BRILLIANT KNOWLEDGE

EDISON INSIGHT

Strategic perspective

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EDISON

Contents

Welcome to the January edition of the Edison Insight. This special edition strays from our usual format as it does not include any company profiles. Instead, we look at the outlook for 2022. Healthcare companies are covered separately in Edison Healthcare Insight, which can be found on our website homepage.

Alastair George believes that the economic risks of Omicron appear to have fallen short of earlier worst-case predictions. Even though other COVID-19 variants are likely to emerge during 2022, developed market economies and the pandemic appear to be steadily decoupling and the world economic recovery should continue. Equities in the first half of the year are likely to be supported by relatively strong economic momentum although the lagged impact of tighter monetary policy and the prospect of slower growth in 2023 may hinder returns during H222.

Our key concern is that the good news on COVID-19 is already firmly embedded in equity market prices. Furthermore, inflation remains at an uncomfortably high level in the United States and Europe while in China the property sector remains in distress. Nevertheless, extended equity valuations are by no means universal and are concentrated both geographically and by sector. This valuation dispersion may offer opportunities to active investors. US markets may be trading well above long-term averages, but many other developed markets are at least within sight of traditional valuation metrics and European and 'old economy' sectors appear better hunting grounds for returns at present. We expect energy sector profits to be supported by strong commodity prices while financials should continue to benefit from rising interest rates. We remain cautious on government bond markets as still-low yields do not appear to factor in a return to the pre COVID-19 trajectory of global GDP. We acknowledge valuations for global equities in aggregate are high but also balance this with the likelihood of another year of corporate profits growth and few alternative options for portfolio asset allocation. Furthermore, outside the United States, equities are not as highly valued and there remain opportunities for active investors. We therefore initiate a neutral outlook on global equities for 2022 while expecting a significant sector and regional rotation in relative performance during the year.

Readers wishing more detail should visit our website, where reports are freely available for download (www.edisongroup.com). All profit and earnings figures shown are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

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We welcome any comments/suggestions our readers may have.

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Director of research

Global perspectives: Finding value in the tail

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- **The economic risks of Omicron appear to have fallen short of earlier worst-case predictions.** Even though other variants are likely to emerge during 2022, developed market economies and the pandemic appear to be steadily decoupling. The world economic recovery should continue in 2022. Equities in the first half of the year are likely to be supported by relatively strong economic momentum in our view, although the lagged impact of tighter monetary policy and the prospect of slower growth in 2023 may hinder returns during H222.
- **Our key concern is that the good news on COVID-19 is already firmly embedded in equity market prices.** The equity risk premium for global markets remains close to 15-year record lows and corporate credit spreads are also tight. This demonstrates a strong investor appetite for risk, even as economic growth is set to moderate over the course of 2022. Furthermore, inflation remains at an uncomfortably high level in the United States and Europe while in China the property sector remains in distress.
- **Nevertheless, extended equity valuations are by no means universal and are concentrated both geographically and by sector**. This valuation dispersion may offer opportunities to active investors. US markets may be trading well above long-term averages, but many other developed markets are at least within sight of traditional valuation metrics.
- **European and ‘old economy’ sectors appear better hunting grounds for returns in 2022.** Regional sector aggregates suggest a ‘long tail’ of sectors outside the United States that fall into this category. We expect energy sector profits to be supported by strong commodity prices while financials should continue to benefit from rising interest rates. While non-US equities are not ‘cheap’ in absolute terms, many sectors are trading only a little above historical valuation norms and priced to offer returns well above domestic bond yields.
- **We remain cautious on government bond markets as still-low yields do not appear to factor in a return to the pre COVID-19 trajectory of global GDP.** We acknowledge valuations for global equities are high but also balance this with the likelihood of another year of corporate profits growth. Furthermore, outside the United States, equities are not as highly valued and there remain opportunities for active investors. We therefore initiate a neutral outlook on global equities for 2022 while expecting a significant sector and regional rotation in relative performance during the year.

Outlook for 2022: Finding value in the tail

We believe the primary challenge to global markets in 2022 will not be a new variant of COVID-19 nor further increases in geopolitical tension, even if these factors are likely to continue to buffet markets as they have done during 2021. In a generally positive environment for global growth the primary challenge for risk assets such as equities is instead more prosaic and reflects the unfavourable combination of extended equity market valuations, compressed credit spreads and inflationary pressure, which has now triggered a policy response by central banks.

Nevertheless, extended equity valuations are by no means universal and are concentrated both geographically and by sector. This valuation dispersion may offer opportunities to active investors. While US markets are trading well above long-term averages other developed markets are at least within sight of traditional valuation metrics and offer similar if not higher levels of earnings growth during 2022.

The currently high profile global technology equipment sector is trading at a multiple of twice its long-term average on a forward price/book basis. However, a variety of 'old economy' sectors trade at levels which, if current earnings guidance can be achieved, would appear to offer scope for shareholder returns well above cash and inflation.

We believe a key theme for 2022 will be a rotation towards slower growing but more cash-generative sectors as investors seek safety in asset values on balance sheets and retreat from richly priced growth themes as monetary conditions tighten and the rate of GDP growth slows in the second half of 2022.

There are likely to be new developments in the COVID-19 pandemic which increase the risk of short-term bouts of volatility. However, we believe exposure to the longer-term trends of 2022 should be maintained. Portfolios should be prepared for higher interest rates as monetary policy settings are normalised and central banks contend with a sustained period of higher inflation. Tightening liquidity conditions should favour the value sectors of the market where free cash flow yields and expected returns remain closer to long-term averages and compare especially favourably with the very low yields on risk-free assets at present. Provided the overall economic recovery continues, this should also favour non-US equities where valuation ratings are less demanding.

A focus on 'value' investing for 2022 should not however be mistaken for relaxing individual company investment criteria, as over the long term a value-destroying company can underperform a value-creating peer almost regardless of the valuation starting point. Yet there are many more sectors than technology that can deliver sustainable value creation – and a broadening of stock market returns is in our view likely to be a further theme of 2022.

Finally, we highlight that earnings estimates for many sectors in 2022 are ahead of those prevailing prior to the advent of COVID-19. This highlights the decoupling that has been achieved between the evolving nature of the viral threat and the still-strong outlook for corporate profits.

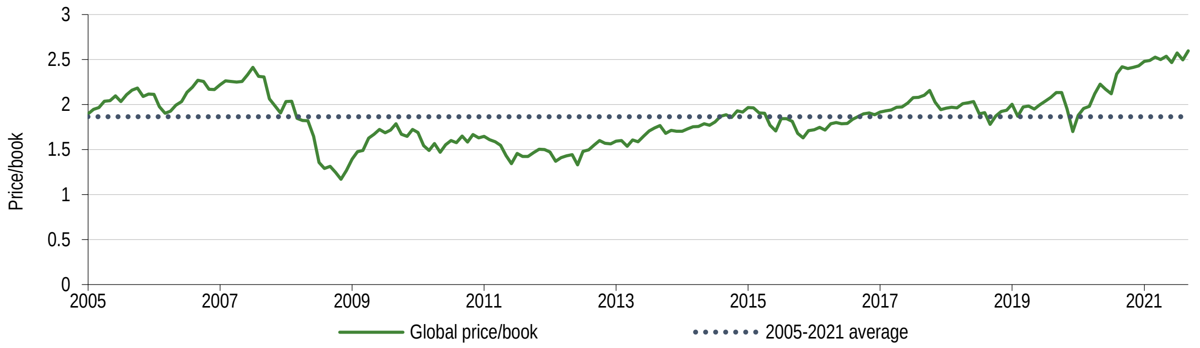
Equity investors must balance still-rapid GDP growth against high market valuations

Taken in aggregate, global equities remain expensive on traditional valuation metrics such as price/book and forward P/E. On our estimates, global equities have only infrequently traded this far above their long-run valuation average, Exhibit 1.

On a global basis, it should hardly be a surprise that valuations have been pushed higher, given the extraordinary levels of monetary stimulus over the past year, even if this is now expected to fade in coming quarters.

Furthermore, Refinitiv consensus earnings forecasts imply that global equities should record 9% earnings growth for 2022 on top of the significant progress recorded during 2021. This year is also likely to represent a period of significant further GDP recovery, with global consensus GDP forecasts suggesting another year of strong expansion ahead before momentum slows in 2023.

Exhibit 1: Global equities trading at a significant premium to the long-run average



Source: Refinitiv, Edison Investment Research calculations

Nevertheless, our estimates of the global equity risk premium, which aim to account for the relatively benign outlook for corporate profits, still suggest that the returns available for taking equity risk are close to the lows of the last 25 years. We also note that high yield credit spreads are also tight confirming investors' appetite for risk and still-easy financing conditions for the corporate sector.

There is clearly a conflict for investors between the relatively modest expected returns on equities and extraordinarily low returns on competing assets such as bonds and cash – and in an environment of mid-single digit inflation well above central banks' targets.

We believe global asset allocators are unlikely to stampede out of equities in the absence of a viable alternative during a period of economic expansion. The appetite to lock in losses in real terms by increasing allocations to cash or government bonds at current yields is likely to be modest in our view until and unless profits forecasts take a negative turn. There are significant lags of up to 18 months between changes in monetary policy and the impact on the real economy. This implies the impact of progressive reductions in the US Federal Reserve's (the Fed's) asset purchases (and an actual interest rate increase in the UK) are unlikely to be felt until the second half of 2022, a period which also sees economic growth tailing off as economies recover towards the pre-COVID-19 GDP trajectory.

Valuations: Looking for value in the tail

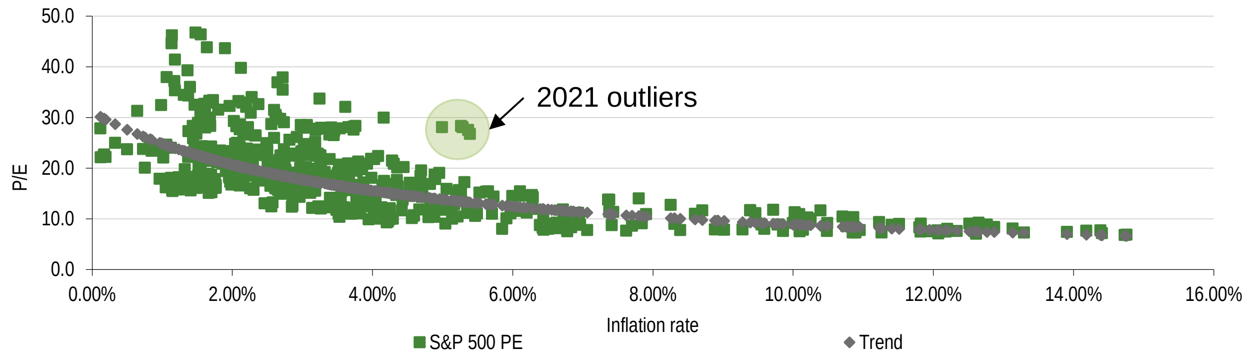
Yet this top-down picture provides insufficient resolution to uncover the nuances that lie beneath the global aggregate. The global valuation statistics mask important valuation divergences between sectors and regions. The United States has clearly been the stock market darling for much of the current business expansion, with a compelling combination of relentless profits growth, loose domestic monetary policy and strong price momentum.

This relative momentum only strengthened during the early phases of the COVID-19 pandemic as spending shifted online and towards digital infrastructure over face-to-face services, disproportionately favouring the technology heavy US market. As a result, the US equity market currently accounts for an elevated share of global equities by market capitalisation, accounting for close to 50% of global market indices, approximately double the US share of world GDP.

While the strong market position and fundamentals of the largest US business franchises are hardly in question, the extent of the upward shift in valuations, which gathered steam from 2017 onwards, does in our view raise questions over the relatively modest expected returns on offer for the future.

For example, we continue to question the sustainability of a trailing US P/E multiple of close to 30x at a time of mid-single digit US inflation, a level of inflation which has typically been associated with much lower P/E multiples, Exhibit 2. A tightening of US monetary policy is clearly underway which may yet create the conditions for a de-rating in 2022 and which would offset the benefits of a generally favourable outlook for profits growth.

Exhibit 2: US P/E versus inflation – current P/E rating is an outlier



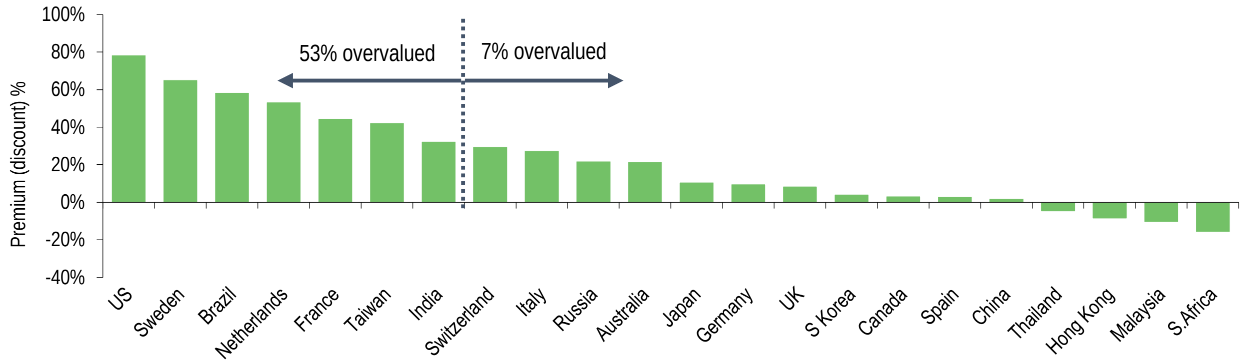
Source: Refinitiv, Edison Investment Research calculations

Despite the challenges facing US equities, we believe investors do have legitimate choices in 2022 but it requires being prepared to look outside the United States for returns. We observe in Exhibit 3 that while global markets are trading close to multi-decade high price/book levels, a full two-thirds of national stock exchanges are trading only modestly above long-run valuation norms.

For investors willing to accept returns within sight of historical averages we note the strong level of corporate profitability in European equities is likely to be sustained in 2022. Excluding France, the Netherlands and Sweden, valuations in both continental Europe and the UK are much closer to long-term average levels than in the United States.

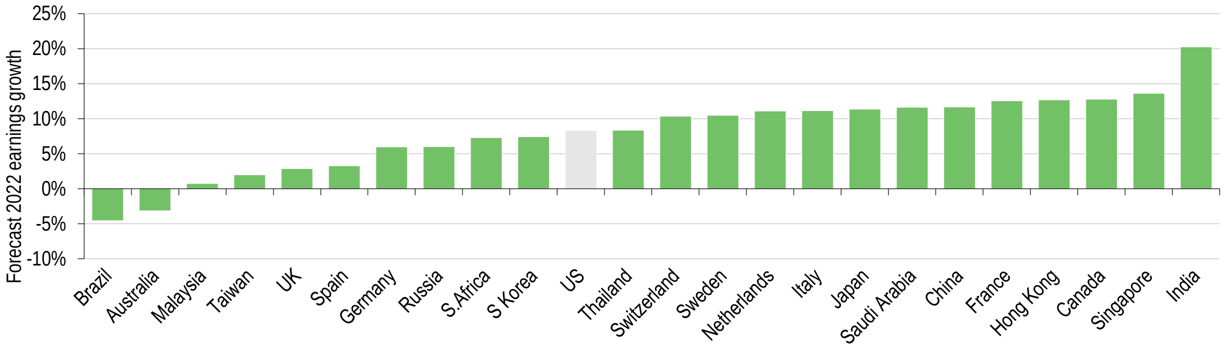
Furthermore, within the eurozone the European Central Bank is significantly further behind either the US Fed or the Bank of England in reining in accommodative monetary policy. We note that Japanese equities are also trading close to long-run averages, yet with consensus earnings growth of 11% forecast for 2022, outpacing the United States at 8%, Exhibit 4.

Exhibit 3: Country premium to long-run price/book average



Source: Refinitiv, Edison Investment Research calculations

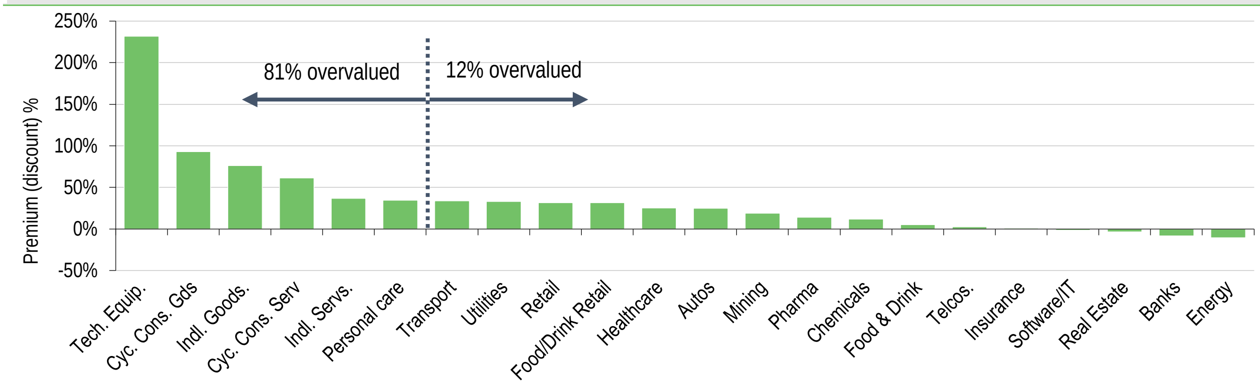
Exhibit 4: United States no longer at the head of the pack for earnings growth in 2022



Source: Refinitiv, Edison Investment Research calculations

To compare regions, we have also calculated forward price/book multiples for each sector in each region. This regional data confirms the long tail of valuation opportunity outside the United States, where the lower two-thirds of sectors still trade over 30% above long-term valuation multiples. This suggests that the premium for US exposure remains relatively broadly based.

Exhibit 5: Long tail of European sectors trading close to long-run P/book multiples



Source: Refinitiv, Edison Investment Research calculations. Note: Data include UK.

However, in Europe, including the UK, we find that two-thirds of the market by sector is only 12% above its long-run price/book multiple, Exhibit 5, a figure which hardly suggests that overvaluation is universal. We recognise that some of the European large cap market leaders in the technology and consumer goods spaces did find favour with investors during the pandemic and now look overbought. In Japan, there is a similar picture to Europe and finance and utility sectors are now trading at a discount.

We believe therefore that despite the challenging valuation picture for global equities in aggregate, active managers should be looking in the 'tails' in 2022 to gain exposure to traditional sectors that also have fundamental support. This fundamental support comes from a further period of expansion of corporate profits together with a recovery in earnings for traditional sectors, which in many cases were the laggards during the rally of 2021.

Financials have also lagged the overall market during the past two years as interest rates were slashed with the onset of COVID-19 and in certain cases limits placed by regulators on shareholder remuneration in anticipation of a much more severe impact on collateral values than was in fact realised. We would highlight banks and insurers as beneficiaries both of increased asset prices and prospective interest rate normalisation.

Finally, energy stocks still appear cheap despite the strong cash flows from currently high energy prices, potentially in part due to the focus on environmental, social and governance factors disincentivising investment in recent years, which we have discussed in more detail in recent notes.

Global government bond yields to remain under upward pressure

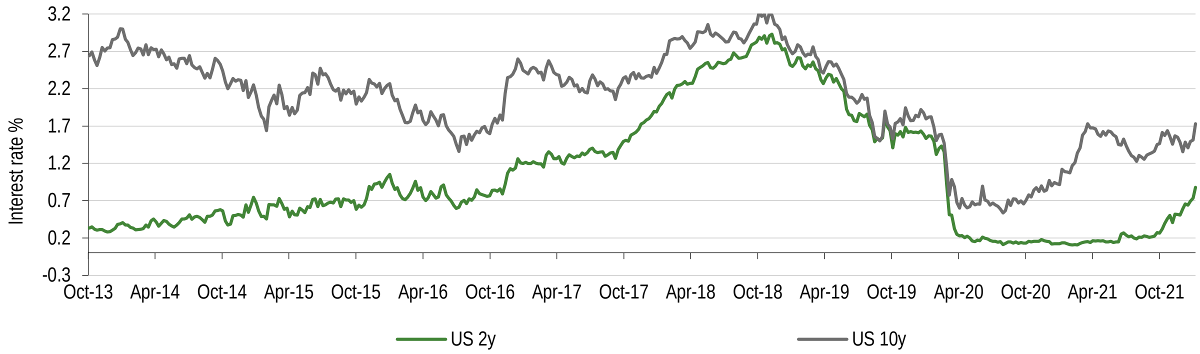
We believe global bond yields will remain on an upward trend in the first half of 2022, but this rise in yields is likely to be orderly. A tail risk of an uncontrolled surge in bond yields remains, given above-target inflation in Western markets. However, we believe it is more likely that investors in long-term bonds will start to look beyond the immediate inflationary effects of COVID-19 on supply chains and spending patterns and towards the impact of tighter monetary policy on the overall economy later in the year.

While inflation has certainly surprised to the upside during 2021, we do not believe it is too early to be certain the inflation genie is out of the bottle. We expect inflation to remain elevated in the first half of 2022 as the lagged impact of increases in energy prices and measures such as owners' equivalent rent maintain upward pressure on prices in the short term. This outlook does of course depend on current supply chain bottlenecks being resolved and further COVID-19 variants having a diminishing impact on the supply side of the economy over time.

Looking further out, as the service sector re-opens following the Omicron wave, excess goods demand could yet moderate in favour of the service sector of the economy. Combined with a currently strong incentive for productivity enhancements in response to rising input costs, a slowing of the pace of growth during 2022 could yet keep a lid on long-term bond yields.

While inflation is a 'risk factor of concern' as inflation uncertainty has risen over the past year, the data to date in our view do not support making an inflation crisis the central case for portfolio asset allocation, even if the pressure on bond yields remains to the upside. Bond markets moving to discount a more hawkish Fed as inflation pressure exceeds expectations in 2021 is on the agenda, but a crisis still represents a tail risk in our view.

Exhibit 6: Long-term US bond yields still well below pre COVID-19 levels and under upward pressure



Source: Refinitiv, Edison Investment Research calculations

We note from the Fed's December projections that nominal US GDP is forecast to average just under 4% over the long term, implying that the equilibrium level for long-term US bond yields is still some way above current levels of 2.07% for 30-year paper. Prior to the pandemic, yields were closer to 3.5% and despite the increase in the debt burden since then, the US economy has proven it can grow much more strongly than originally expected at the advent of COVID-19.

As it becomes increasingly clear that short-term rates will remain on a rising track as both the United States and the global economy decouple from the continuing waves of COVID-19 infections, we expect bond yields to remain under upward pressure at least until the second half of 2022, when the slower pace of growth for 2023 comes into view.

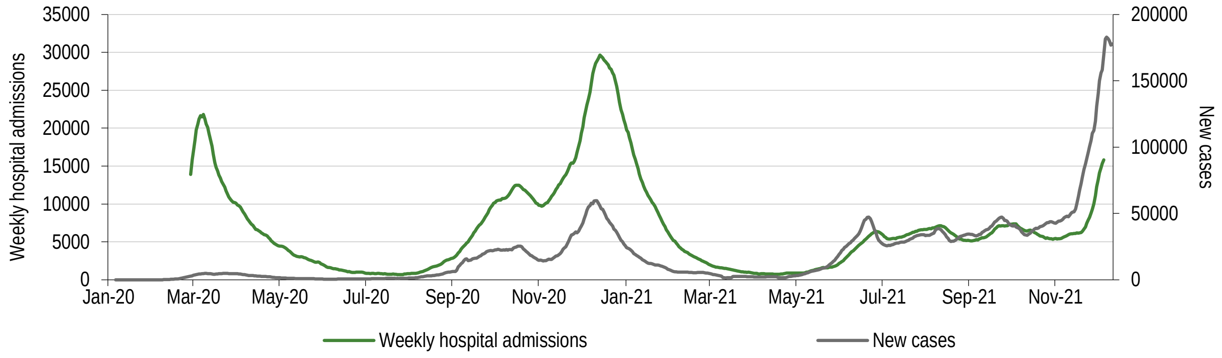
COVID-19: A 2021 story offering transient risks and opportunities in 2022

The recent 'risk off' Omicron market scare in the UK and Europe, which started in late November, was immediately followed by a sharp 'risk on' recovery in December. This episode holds valuable lessons for investors for 2022. Despite COVID-19 case rates surging to new records as forecast due to the increased transmissibility of the Omicron variant, UK hospital admissions have remained well contained and deaths to date have been a fraction of the modelled outcomes of early December.

Therefore, for Omicron, early forecasts for a tsunami of hospitalisations following rising case numbers appear to have been wide of the mark, to date at least. In this wave, there have been far fewer hospitalisations per case compared to the Delta wave, Exhibit 7. As a result, health services have not been under insurmountable pressure and strict lockdowns (outside regions of Asia where zero-COVID-19 policies apply) have been avoided. In most respects, it has been business as COVID-19 usual for consumers and companies over this period. Even transport and leisure stocks have swiftly recovered despite bearing the brunt of efforts to control the spread of the virus in public places and through international travel.

Early reports suggesting that symptoms of this variant can be easily mistaken for the common cold have proved consistent with studies suggesting Omicron is better at infecting cells in the throat rather than in the lungs. As the clinical severity of this variant is mild and potentially provides protection from reinfection by future variants, markets may move to discount the possibility of this COVID-19 wave fading as soon as the end of January.

Exhibit 7: UK Omicron wave suggests significantly lower hospitalisation rate



Source: UK National Statistics

We believe the experience of Omicron, which follows a similar pattern to that of the Delta variant earlier in the year, shows that provided new variants follow the anticipated pattern of increased transmissibility but reduced morbidity, strict lockdowns do not necessarily follow rising case numbers. As a result, the economic impact is likely to be transient and moderate with limited long-term effects and investors should avoid being 'whipsawed' in and out of equities during 2022.

Omicron could yet represent the final decoupling of the evolution of the pandemic from the direction of the global economy. The combination of prior infection and vaccination within the community and new treatment options suggests that societies and economies are adapting to co-exist with circulating COVID-19 viral particles.

It is always difficult to be certain in real time but the early data from South Africa later proved correct in suggesting that Omicron would not cause a surge in hospital admissions of a scale which warranted strict lockdowns. We expect that further new variants of COVID-19 will be discovered over the next 12 months and this type of early data, even if partly anecdotal, will continue to be critical if investors are to avoid jumping in the wrong direction. While each variant will be different, there should in our view be a bias to buy these short-term dips rather than to reflexively rotate out of equities or switch to lockdown beneficiaries.

Conclusion

We move to a neutral view on equities as we recognise that within a global equity market that appears overvalued in aggregate, there remains a long tail of sectors outside the United States which are set to benefit from a continued economic and corporate profits expansion, and which currently trade only a little above long-term valuation averages. In contrast, both interest rates and long-term bond yields have a significant distance to travel before approaching pre-pandemic levels. We also note that European earnings growth is forecast to outstrip that of the United States during 2022. Nevertheless, within our neutral outlook, we acknowledge that a slowing economic trajectory, combined with a period of tightening monetary policy, is unlikely to lead to another banner year for equities.

We believe bond yields will continue to increase until the normalisation of monetary policy and the restoration of GDP to its pre-pandemic trajectory has been discounted by markets. While inflation uncertainty is elevated, the data at present suggest an inflation crisis remains a tail risk and orderly increases in bond yields should not derail other asset markets, except where overvaluation is endemic.

Investors looking to adjust portfolios and allocate to sectors that have traditionally offered better performance in periods of higher inflation can at the same time benefit from valuation levels closer to historical norms such as banks, energy and European rather than US equities.

Company	Sector	Most recent note	Date published
1Spatial	Software & comp services	Update	29/09/21
4iG	IT services	Update	13/10/21
4imprint Group	Media	Update	11/08/21
AAC Clyde Space	Aerospace & defence	Update	28/09/21
Aberdeen Asian Income Fund	Investment companies	Investment company review	10/11/21
Aberdeen Diversified Inc & Growth Trust	Investment companies	Investment company review	20/08/21
Aberdeen Latin American Income Fund	Investment companies	Investment company review	19/08/21
Aberdeen New Thai Investment Trust	Investment companies	Investment company review	29/01/21
Aberdeen Standard Equity Income Trust	Investment companies	Investment company review	07/02/19
Accsys Technologies	General industrials	Update	26/11/21
Acorn Income Fund	Investment companies	Investment company review	04/10/21
Agronomics	Investment companies	Initiation	10/01/22
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Dentsu Group	Media	Update	16/11/21
Deutsche Beteiligungs	Investment companies	Investment company review	17/12/21
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Lookers	General retailers	Update	26/10/21
Lowland Investment Company	Investment companies	Investment company review	01/11/21
LXi REIT	Real estate	Update	23/08/21
Marble Point Loan Financing	Investment companies	Outlook	23/11/20
Marshall Motor Holdings	Automotive retailers	Update	15/10/21
Martin Currie Global Portfolio Trust	Investment companies	Investment company review	10/06/21
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Molten Ventures	Listed venture capital	Update	08/12/21
Mondo TV	Media	Update	16/11/21
Murray Income Trust	Investment companies	Investment company review	10/12/21
Murray International Trust	Investment companies	Investment company review	11/10/21
Mynaric	Technology	Initiation	30/10/20
Mytilineos	General industrials	Update	14/12/21
Nanoco Group	Tech hardware & equipment	Update	18/11/21
NB Private Equity Partners	Investment companies	Investment company update	29/11/21
Newmont Corporation	Metals & mining	Update	10/11/21
Norcros	Construction & materials	Update	20/12/21
Numis Corporation	Financial services	Update	10/12/21
Ocean Wilsons Holdings	Investment companies	Update	23/08/21
OPAP	Travel & leisure	Update	30/11/21
OPG Power Ventures	Utilities	Update	08/12/21
Osirium Technologies	Software & comp services	Update	30/11/21
OTC Markets Group	Financial services	Update	24/11/21
Palace Capital	Real estate	Outlook	01/12/21
Pan African Resources	Metals & mining	Outlook	28/10/21
paragon	General industrials	Update	27/11/19
Phoenix Spree Deutschland	Real estate	Update	11/10/21
Picton Property Income	Property	Update	23/11/21
PIERER Mobility	Automobiles & parts	Update	15/02/21
PowerHouse Energy Group	Alternative energy	Flash	15/07/20
Premier Miton Global Renewables Trust	Investment companies	Investment company update	31/08/21
Primary Health Properties	Property	Update	01/11/21
Princess Private Equity Holding	Investment companies	Investment company update	26/11/21
ProCredit Holding	Banks	Update	19/11/21
Quadrise Fuels International	Alternative energy	Outlook	30/11/21
Raven Property Group	Property	Outlook	09/09/21
Record	Financials	Update	30/11/21
Regional REIT	Real estate	Update	01/10/21
Renergen	Oil & gas	Update	30/01/20
Renewi	Industrial support services	Outlook	20/12/21
Riber	Tech hardware & equipment	Flash	02/11/21
Riverstone Credit Opportunities Income	Investment companies	Investment company update	13/10/21
Rock Tech Lithium	Metals & mining	Update	18/12/20
Round Hill Music Royalty Fund	Investment companies	Investment company review	23/11/21
S&U	Financials	Update	10/12/21
SandpiperCI Group	Retail	Update	21/05/21
Schroder AsiaPacific Fund	Investment companies	Initiation	24/11/21
S Immo	Real estate	Update	02/09/21
Secure Trust Bank	Financials	Update	30/11/21
Securities Trust of Scotland	Investment companies	Investment company update	13/12/20
Severfield	Construction & materials	Update	01/12/21

Company	Sector	Most recent note	Date published
Silver One Resources	Metals & mining	Update	12/10/21
Smiths News	Industrial support services	Update	08/11/21
Standard Life Private Equity Trust	Investment companies	Investment company review	03/12/21
Standard Life UK Smaller Cos Trust	Investment companies	Investment company review	07/10/21
Stern Groep	Automotive retail	Flash	14/12/21
Studio Retail Group	Retail	Outlook	20/12/21
Supermarket Income REIT	Property	Update	13/12/21
Sylvania Platinum	Metals & mining	Initiation	29/10/21
SynBiotic	Consumer	Update	06/12/21
Target Healthcare REIT	Property	Update	15/11/21
Technicolor	Media	Update	14/05/21
Templeton Emerging Markets Inv Trust	Investment companies	Investment company review	05/08/21
Tetragon Financial Group	Investment companies	Investment company update	15/12/21
The Bankers Investment Trust	Investment trusts	Investment company review	20/12/21
The Law Debenture Corporation	Investment trusts	Investment company update	03/08/21
The MISSION Group	Media	Update	20/01/21
Thrace Plastics	General industrials	Update	06/12/21
Tinexta	Professional services	Flash	05/01/22
Trackwise Designs	Tech hardware & equipment	Update	23/12/21
TR European Growth Trust	Investment trusts	Investment company review	03/12/21
Treatt	Basic industries	Update	30/11/21
Triple Point Social Housing REIT	Real estate	Update	13/10/21
TXT e-solutions	Technology	Update	13/12/21
Tyman	Construction & materials	Update	25/11/21
UIL	Investment companies	Investment company review	08/11/21
Utilico Emerging Markets Trust	Investment companies	Investment company review	20/08/21
Vietnam Enterprise Investments	Investment companies	Investment company review	10/09/21
VietNam Holding	Investment companies	Investment company review	28/06/21
VinaCapital Vietnam Opportunity Fund	Investment companies	Investment company review	18/12/20
VivoPower International	General industrials	Flash	25/08/21
WANdisco	Technology	Flash	21/12/21
Wheaton Precious Metals	Metals & mining	Update	16/12/21
Witan Investment Trust	Investment companies	Investment company review	10/09/21
Worldwide Healthcare Trust	Investment companies	Investment company review	20/07/21
XP Power	Electronic & electrical equipment	Update	11/10/21
YOC	TMT	Flash	10/12/21
YouGov	Media	Flash	12/10/21

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