The return of emerging markets

Robust economic growth, first interest rate steps in the USA and a recovery in emerging markets should make 2022 another exciting investment year.

Mr. Bärtschi, an eventful year is drawing to a close. The economy has continued to recover from the setbacks caused by the lockdowns. Now rising inflation rates are forcing central banks to act. What do you expect for the coming year?
It will definitely remain exciting, that much is certain. Many factors of uncertainty from this year will continue to be with us in the coming year: First and foremost, of course, the further development of inflation rates. And connected with this, the future monetary policy path that the major central banks, and above all the US Federal Reserve, will take. We expect the Fed to have completed its tapering by mid-2022 at the latest and a first rate hike before the end of the year. Inflation rates are likely to return from their current very high level in the course of the coming year. However, I expect the level to remain elevated in 2022. After all, the growth environment is likely to weaken, but still very robust.

Interest rates in the government bond markets fell after the occurrence of the COVID-19 variant omicron, despite increased expectations of future rate hikes. Yield levels remain very low. What do you expect for 2022?
We expect yields to rise slightly. Our forecast for ten-year US government bonds is 2% by the end of 2022, but the rise in yields is more likely to be an issue for the second half of the year. Currently, investors' uncertainty about the further development of interest rates and a potential monetary policy error by the US Federal Reserve, as well as uncertainty about the further path of the pandemic, are weighing heavily on yields. Volatility in the bond market has increased significantly in recent months. The same applies to credit spreads. The negative impact can be seen particularly in the investment grade segment, which offers hardly any risk buffer. We therefore feel better off in the high-yield segment and selectively also in emerging market bonds.

Let's stay with emerging market bonds for a moment. The widening of credit spreads in Asian bond markets over the past few months has been dramatic. Rightly so?
I think so, yes. The political uncertainties in this segment are immense. Sectors that make up a significant portion of these benchmark indices were directly affected by the Chinese government's regulatory measures. However, market reactions were exaggerated in certain areas of the market. Such extreme events therefore also create investment opportunities. However, as an investor, you have to be very selective.

In this context, let's talk about equities. While US and also European equities have repeatedly climbed to new all-time highs this year, things have looked rather bleak for emerging market equities. Do you see opportunities here as well?
Equity markets in the emerging markets are extremely heterogeneous and strongly influenced by idiosyncratic events. But you are right, of course: Investor differentiation between developed and emerging markets has been very pronounced this year.

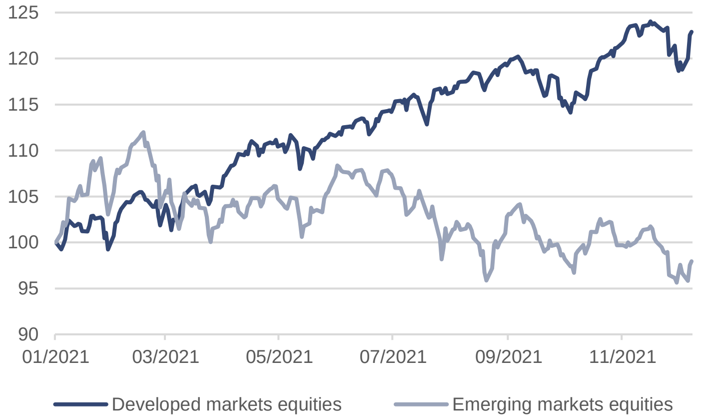
Editorial

Dear Reader,

As the year draws to a close, we look forward to what 2022 will bring us. Many of the important topics for financial markets, such as inflation or sustainability, will remain with us in the coming year. For this issue of the "CIO Update" we have chosen an interview format to discuss these topics and many more. Despite many uncertainties, the next year also offers some interesting investment opportunities. We expect a positive surprise with the return of emerging markets. Now we wish you peaceful holidays, good health and all the best for the new year.

Philipp E. Bärtschi, CFA, Chief Investment Officer

Emerging market equities lost out in 2021



Source: Refinitiv, Bank J. Safra Sarasin, daily data, 1.1.2021 to 7.12.2021

China, in particular, has sometimes been viewed by investors as uninvestable due to government policies. Although concerns are warranted, we believe this is exaggerated. The government's policy is not new and follows the goal of ensuring that prosperity does not benefit only a few, but is distributed evenly throughout society. This "common prosperity" also reduces social risks and promotes more sustainable growth in the long term. This is about issues such as competition or data protection but also about social fairness. To make a long story short: Yes, we see opportunities here.

For the most part, these are sustainability issues that have been increasingly in the focus of investors for some time, not just in the context of this year's COP26.

Absolutely. The focus on sustainability did not come overnight. However, the issue has received significantly more attention since the outbreak of the pandemic. This trend, toward a sustainable future, will, I am convinced, become a long-term one. And it will be accompanied by massive spending under fiscal policy programs, as well as pushes at the corporate level. Therefore, we remain invested in our thematic equity strategies where we see the most promising opportunities, such as disruptive technologies or renewable energies. Safra Sarasin has been following this sustainable approach for more than 30 years now and we integrate it throughout our entire investment process.

Do you expect 2022 to be another good year for developed market equities? After a decade of US outperformance, is now the time for Europe or even Japan to take the baton?

In principle, the outlook for equity markets remains positive in the coming year. Consumers have built up high excess savings in recent months, so demand is likely to remain strong. At the same time, companies will have to restock their inventories, so production is likely to remain robust. However, a regional view is not necessarily helpful when making investment decisions. The right sector and stock selection or a thematic orientation are more important than positioning at the regional level. We see considerable potential in the coming year, particularly in cyclical sectors and, selectively, also in the value segment. However, rising interest rates and a revival of economic momentum are crucial for this. This is likely to be a theme for the second half of the year. Currently, there is little to prevent positive momentum in growth stocks due to extremely low real yields and interest rates.

How is all this reflected in the positioning of your multi-asset portfolios?

As you might guess, we are overweight in emerging market equities. The valuation of Chinese equities is attractive. The P/E ratio shows a discount of more than 30% compared to the US. It is questionable whether corporate earnings in the US will grow significantly faster than in China in the coming years. The Chinese stock market is therefore significantly undervalued. In addition, the credit impulse should move into positive territory in 2022 and serve as a strong support.

In the bond segment, we remain underweight with a focus on the credit segment and inflation linked bonds. The return behavior of both asset classes is very solid in the environment of increased inflation rates. In addition, in the high-yield segment, the rating outlook remains robust and expected default rates have recently declined further from already low levels. In alternative investments, we are overweight in cat bonds. The asset class continues to have a strong positive diversification effect in a multi-asset strategy and contributes accordingly to the robustness of the portfolio.

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Attractiveness of individual investments

Asset class	Weighting	Relative attractiveness within the categories			
Equities	+	Developed markets –	Emerging markets +	Large caps =	Small caps =
Bonds	–	Government bonds – – –	Corporate bonds –	High-yield bonds +	Emerging markets +
Alternative assets	=	Money market =	Convertible bonds =	Other alternatives +	Real Estate =

Source: Refinitiv, J. Safra Sarasin

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