# Looking into 2022 with Federated Hermes

Federated Hermes International

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## Corporate

**Saker Nusseibeh, CBE**
**CEO**

If 2021 was a year of pledges and commitments, then 2022 has to be a year of action. As does the next year, the year after that and frankly every year to come until our climate and biodiversity are no longer in crisis.

At COP26 in November, the IFRS Foundation announced it was working on the formation of the International Sustainability Standards Board to properly assess risks as it relates to "sustainability and climate change". For me this was a stand out moment, at last introducing a standard against which business is measured as well as drawing on both the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD) and The Sustainability Accounting Standards Board (SASB) frameworks, whose development we have been closely involved with as a firm.

Staying with COP26, we also saw GFANZ (Glasgow Finance Alliance for Net Zero) under Mark Carney, former Bank of England governor, declare there that 450 global financial institutions managing $130tn of assets had joined and pledged to use their financial muscle to promote decarbonisation and meet net-zero emission targets by 2050. It sounds big and bold and let's hope real action follows.

There were many other commitments and I was encouraged by the presence of  so many senior finance figures from both the private and public sector. Something not seen at prior COP meetings. In fact, it was the first time that a US Treasury Secretary turned up.

But where next? I can only speak for my own industry but it is a fact that we have a vital role to play.

Sitting across all economic activity as we do, we are in a unique position to create wealth sustainably in a way that is both good for the end investor and for society.

We can invest in sustainable business – those that will have an impact on our net zero goal.

We can also use our role as stewards of investments to drive change needed to secure our planet's future, by supporting companies in their transition to a sustainable footing.

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In this regard, I see three principal priorities for our industry.

First, as business embarks on rapid decarbonisation, the investment industry must make a quantum leap in its willingness to work together and the lengths we are prepared to go to. This is something we have begun to see via shareholder resolutions at fossil fuel companies.

We also need to provide the capital to accelerate take up of renewables, green steel, and carbon capture and storage.

Secondly, we need to use our influence with companies. Through our advocacy, we must ensure business stops fouling our oceans, rivers and land. That it stops cutting down forests, destroying wildlife and removing nutrients from the soil faster than they can be replaced.

Thirdly, we need to use our position to ensure business plays its part in building social cohesion, through fairness in remuneration, protecting human rights and providing equity and equality of opportunity.

By investing in sustainable businesses or, through stewardship, supporting their transition to becoming sustainable, we can and should play a major role in driving the COP26 agenda over the coming years.

Investors, businesses, and policymakers all have an important role to play, and success is contingent on us stepping up and working together.

Not only is that good for society and our planet, but it is not, importantly for our clients, incompatible with delivering returns.

# Macro view

**Eoin Murray**
**Head of Investment**

With COP26 out of the way, we can look forward to 2022. While the Glasgow event was long on promises and short on action, we can overall sound a positive note. If companies and countries are good to their word, then we have nudged closer to a +1.5C warming pathway, even if we are not actually on it yet.

This summer, climate change became deeply personal for many around the globe – severe flooding in Germany, Benelux and China resulted in massive damages, while the world burned in Greece and the Northwestern US and Canada. The day after the small Canadian village of Lytton encountered Canada's highest ever recorded temperature of 49°C, 90% of the village burned to the ground. Climate change became personal – I expect it to become even more so in the year ahead.

Although carbon pricing schemes are proliferating, a majority of global emissions remain unpriced, but carbon pricing schemes are growing in number and coverage levels. A rising cost of carbon remains a critical piece of the jigsaw for tackling climate change, and achieving climate goals is dependent on the carbon price increasing to as much as $100-120/tonne by 2030, as we move up the abatement cost curve. Carbon prices are likely to continue rising for that reason, and companies operating in sectors and countries where carbon is currently mis-priced face risks from any adjustment, which depend on their ability to reduce emissions or pass on higher costs to consumers. Engagement to ensure an orderly transition will become ever more important as a result.

To enable a green and socially just future for all countries, public debt problems must also come into the mix of thinking – debt relief and debt swap arrangements are useful tools to encourage the required change. We in the private sector can also get involved, potentially swapping old debt holdings for new green recovery ones. We can work together to avoid the 'climate investment trap' in which developing regions tend to pay a higher cost of financing for green energy relative to fossil fuels.

It's heartening to see that cumulative annual sustainable debt issuance stood at almost $1.2 trillion to the end of September this year, compared to $765 billion in 2020 and $574 billion the year before that. But we can and must do more. If there is no substantial penalty for falling short of stated goals behind the green lending, and only a miniscule discount if targets are met, it strikes me that we are merely scratching the surface of the potential of the sustainable debt markets. Performance-linked sustainable bonds and loans offer a meaningful option that we will urge all firms to consider – linked to specific outcomes, penalties seem to be more meaningful. The targets embedded can also be linked to executive remuneration.

In economic terms, vaccines have not been the silver bullet that was hoped, and the economic recovery has been slower. We expect it to continue in 2022, despite headwinds from labour shortages in certain areas, high commodity prices, and ongoing supply strains, as the world continues to recover from the pandemic. Central banks and investors will continue to wrestle over tapering and rate rises, both of which will continue to a tougher outlook.

I want to leave you on a positive note as we think about the year ahead. As we bridge the gap in our understanding between investment and climate change, a better world IS possible. Policies to green the economy, such as carbon taxes and emissions trading, are much better understood, and getting to net zero is both commercially and technologically feasible. The biggest obstacles though remain ahead of us: mobilising the political will, corporate action and mass public support for solutions that will be more demanding than anything that's been done so far.

**Silvia Dall'Angelo**
**Senior Economist**

In our baseline macro scenario for 2022, the economic recovery from the Covid-induced recession will continue, although at a slower and less volatile pace than in 2021. The slowdown will likely largely reflect a physiological normalisation in growth rates, as the initial impact from the re-opening of the economies and the sugar rush from fiscal and monetary stimulus start to fade.

Demand should stabilise, as generous cash buffers allow households and corporates to withstand the impact from the fiscal cliff due to the expiry of most emergency-related fiscal measures. Households in particular have managed to build up significant excess savings – amounting to between 5% and 11% of 2019 nominal GDP across advanced economies. Supply constraints should gradually ease, as the pandemic heads towards endemic equilibrium, supply chains readjust, and supply-demand imbalances lessen. Accordingly, inflation should start a gradual descent after the winter. A moderating picture for inflation and more clarity concerning underlying trends in labour markets (likely showing some lingering slack) should allow central banks in advanced economies to maintain accommodative financing conditions, with an only gradual withdrawal of monetary policy stimulus. G4 central banks' balance sheet will remain large once major QE programmes end in H1 2022 and hiking cycle will likely start around mid-2022 and proceed at a slow pace.

Yet, alternative and less benign scenarios are well possible. Protracted supply constraints and elevated cost-push inflation during winter months have the potential to derail the recovery, paving the way to stagflation scenarios. It is also possible that inflationary dynamics spread to expectations and the labour market, thus becoming engrained, which would call for tighter monetary policies. Crucially, our base line view for inflation relies on the assumption of a return to pre-Covid patterns e.g. consumption shifting back to services from goods, participation rate in the labour market going back to roughly pre-Covid levels, correction of supply chain disruptions. However, there is a risk that some of these Covid-induced changes become more permanent and structural.

In general, risks to our baseline are skewed to the downside, due to residual uncertainty about the evolution of the virus, persistent divergences across countries and regions, and (geo) political and policy risks. The emergence of new variants would likely result in more protracted supply chain disruptions, which would both weigh on activity and sustain inflation. The recovery will likely remain uneven, hence inherently fragile, with emerging markets continuing to lag advanced economies. The ongoing structural transition in China to a more mature and slower growing economy is rife with risks, as the correction in the property market continues. Policy uncertainty – concerning fiscal and monetary policy, structural reforms and regulations – has been on the rise and is set to be compounded by political deadlines across several key countries (presidential elections in France, mid-term elections in the US, China's 20th National Party Congress).

2022 might be the first year in the post-Covid era. Covid-related distortions should start to unravel, exposing the more permanent effects of the pandemic and the contours of a new normal. A normal that will be dominated by an increasingly pervasive ecological crisis and the need to rewire our economic and policy frameworks to give prominence to environmental and social considerations.

## Responsibility and Stewardship

**Leon Kamhi**
**Head of Responsibility**

There was many a placard in demonstrations at November's COP26 in Glasgow that said, 'no more blah, blah, blah' or 'hot air' and 'what a COP out'. There was a plethora of news stories of all the private jets being used – in one case I heard from people in Glasgow that senior business people had taken a private jet to go for a meeting in London before returning the same day! The trillions of dollars put behind Net Zero commitments are general rather than targeting specific renewable technologies, investments and businesses whose commitments remain in the billions.

So in 2022, whilst the commitments are important, the hope is to turn the words into real action and the investment industry has a role to play. Whilst investing in green leaders is an impactful approach, I would like to see a much greater focus from the industry on what could become greener, supporting and empowering the radical change needed at investee companies. We need to see private capital taking more risk by investing in companies transitioning to become renewable, rather than investing purely in green leaders. Also, asset owner mandates which unequivocally integrate systemic environmental and societal risks in full knowledge that not doing so will destroy wealth for investors across all their portfolios. It will be important for there to be mandates encouraging investment managers taking action through means such as engaging with banks to stop new fossil fuel loans.

Investor stewardship has a significant role to play to effect the necessary change. Investment managers will need to engage across sectors to help companies determine specific net zero solutions and empower them to make the radical transformations needed, be that in their capital allocation, products and services or operations.

Through engagement we can encourage companies to look after their workers and contribute to local communities as the upheavals brought by climate and technology disruption hit the working poor the hardest.

Engagement with governments is also crucial to end fossil fuel subsidies, ensure sufficient subsidies for private investment in stable renewable technologies able to help them become cost competitive and to implement progressive taxation. This would ensure that the poorest would not have to pick up the bill for the economic destruction others have wrought.

**Dr Hans-Christoph Hirt**
**Head of EOS**

Investors will need to develop a sophisticated, holistic understanding of the ESG challenges at companies if climate change is to be tackled successfully. In the run up to COP26, we saw how ambitious plans to decarbonise economies and accelerate the shift to renewable energy could be jeopardised by opposition from those heavily dependent on coal and other fossil fuels.

One of the challenges for 2022 and beyond will be to work with companies and policymakers to ensure a just transition for employees and communities at the sharp end of structural change, to ensure that efforts to keep global heating within 1.5°C are not derailed.

We recognise that these complex environmental and social challenges are interlinked, and the pace of the low carbon transition – and ultimately its success or failure – will be driven by companies, investors, policymakers, and civil society working together.

Through our direct engagements and our collaborative work with Climate Action 100+, where we lead or co-lead engagement at over 25 companies, we will continue to press companies to align with the Paris Agreement. Climate transition votes must be made to count. We will scrutinise companies' strategies closely and recommend votes against plans that fail to come up to scratch. Where necessary, we will recommend voting against the chair and other relevant directors to escalate concerns at climate change laggards. In this way, shareholders can connect environmental and governance issues.

Next year the second, in-person phase of the COP15 on biodiversity will go ahead in Kunming, China. Climate change is one of the five main drivers of biodiversity loss, and a failure to act could result in the collapse of global food systems. We have developed a detailed engagement framework to guide our interactions with companies on biodiversity, outlining how each company's net-positive goal should be accompanied by strong governance, effective measurement, an impactful strategy, and regular disclosure.

With the challenges of balancing competing interests and needs in the battle to mitigate and adapt to the climate crisis, investors will need to develop a more holistic understanding of ESG issues, and how they intertwine. This is a critical next step, not just in terms of a just transition on climate change, but in the development of responsible investment.

**Gemma Corrigan**
**Head of Policy and Advocacy**

Over the course of 2021, and in the lead up to COP26, there has been a strong focus on climate change and the role of finance in supporting the transition to a net zero economy.

More needs to be done to mobilise the $100 trillion investment needed in technologies such as hydrogen-based green steel, sustainable aviation fuel, and carbon capture, utilization and storage, and to help emerging markets and developing countries credibly reach net zero. Engagement and advocacy will be key to delivering real economy impact and ensuring the responsible retirement of fossil fuel assets and the scaling of voluntary carbon markets over the coming years.

Pressure is also increasing on a wider set of environmental issues, such as nature and biodiversity, as well as social and governance issues, such as diversity and inclusion, inequality, living wage, fair taxation and sustainable supply chains. Greater focus is being placed on the need for a 'just transition', which considers the social consequences of the shift to a net zero economy for the most vulnerable communities around the world – many of which are most exposed to the physical risks posed by climate change. Taking a more holistic view, which recognises the interdependencies between climate, nature and social justice, will become increasingly central to economic and financial decision making.

The regulatory landscape continues to rapidly evolve. The UK and EU have both set out clear roadmaps for their respective sustainable finance agendas, with a significant focus on disclosure. In 2022, the UK will be focused on defining its disclosure regime, including the UK Green Taxonomy – a classification system for economic activities that sets the bar for what is environmentally sustainable. The EU is further down this road, with detailed disclosure requirements under SFDR and the Taxonomy Regulation coming into force for financial institutions in 2022. All of these developments have significant data implications, and firms will need to keep abreast of changes to the UK and EU taxonomies as they are expanded further. Similar developments are taking place in the US and other jurisdictions which will hopefully start to converge with the creation of the ISSB.

**Dr Michael Viehs**
**Head of ESG Integration**

Whilst significant uncertainties remain following the Covid pandemic, the rise of investing responsibly – which was accelerated in part because of the pandemic – will continue. Not least because of COP26, there will be increased demand for more climate-friendly investment solutions that are aligned with a 1.5 degrees global warming scenario.

The last two years have shown that investors are increasingly looking for responsible investment products across various asset classes that authentically integrate ESG and stewardship insights into the investment processes. We expect this trend to continue, and investors will be looking at a much broader set of material ESG topics to be integrated in investments. Whilst I expect that climate change and other environmental considerations such as biodiversity will deservedly remain at the top of the agenda, investors will also be looking for investment products which more systematically integrate material social factors, such as health and safety standards, employee wellbeing, mental health, and supply chain standards. A holistic view on ESG and stewardship will therefore be required.

Following COP26, the most important trend that we expect to see in 2022 and beyond is an increased interest in "net zero" investment products, to accelerate the transition to a low carbon economy. Private capital has its role to play in this transition. This holds true across the various asset classes and spans beyond the public equities and credit space. To deliver on this goal, it is crucial that investors have the right data sets on climate considerations at their fingertips to design authentic "net zero" investment products. Such products should feature not only a quantitative assessment of investees' climate performance, but also feature the qualitative dimension of ESG and meaningfully integrate stewardship insights.

More broadly speaking, I also hope that financial markets will continue to invest in a more impactful way to align investment outcomes more directly with measurable, tangible, and meaningful positive impact on society and the planet. The Sustainable Development Goals will continue to play an important part in that journey.

The current regulatory developments in Europe, including the introduction of the EU Taxonomy and Sustainable Finance Disclosure Regulation, will positively contribute to helping financial markets become more sustainable. Going forward, I hope these developments and new regulatory initiatives around the globe will allow for stewardship to play a more important role, because it is, at the end of the day, the necessary prerequisite to become a responsible investor.

## Equities

**Gary Greenberg**
**Head of Global Emerging Markets**

Earnings recovered strongly in 2021, boosting developed markets. Emerging markets were unable to achieve effective vaccination of their populations, however, and thus were unable to generate investor support. Many investors are bullish emerging markets for 2022, hoping to play a catch up trade, but we are more cautious, for several reasons.

First, monetary tightening in the US is looking increasingly possible, which would strengthen the dollar and weaken those emerging economies which are reliant on foreign portfolio inflows.

> **Second, progress on vaccination is and is likely to remain slow in many emerging regions, holding back economic progress.**

Third, many of the most attractive business models in emerging markets are highly rated, and vulnerable to de-rating if US interest rates rise (as are their global peers).

Against these headwinds, there are developing tailwinds. As supply constraints ease, chips will become available bolstering the global automotive industry and its suppliers. Taiwanese tech should recover from a lacklustre year, as should memory companies globally. If rates do indeed rise, financials should have their day in the sun as net interest income climbs. Regulatory pressure should ease in China benefitting internet names, and a detente with the US (temporary, within the context of a long term strategic rivalry), could strengthen sentiment in China. Sentiment there is also likely to receive a boost from further easing measures during the course of the year.

Looking past 2022 and past short term cycles, greying populations in North Asia, Europe, and North America will continue to generate demand for innovative automation technology.

The climate crisis will continue to force wholesale change in energy generation, distribution and consumption, driving demand for raw materials such as copper and aluminium. Data will keep its role as the oil of the 21st century, and oil prices will peak out as electric fleets are built out on land, sea, and in the air. The circular economy demanded by consumers will force companies to review and adjust their sourcing, manufacturing and distribution in line with planetary boundaries, creating myriad opportunities for other companies to disrupt, or to help them adapt. Our portfolio is focused on these long term themes, investing in the world to come.

## Hamish Galpin
## Head of Small and Midcap

Inflation and labour shortages are likely to be ongoing concerns for the market in 2022. The October/November result season demonstrated that many, but by no means all, quoted companies fared better from market disruptions than the market had feared in September.

The market should favour companies that can evidence pricing power and these tend to be businesses operating in niche markets and/or high market shares within their industries. This in turn leads us to think that relatively high-quality businesses – for which we are forever hunting- should fare better in 2022 than they have in the recent past when high growth and deep value performed best. Higher quality businesses also tend to manage their talent better, so these types of company should outperform in challenging labour market conditions (and have greater capacity to absorb related cost pressures).

Will these stocks stand out from the noise? In other words, will good fundamental performance show through in a market that, this year, has seen substantial changes to market leadership at a factor level? Interestingly, in the third quarter, the differential in factor performance (growth, value, momentum, quality, low volatility etc) was the lowest it had been for over five years. As a bottom-up stock picker, we hope that current market conditions will result in a greater focus on how businesses themselves are performing.

And what of small and midcaps as an asset class? Developed equity markets generally are trading at elevated levels, which will come as no surprise to readers of this document. However, 25-year charts (on a monthly basis), show developed small and midcap stocks at around 1.4 standard deviations above trend, dropping to 1.2x if emerging stocks (around 10% of the overall index) are added. This contracts with large cap indices which are at two standard deviations above trend; trend is 6.6% p.a. for SMID stocks globally, 5.6% for large cap. Conclusion; small and midcaps are less stretched and are growing faster (and that growth is more than enough to offset the higher risk).

Note that emerging markets are below their 25-year trend; only earlier this year did they break through their pre-financial crisis peak, so perhaps emerging markets' time will come again in 2022.

European equities did the same thing too this year, although more convincingly, which might be because they'd had longer to wait, not in fact having been higher since the tech boom all the way back in 2000. If you believe EM growth prospects have improved, you will not be allocating to an expensive part of the market.

## Geir Lode
## Head of Global Equities

Global equity markets have continued to break new ground this year, but could the bull market that started in 2009 be coming to an end? Equity valuations are at peak levels with measures such as the GDP to market cap ratio at an all-time high. Earnings growth remains strong, but we are seeing signs of fatigue and momentum has started to slow.

Part of the reason for this is technical, with comparable earnings set to get more difficult from here. Inflation and supply constraints are also playing their part, although the latter is likely to mean that growth is being delayed rather than declining and is reflected in robust earnings growth estimates for next year.

Inflation expectations are likely to remain a key influence on markets as we head into next year. Currently inflation expectations are elevated, especially in the US, but with inflation-hedged bonds still showing negative real yields, the bond market is indicating that it is transitory and suggests that interest rate rises are likely to be modest. Any change to the belief that inflation is transitory could result in interest rates rising faster than expected creating a real risk for the global economy and global equity markets.

The sensitivity of markets towards inflationary expectations and interest rates is likely to remain high, which could lead to some significant, short-term factor swings and keep volatility at an elevated level. This provides opportunities for active investors with diverse portfolios to generate alpha by taking advantage of short-term price swings to build exposure to sustainable companies with structural tailwinds that should grow regardless of the market environment. In a transitional inflationary environment equity markets will do well.

**Ingrid Kukuljan**
**Head of Impact and Sustainable Investing**

## Global equity markets have seen significant volatility in 2021 driven by price inflation, expectations for interest rates and commodities shortages. Whilst these trends may persist and cause periods where market performance is driven by style factors, we remain focused on company fundamentals and their long-term prospects.

In fact, volatility in markets can provide us with opportunities to buy into companies which are exposed to impactful megatrends at attractive valuations. We were encouraged to see majority of our companies beat estimates and raise guidance during 2021, a testament to the strength of the demand for their goods and services which are addressing world's pressing need.

Inflation has been one of the main investor concerns going into next year. Our view is that the supply chain bottlenecks which are occurring as a result of a global re-opening, will continue to push prices up well into 2022. This coupled with a re-opening surge in demand and base effects will further exacerbate the current inflation hysteria. We are in the transitory camp and do not see the recent price increases as sustainable.

As long-term investors we focus on megatrends we expect will play out over the next five years and beyond. To that end, we see long-term structural trends as deflationary, driven by technological advancements, demographics, the slowdown of growth in China and elevated debt levels. For our Impact Opportunities strategy we invest in stocks that are providing innovative solutions to critical needs of the planet and the society. As such, they are exposed to scalable and enduring sources of demand. Post this price surge, we expect growth to trend lower and lower inflation which favours quality and growth stocks, where our portfolio is positioned. We are favouring healthcare and financials sectors that are currently exposed to strong megatrends and also have a history of defending margins and long-term earnings growth.

**James Rutherford**
**Head of European Equities**

## European markets have primarily been driven by the expectations and delivery of a strong earnings rebound post the pandemic. However, next year, we may see a more normalised period where investors will be more discriminating to earnings delivery and outlook statements.

Earning estimate upgrades are showing signs of fatigue and breadth is narrowing in the market. With fundamental earnings growth losing momentum and positive earnings surprises less likely, the opportunity to exploit mispriced assets will be diminished.

Factor influence on markets such as inflation, yields and yield curves are likely to become more prominent, as policy makers and markets remain at odds over inflationary expectations. Speculative behaviour is likely to diminish and delivery of fundamentals will be paramount.

Earnings risks will continue to present themselves around supply constraints and input costs although these should dissipate as we move into the second half of 2022. That in itself may present good opportunities where markets are fixated by the past and present and not the future.

However, should yields move higher, highly valued growth stocks are likely to get punished if growth rates aren't met. It is clear, therefore, that there are more hurdles to overcome for markets in 2022 and this could lead to increased volatility around short-term datapoints.

Against this backdrop, it will be more important than ever to recognise the noise from fact. We will continue to look for sustainable companies that will continue to deliver structural earnings growth and that are valued on fundamentals not hope, regardless of the economic environment that we may find ourselves in.

## Jonathan Pines
**Head of Asia Ex-Japan**

As contrarian investors our favourite hunting grounds are those parts of the markets where there are many stocks that we believe are hated 'too much'. The poorest performing parts of the market over the last decade in our region (consistent with the global experience) are well known – value, anti-momentum (or contrarian), and smaller-than-mega cap stocks.

More recently, we are able to add one country with strikingly poor stock market performance into the 'most hated' mix. Since 1 January 2019 our MSCI Asia ex Japan benchmark has risen by around 50%. But the China Enterprise (H share) index has remained approximately flat.

> **Value, smaller-than-megacap, contrarian stocks in China offer the most compelling value in public markets worldwide in our view, and we expect significant outperformance from here.**

Of course, China's many recent problems have contributed to the poor performance – rising tensions with the West, a regulatory crackdown on technology stocks, the fallout resulting from property giant China Evergrande's financial distress, and a zero-covid policy with no clear exit strategy.

Still, at a price-to-earnings multiple of a mere 8 times at the index level, we consider that stock market to be more than pricing in China's current difficulties.

Value, smaller-than-megacap, contrarian stocks in China offer the most compelling value in public markets worldwide in our view, and we expect significant outperformance from here.

## Mark Sherlock
**Head of US Equities**

The economic backdrop in the US remains supportive of positive equity market returns in 2022, albeit perhaps at a more modest level than those enjoyed over the last couple of years. Nearly two years on from the start of the pandemic, with the vaccination rollout substantially complete, US GDP has recovered to new highs, the economy is getting 'back to normal', and consumers are sitting on significant levels of excess savings.

Job openings exceed the number of unemployed. Consequently, while Covid-risk still lingers, we believe the underlying economy is strong. This backdrop should benefit company earnings, particularly in small and mid-capitalisation companies which have a higher domestic exposure and a – typically – more local supply chain.

The two key economic risks we are monitoring are inflation and higher interest rates. While a policy mistake regarding rates cannot be ruled out, the Federal Reserve appears to be taking a cautious stance, content to let a level of inflation into the system. Rates remain incredibly low in absolute terms (and negative in real terms) and should continue to support economic growth even as they drift somewhat higher. While inflation presents some risks to economic growth longer term, our exposure to high quality stocks will help mitigate its effect: such businesses typically have pricing power which enables them to pass through increased costs to end customers more effectively. Leading market positions, strong balance sheets and a low exposure to increasingly expensive unskilled labour should all be positive attributes in 2022.

With market levels at, or near, all-time highs, stock picking will be key. The 'factor' exposures which have driven the market over the past few years are likely to abate with idiosyncratic stock picking a much more likely alpha generator. This is where detailed knowledge of the companies in our index will prove advantageous. The last two years has seen much disruption and the pace of change continues to increase – this provides an exciting opportunity set for investors and an environment supportive of attractive ongoing investment returns.

# Fixed Income

**Andrew Jackson**
**Head of Fixed Income**

## After such a tumultuous 2020, who would have thought that I would summarise 2021 to you as "boring" for our fixed income portfolios? We entered the year expecting volatility from Covid aftershocks, and they did not materialise.

Or rather, I should say the renewed infection waves, record cases, supply chain disruptions, inflationary spikes, steepening rate curves, and the end of furlough support mechanisms DID materialise, but the market moves one would expect as a result did NOT. So will 2022 be the same, full of potential pitfalls but incredulously benign in performance?

We view some of the disruptions listed above either as temporary or reflective of the successful conclusion of government remedies; however, in regards to the inflationary pressures and associated rates moves, we are more concerned that there might be a more substantial reaction in 2022. The market has readily accepted the message from central banks that this ought to be transitory – and maybe it will be. But the mere possibility that it is not, and the reaction to that, is enough to be a major risk in our view. Likewise, the focus on the global healthcare emergency has detracted from geopolitical rumblings for the last couple years, but we would not be too surprised to see more destabilisation from headlines around Taiwan or Crimea – and emerging market debt could be an interesting area for us. Indeed, quite a few participants seem to still be relying on mean reversion for performance and they may be disappointed.

With all of this in mind, we will start the year with a slightly more cautious beta approach to credit risk but with a higher inclination to extract alpha from fundamental credit work. We also believe that anomalous pockets of illiquidity and complexity premia still remain available, and will maintain overweight exposures to those assets, such as CLOs. In certain areas of the credit world, dispersion has risen and not reversed post covid, and we view this as not only healthy but a potential source of opportunities to seek improving stories. Likewise, where dispersion has remained too narrow, we would seek to underweight those credits that are benefiting from the rising tide.

2022 will be a year that will reward diligence and discipline. As spreads remain compressed and until rates rise enough to provide sufficient yield, intrepid investors will continue to seek more risk to achieve their return objectives. And while it is possible that 2022 serves another year of steady performance, it is equally probable that those stretched balance sheets and leverage ratios, squeezed cash flows and interest coverage multiples get properly tested – and if this time the shock is less systemic or if the central banks and governments do not, or cannot, bail out the weaker credits again, the more discerning and less aggressive will definitely benefit. Complacency is the enemy. As I repeatedly tell our PMs and analysts, "Do your work."

**Fraser Lundie, CFA**
**Head of Credit**

## Credit market fundamentals have seen an impressive rebound and are set to remain strong in 2022, with the reopening of the economy fuelling recovery in balance sheet health. Corporate earnings have exceeded expectations but are likely to exhibit more differentiation going forward. The distinction will be driven by supply constraints causing disruptions in some areas creating pressure on output growth and inflation, which we think is already beginning to bite.

This may transition the backdrop to more of a 'muddle through' one, where margin deterioration poses the primary headwind to credit fundamentals. This is unlikely to be enough to challenge the allocation case, but it may test the valuations currently reflected in more cyclical sectors, parts of emerging market debt, and in the lowest segments of credit quality.

The technical picture is more supportive for credit in 2022. Net supply is forecast to fall moderately from record levels posted this year. Strong cash balances will secure credit metrics and asset rotation is unlikely with only small rises in rates and central bank policy stimulus remaining highly accommodative. Dare we say it, but in light of the lofty valuations and ownership present in the equity market, combined with the very uncertain backdrop for government bonds, the lower beta and quality nature credit may see it being used more as a safe haven asset class.

The rise and rise of commodities, particularly oil and natural gas this year, has to some degree masked the continued importance of sustainability and ESG in the asset class. We expect this to be short lived and in the aftermath of COP26, to see a renewed drive toward an ever more nuanced marketplace – rewarding companies with a keener eye on climate related risks and opportunities through the lens of governance, strategy and risk management. Companies will increasingly have their decarbonisation strategies analysed, with science-based targets (SBTs) proving to be a good indicator that many are now signing up to via the SBT Initiative. Holistic financial and sustainability analysis is key to delivering positive outcomes. This can be aided through active engagement. As metrics and targets become better understood, so too will the differentiation between corporates, financials and sovereigns, leaving active asset managers with a wealth of opportunity to add value.

Going forward, we will continue to take an active, conservative approach to credit investing that uses detailed, bottom-up analysis of company's creditworthiness and sustainability credentials – something we believe will help us seek out the opportunities that are so often overlooked.

**Mitch Reznick, CFA**
**Head of Research and Sustainable Fixed Income**

Before looking ahead at what portends for sustainable fixed income in 2022, let's review some of the highlights of 2021. Fixed income markets witnessed several landmark events over the course of the year – too many to list in this brief note. While many of the events were in-the-making for several years, doubtless that COP26 took place during the year served as a catalyst to sustainable fixed income markets, now some $1.7 trillion in size.

The exuberance in sustainable fixed income leaves us concerned about two issues: greenwashing and valuations. As for the former, as we progress into next year our antennae will be poised to differentiate those companies that seek to convert pledges made in a period of enthusiasm for sustainability to realised progress. Our credit research team and engagement specialists are well aware that there are merits to investment returns in such an exercise.

In our thematic fixed income strategies, we remain committed to delivering investment solutions that deliver into the dual objectives of returns to society and returns to the investor. Combine that with our flexible approach to fixed income – from liquid to private markets – we avoid being a forced buyer of any specific type of security. We see the "greenium" in the market and prefer to look through specific instruments and focus on overall corporate sustainability credentials and direction. This investment culture exists across liquid credit, structured, direct lending and real estate.

As for market evolution in 2022, of course we expect the GSS market to grow with increased participation from the US and Asia as these regions join Europeans. Finally, regulators, central banks, and fiscal policymakers will continue to facilitate structural change in the economy that serves to defend the health of the planet. Companies and banks that go along for the ride could be great investment opportunities.

Finally, as COP26 fades in the rear-view mirror, although the climate crisis will remain prominent, biodiversity will draw more share of the spotlight.

**Vincent Nobel**
**Head of Asset Based Lending**

The first year of the pandemic saw capital values increase for residential and logistics real estate and significant falls in value for all other real estate asset classes.

With full interest collections, this allowed real estate lenders to outperform their equity colleagues. In 2021 we saw some values recover, though rent collections remained troubled, particularly in high street retail. We made some investments in retail warehousing, where we saw considerable upside. These investments are performing very well, and that market is seeing strong capital value recovery (for the right assets) as we approach the end of the year. We now turn our mind to what 2022 will bring.

As far as real estate asset classes are concerned, office remains the big question. Office landlords and office occupiers (as well as their staff) are considering what they think the *modus operandi* should be for office use. In a world where many office workers routinely work from home, office use intensity will drop. Over time we expect this to translate into lower demand, and thus lower rents overall. This will hit offices in marginal locations very heavily. Particularly for offices that also struggle to boast green credentials, obsolescence becomes a real concern. As a lender our preferred office trade is to fund the development of new offices with strong green credentials, such as the property being constructed at 150 Holborn.

In a world with higher inflation, we expect rate rises to feature next year, which will give floating rate loans the edge over fixed rate loans. Real Estate yields and interest rates do not always move in sync. When rate inflation is driven by supply side issues, rather than excess growth, the rental growth that is normally anticipated may be elusive, which could see property yields widen. In such a scenario, floating rate loans may well be a good hedge for real estate investors in the short term.

## Private markets

**Chris Taylor**
**CEO, Real Estate**

With investor allocations set to further increase into real assets, in a post-covid world there is an increasing awareness that investments in real estate can not only deliver the relatively attractive yield being sought, but positive environmental and societal outcomes too.

The challenge for investors is accessing the market to secure relevant assets to meet this increasing demand with an awareness of the pivotal role which specialist operating platforms can play in delivery and the critical importance of ensuring that ESG risks are firmly embedded within such operators business models. Expect to see an increased premium for those platforms that can deliver and authenticate these holistic outcomes being demanded.

Covid has accelerated profound structural changes which were already underway – technology, increased environmental awareness, of social inequality, wellbeing and justice – as a consequence we can expect to see an increasing bifurcation between those assets which are functionally and physically obsolete and those assets which are relevant to both occupiers and investor needs and are well placed to witness rental growth as the economy rebounds.

We therefore expect to see further deterioration in values of many obsolete offices and much of the commoditised retail floor space currently on offer across most U.K. town centres; conversely, we expect continued strong demand for thematic investments such as life sciences and high performance technology; demographic lifestyle shifts continue to support accessible Build to Rent (BTR) projects and social housing; the logistics sector will continue to benefit from the shift in retail habits and further demand for last mile delivery space; we also believe the halo effect of well managed estates benefitting from high quality infrastructure, community engagement and public realm will continue to appeal to corporates as their capital gravitates to those places which attract and retain talent.

Finally, given the Government's levelling up agenda, 2022 will see a further appreciation of the role which transformative urban regeneration schemes such as King's Cross and Paradise Birmingham can play in delivering resilience and relevance in a post-covid world for wider communities, surely the clearest and most tangible manifestation of what we mean when we describe sustainable wealth creation. This concept of creating the 'meaningful city' embraces both environmental and social factors and can provide resilience for our cities ahead. We anticipate a further appreciation by investors and government of the pivotal role which real assets can play in creating sustainable wealth for all stakeholders.

**Patrick Marshall**
**Head of Private Debt**

On the back of the optimism from the vaccination rollout in the UK and mainland Europe, coupled with policies to reopen economies, the market has been very buoyant during the latter part of 2021. Transaction flow is at an all-time high across Europe, including across southern Europe where countries have traditionally been viewed as challenging territories for investors due to the legal environment which is less creditor friendly. This is expected to continue in 2022, even if Covid cases start to rise again across Europe and some countries go back into lockdown.

With significant 'dry powder' available from lenders, however, competition for transactions will continue to be intense and this is expected to continue for all 2022. Unitranche lenders will want to win back market share from the banks by competing on loan structures, and there is expectation in the market that leverage will continue to rise in the unitranche segment – possibly to above 7.5x. Whether this is a successful strategy will be seen, but we expect it to be attractive to borrowers in more cyclical sectors of the economy who will want to benefit from looser terms in order to protect themselves in case of future downturn. Furthermore, private equity firms will seek to increase leverage on transactions in order to enhance returns on their investments as a result of ever-increasing valuation multiples which makes their cost of acquisition higher for investments.

> **We will continue with an ESG approach focused of documenting required changes in behaviours rather than incentivising them.**

In the senior-secured space, yields are expected to remain steady. The senior secured segment is controlled by the banks who cannot reduce yields due to return on capital constraints and the unitranche are not able to undercut senior secured lending yields due to their return targets. However, over the long-term in the unitranche space we see yields falling marginally as competition to deploy continues. This will be marginal as competition will not focused on price but on loan terms. Increased pressures on supply chains, which has put in question the "just in time" supply chains of many European companies, remains a risk factor going forward. The increasing price of oil and gas coupled with reduced government support on the back of European economies reopening could also have an impact on credit quality and these will be potential areas of risk for 2022.

The focus on ESG will continue to grow amongst direct lenders. Lenders who have adopted a reward-based approach to ESG by rewarding borrowers with reductions in loan interest charges for good behaviours, will increase potential reductions in loan yields from the current 5bps to 15bps to more material reductions. This will be the direct result of an increasing view in the market that these small reductions in loan yields do not guarantee improved ESG behaviours. We will continue with an ESG approach focused of documenting required changes in behaviours rather than incentivising them.

Although the market is expected to remain very buoyant in 2022, participants are all aware of the uncertainty and risks lurking in the background. we continue to see value for 2022 in the creditor-friendly northern European jurisdictions, despite the current uncertainties surrounding the possible reduction of government support for borrowers, which could impact credit quality. Similarly, senior secured lending is the key area of focus in a market that requires discipline in lending practices.

## Perry Noble
**Head of Infrastructure**

The outlook for infrastructure is increasingly dominated by responding to the climate emergency, accentuated by the plethora of commitments made by the UK government in preparation for COP 26.

One consequence is the increasing emphasis placed on accurately measuring carbon emissions and disclosing, including under TCFD, the outcomes for specific assets under a range of climate scenarios. We expect this trend to continue in the years ahead, with an ever-growing compliance responsibility related to capturing and disclosing accurate emissions data.

Our portfolio businesses continue to navigate the ongoing pandemic whilst also striving for continuous operational improvement and tackling a range of sustainability initiatives. This is all happening in an environment where essential infrastructure is subject to increasing political, regulatory and public scrutiny. This underlines a trend we have highlighted previously, which is the increasing demands placed on executive teams in infrastructure businesses. The quality, capability and robustness of executive teams are becoming prerequisites for success. One result is that attracting and retaining top talent is now a priority strategic objective. Testing our portfolio companies' capacity in this important area, which extends to succession planning and beyond the need to promote diversity generally at all levels of portfolio businesses, will be an asset management theme for 2022.

As has been noted by some market commentators, the lockdowns imposed as a result of the pandemic to an extent obscured the impact of Brexit on the UK. We expect this to play out in the wider economy and our portfolio over the coming year. For example, at our transport businesses managing customs and immigration challenges and the utilities facing supply interruptions importing chemicals and other essentials. All of the potentially affected portfolio companies have in place contingency plans to mitigate resulting disruption which we continue to monitor closely.

Finally, the macro-economic outlook continues to be mixed as the economy in the UK and Europe emerges from the pandemic. The sustainability of the current inflation trend and the potential for near term interest rate rises in response are adding to the uncertainty. Whilst several of the portfolio companies would benefit from higher inflation either through regulatory mechanisms or pricing power, increasing interest rates for more highly indebted companies would represent a headwind. Elevated energy prices are already feeding through to higher than budgeted operational costs, and there is a general expectation that they may persist well into 2022. We continue to work with management teams to navigate the uncertainty.

## Peter Gale
**CIO and Head of Private Equity, GPE**

Psychologists use the concept of a habit loop – a cue, a routine, and a reward – to contextualise behavioural changes. This very neatly applies to the changes we have seen in business behaviour over the last two years and are equally applicable to the future. 2020 was the year where new habits – think operating in the virtual economy – were initiated and became routine, while 2021 was the year those new habits got rewarded: Companies that adapted to the new realities of the virtual economy prospered, while old business models saw accelerated decline. Investors now need to look ahead to identify the next transformative phase and position their portfolios accordingly as we move into 2022.

There can be no doubt that the next defining investment (and societal) habit will be the transformation, over the next decade, to a Net Zero Economy environment. Much like the digital transformation of the last decade, the Net Zero Economy transformation will require companies, consumers and governments to rethink and change the way they operate across an entire spectrum of economic activity. This will give rise to compelling new business opportunities for innovative companies. Excitingly, we believe the majority of the economic transformation can be achieved by applying existing technology to new problems and scaling those solutions into new markets. The rewards for investors who embrace the upcoming transformation to a Net Zero Economy will be the capture of powerful long-term tailwinds across industries, ranging from next-generation energy, to food & farming technology, to accelerating themes around the circular economy and responsible consumers, and the required upgrading of supply chains.

While these structural observations are set against the context of record-high valuations, and the real risk of an inflationary uptick, the opportunity set for investors who take a disciplined, research-driven, and diligent approach to stock selection, has never been greater. At the same time, we believe it is important to take advantage of the elevated valuation environment, where possible, and to be alert to the speed of potential disruption affecting even successful businesses. On that basis we will continue to actively drive exits across our clients' portfolios to minimise downside risks and ensure optimal allocations to this decade's most relevant growth trends.

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## Federated Hermes

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