuvres in the air defence identification zone above Taiwan as China sets out its red lines for the new US administration. Meanwhile, multiple rounds of commander-level talks between China and India have failed to yield an agreement, making it harder to de-escalate the unrest at this increasingly contentious border.

Although tensions are high, the main risk facing investors is not imminent conflict between the world's two largest economies, but a miscalculation that might tip slowing economies over the edge into recession, just as the US–China trade war of 2018–19 threatened to do.

Managing risk while embracing change

In 2022, investors will need to embrace the new and unique risks of the pandemic-era economy. UBP's active risk management approach allows investors not only to mitigate these risks, but also to embrace change and exploit the long-term changes that will continue to take shape in the post-pandemic era.

The pandemic-era economic cycle poses unique risks as well as unprecedented opportunities for investors. The cycle itself began with the shortest and sharpest recession followed by the fastest and steepest economic rebound in history.

In 2022, as the US economy follows China and is set to be followed by Europe into the mini-cycle phase of this expansion, investors will need to embrace not only the changes accompanying the evolution of the economic cycle but also new risks on the horizon.

The move into the mini-cycle itself suggests more modest returns for equity and fixed income investors, with drawdowns and volatility greater than those seen during the recovery phase just ended.

Our active risk management approach allows investors to exploit long-term transformation themes

Just as importantly, going back to the early 1990s, all mini-cycles have been characterised by localised credit events, i.e. the Mexico crisis of 1994, the Asia/Russia crises of 1997–98 and the eurozone sovereign debt crisis of 2011–12. For the year ahead, therefore, proactive risk management in the fixed income arena, involving alternative income opportunities uncorrelated to both interest-rate and credit-spread volatility, is a prudent option.

With equity volatility plumbing historic lows as 2021 comes to a close, option strategies are once again offering attractive protection as policymakers around the world attempt to contain inflationary pressures and also spur investment in greening the global economy in the decades ahead.

The realignment of geopolitical alliances amidst China's attempt at transforming its domestic economy brings a new uncertainty to the global landscape. Since the turn of the century, China has underpinned global growth. However, with the prospect of a secular slowdown in the years ahead, alongside the risk of new Indo-Pacific alliances forming with the aim of containing China's global ambitions, the risk of trans-Pacific policy error between the world's two largest economies has resurfaced.

As a result, the active risk management approach that forms the foundation of UBP's preserve-and-grow investment philosophy allows investors to mitigate not only the typical cyclical risks, but also the unique risks that this new journey into a post-pandemic era presents.

By mitigating these risks, we are more able to embrace change and capitalise on opportunities that emerge during episodes of volatility, allowing clients to focus on exploiting the continued long-term transformation themes that continue to take shape in the post-pandemic world.

MICHAËL LOK

Group CIO and Co-CEO Asset Management

Michaël Lok, who has over twenty years of experience in wealth and asset management, joined UBP in 2015 as Head of Investment Management. Previously, he was Global Head of Asset Management with Indosuez Wealth Management (Crédit Agricole Group), where he developed a range of UCITS funds for Private Banking and a set of UHNWI mandates and dedicated investment solutions with a focus on Asia and Latin America. This followed his roles as Head of Investment and Head of Risk and Quantitative Portfolio Management. Before that, he was Portfolio Manager at Banque Martin Maurel and HSBC France (ex-CCF). Michaël Lok holds two Master's degrees, one in Finance (DESS) and one in Banking and Finance (DEA), from the University of Aix-en-Provence.

NORMAN VILLAMIN

Chief Investment Officer (CIO) Wealth Management

Norman Villamin joined UBP in November 2015 as Head of Investment Services and Treasury & Trading of UBP Zurich. He was appointed Chief Investment Officer Wealth Management in 2016. With over twenty years of experience managing wealth both on an advisory and discretionary basis, Norman Villamin has been Chief Investment Officer for Coutts International, Head of Investment Analysis & Advice for Citi Private Bank in Asia-Pacific as well as the Head of Asia-Pacific Research for HSBC and the Head of Asia-Pacific Strategy for Morgan Stanley based in Hong Kong and Singapore. Norman Villamin holds a Bachelor's degree in Business Administration from the University of Michigan and a Master's in Business Administration from the University of Chicago.

PATRICE GAUTRY

Chief Economist

Patrice Gautry joined UBP in Geneva in February 2000 and heads the Bank's Economic and Thematic Research department. Prior to that, from 1991 to 1999, he worked in the Institutional Asset Management department of HSBC Group in Paris as head of economics and investment strategy. From 1988 to 1991, he was a manager of European diversified SICAV and mutual fund portfolios for the Ecofi-Finance Group. Patrice Gautry holds a Research Master's degree (Diplôme d'Etudes Approfondies) in economics from the HEC-CESA Paris and the University of Orléans, with specialisations in currency, finance and banking.

PETER KINSELLA

Global Head of Forex Strategy

Peter Kinsella, who has over 14 years of experience in wealth management and investment banking, joined UBP in November 2018. Previously, he was Head of Emerging Market Research at Commerzbank, where he managed an international team covering all of the key emerging market economies (Russia/CIS, EMEA, China and LatAm). Peter Kinsella has significant experience with advanced currency hedging and risk management techniques, gained from his position as FX and Derivatives Trader at Pioneer Investments/Amundi. Peter Kinsella holds two master's degrees, one in economics from the London School of Economics and one in Law & Economics from the University of Bologna.

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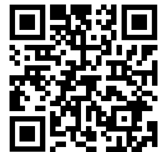

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