Optimal Income Strategies

Covid is back, but markets are still expected to rise further in 2022

- Diversifying our equity exposure by tactically adding Small Caps
- Positive performance last month and globally over 2021
- Post-COVID rebound should persist and global growth remain slightly above potential in 2022

Serge Pizem
Global Head of Multi-Asset
Lead Portfolio Manager

What's happening?

Covid-19 is back in the news due to the much more transmissible Omicron variant. If the new restrictions are mainly in Europe, the worst is probably to come in the United States and China where the vaccination rates or vaccine efficiency are low. Inflation is also being closely monitored whilst the Federal Reserve accelerated its monetary policy normalization timetable.

In the US, domestic demand remained strong as evidenced by preliminary retail sales data which continued to rise in November. However, the persistence of inflation (6.8% annualised) and the scheduled end of the child tax credit, worth up to $300 per month, should weigh on household purchasing power. Despite the economic uncertainties, the Federal Reserve decided to tighten its stance to fight inflation with an acceleration in the reduction of its net asset purchases and an anticipated minimum of three rate hikes in 2022.

In the euro zone, industrial production remained buoyant. On the other hand, business and household confidence surveys fell back slightly and are expected to deteriorate further given the new Covid wave and Omicron related uncertainties. Higher prices (+4.9% in November) also eroded household purchasing power. In this context, the ECB announced the end of its emergency program (PEPP) in March 2022 but decided to increase net purchases within the PPA.

Despite the Omicron variant still dominating the narrative, most equity markets recovered. The MSCI AC World index thus rebounded +2.9% in Euros. The US stock-market (S&P 500 in local currency) rose 4.4%, ending the year just below its historic highs. Eurozone equites benefited even more with the Eurostoxx 50 up +5.8%. Within the fixed income space, sovereign bonds were slightly weaker as several major central banks confirmed a normalisation of their monetary policy over the coming months.

Positioning & Performance:

	GLOBAL OPTIMAL STRATEGY				OPTIMAL STRATEGY				DEFENSIVE OPTIMAL STRATEGY			
	Dec-20	Nov-21	Dec-21	Δ	*Dec-20*	Nov-21	Dec-21	Δ	*Dec-20*	Nov-21	Dec-21	Δ
Net Equity	*89,10%*	77,20%	86,50%	↑	*70,20%*	58,90%	72,30%	↑	*32,80%*	24,80%	32,80%	↑
Equities	*89,90%*	91,10%	89,80%		*76,10%*	58,50%	64,70%		*37,70%*	39,90%	40,40%	
Equities derivatives	*4,40%*	-12,40%	-2,20%	↑	*-0,60%*	2,30%	9,10%	↑	*-2,50%*	-15,10%	-7,60%	↑
Risk Mitigation Strategies	*-5,20%*	-1,50%	-1,10%		*-5,30%*	-1,90%	-1,50%		*-2,40%*	0,00%	0,00%	
Fixed Income	*5,70%*	0,60%	0,50%		*18,10%*	15,00%	14,70%		*52,20%*	51,80%	49,90%	
Govies	*0,00%*	0,00%	0,00%		*0,00%*	0,00%	0,00%		*2,10%*	0,30%	0,30%	
Bond Derivatives	*0,00%*	-29,00%	-23,00%		*0,00%*	-33,60%	-25,90%		*0,00%*	-51,70%	-36,30%	↓
High Yield Credit	*2,50%*	0,00%	0,00%		*3,90%*	3,10%	2,90%		*5,30%*	10,40%	10,10%	
Investment Grade	*2,60%*	0,00%	0,00%		*13,60%*	11,40%	11,30%		*44,20%*	40,40%	38,90%	
Emerging Debt	*0,60%*	0,60%	0,50%		*0,60%*	0,50%	0,50%		*0,60%*	0,60%	0,60%	
Diversification	*6,60%*	1,70%	1,60%		*8,10%*	3,20%	3,20%		*5,50%*	0,80%	0,80%	
Cash & Money Market	*-1,30%*	20,60%	11,40%	↓	*3,50%*	23,00%	9,70%	↓	*9,40%*	22,70%	16,50%	↓

Key tactical positioning

			Recent ptf activity	YTD absolute contribution
1	Overweight equity	We are still positive on equities as it remains our favorite asset class with good earnings potential and still favorable financial conditions ➔ exposure gradually reduced by taking profits	=	+
2	Underweight duration	Underweight duration trade implemented in February (short duration diversified on US and EU for OI range) ➔ portfolio duration reduced to around -2	=	+
3	Risk mitigation strategy	Implementation of a risk mitigation strategy aiming to reduce the equity exposure in case of market downturn ➔ optional strategy based on Eurostoxx 50	=	+

In December, portfolio activity remained relatively calm. For the first time since the summer, when we began to reduce our equity exposure, we added a tactical 2% of Russell 2000 exposure as Small Caps have underperformed large caps over 2021 whilst maintaining our positive view on equities. Indeed, we expect growth to remain above trend in 2022.

In terms of performance, December was positive for our three strategies mainly due to the year-end rally of equity markets.

2021 was a challenging year for our strategies even if they all posted a positive gross performance. Our portfolios, favouring pro-risk/pro-reflation assets, were globally well positioned to address the 2021 market environment. Although our structural growth bias was negatively impacted in Q1, we tactically added some cyclical exposure to our equity bucket (via UK, Financials, Industrial, Energy, and reopening economy baskets) which contributed positively. However, we suffered from of our Chinese stocks exposure. Strong yesterday, fragile today, the Chinese economy decelerated sharply in the 2nd half of 2021. While Chinese stocks were amongst the best contributors in 2020, they were amongst the main detractors in 2021, negatively impacting the relative performance of our portfolios.

Outlook

For equity investors, 2021 was a rewarding year with global shares up around 20% year-to-date (MSCI World in local currency). Despite Omicron's wobble, we expect equity markets have further to run in 2022, even if the balance of risk is less supportive than in 2021. In our view, equities should post modest positive returns this year.

Our macroeconomic scenario underlying this view is for the post-COVID rebound to persist and global growth to remain slightly above potential in 2022, although decelerating from 5.7% to 4.2%. Demand should remain robust, excess savings are massive, corporates investments should also be solid and inventories are low. However,

Source: AXA IM as end of December 2021

persistent supply-chain constraints dampen the outlook even if we expect these supply-chain headwinds to gradually fade in 2022.

A bigger source of concern and uncertainty in our 2022 outlook is inflation. The sharp acceleration in demand for goods coupled with supply-side shocks, particularly in goods, commodities, and labour markets, has resulted in increased inflation pressures. Whilst inflationary pressures should ease across major economies over the second half of 2022 as demand slows and supply rises, cooling down prices for goods, we expect inflation to remain slightly above the Fed's target for some time in the US, while euro zone inflation should come back within the ECB's tolerance range.

In this context, the Fed stopped characterizing inflation as transitory and announced a tightening of its monetary stance including three rate hikes this year, with most Central Banks following suit. In this environment, real yields should start to very gradually normalize in 2022 from their lowest level in nearly 50 years. If US real yields do indeed rise, this will likely be the most important theme across markets over the coming year and suggests some potential downward pressure on asset valuations, including corporate credit.

Nevertheless, we remain moderately bullish on equities. As was the case last year when equity valuations broadly declined, earnings should continue to be the main driver of returns in 2022. But risks abound and volatility is likely to rise. Reactivity and selectivity will be key.

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