2022 Investment Outlook: "We Can Work It Out"

2nd February 2022

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Given our penchant at Arlington for music, we have chosen another popular anthem as the title for this year's outlook piece: "We Can Work It Out" by the Beatles. The song was written by Paul McCartney and John Lennon and released in December 1965. It reached number one in Britain, the USA, Canada, Australia and Ireland. In the UK it was the seventh highest selling single of the 1960s.

Review of 2021

The substantial market drivers of 2021 were dramatic monetary and fiscal policy moves to address ebbing and flowing Covid concerns.

At home the blue-chip FTSE 100 index closed on New Year's Eve at 7,384.54, near to its highest level in 22 months, as investors dared to hope that Covid was finally on its way out and seeing Brexit impacts as managed and temporary rather than structural and persistent. That means the FTSE started 2022 a whisker below where it stood before the pandemic hit Europe, helped by super-low interest rates and other monetary policy stimuli pushed through by the Bank of England and others since Covid first struck. We expect to see choppy markets and some good buying opportunities particularly in the early part of the year as investors process the changing environment. UK Economic output exceeded pre-pandemic levels for the first time in November, fuelled by strong growth in construction before the Omicron variant took hold. GDP rose by 0.9%, which was more than double the 0.4% rise predicted by economists. The statistics confirm that the economy had gained momentum before the new variant emerged in November.

Globally, the underlying investment thesis for real estate holds that bond yields will continue to remain low, and while inflation is on the rise real assets will provide an income producing hedge. UK real estate has proved resilient in both volume and values through 2020 and 2021 with Q4 2021 at a six year high, setting new records in industrial investment, for investment in the South-East, and in REITs. It is astonishing to be able to note that in UK real estate some sectors have returned almost 20% in the past twelve

months. Investment volumes are widely predicted to increase again in 2022. Yield compression is predicted in most segments of the market, especially prime assets in all segments, with uncertainty around construction supplies adding an additional lift to values for finished product, and demand high for ESG tailored demand in offices, life sciences and flexible working environments. There is strong investor demand for supermarkets and the warehousing, logistics and industrial markets remain attractive. As with stocks, international investors had steered away from the UK while Brexit impacts were observed, and now are returning to the market with demand across a wide range of assets and increasingly regional geographies. Yield compression and upwards pressure on interest rates are likely to see investors and lenders preferring more core-plus and value add opportunities, with a strong bias to the green economy.

Economic Outlook

Now it is increasingly clear the stage is set for 2022 for a year of transition as policy frameworks and economies move back toward the norm. However, hangover effects from Corona remain likely to define the economic and market environment across many economies. Impacts include continued supply-chain disruptions, commodity price fluctuations and an upsurge in demand threatening to keep inflation high globally, with further disruption possible where conflicts emerge. Consequently, we expect market performance in 2022 to be determined by the dynamic interaction between strong economic growth and inflation.

The global economic picture also remains comparatively rosy, with growth to normalize, remaining above its long-term trend but decelerating to a more sustainable rate as fiscal stimulus is gradually removed. We anticipate that inflation will peak in mid-2022 and then start to slowly moderate by the end of 2023 as supply-chain issues resolve, vaccination levels increase, and more employees return to the workforce. The OECD predicts that the UK, Euro zone & US will grow at 5.2%, 4.6% and 3.9% respectively in 2022. These numbers look promising and will power the stock market, but will be subject to revision, possibly downwards, against external forces. The backdrop does indeed still demand some caution in that the Corona virus clearly could yet hold some nasty tricks up its sleeve. So far, the Omicron variant has introduced only temporary uncertainty, has not yielded a draconian shutdown in economic activity, and politicians seem to have held their nerve. Barring an unexpected more severe strain, most analysts seem to expect no return to a lock down again, at least as at writing. As we have said so

many times throughout this pandemic, the risks are elevated, but we remain optimistic about the path forward as we learn to live with the virus, and other factors are managed.

Arlington believes that we are still solidly in 'growthflation' rather than stagflation territory and while growth has slowed recently almost exclusively due to Omicron, it should start recovering in a quarter's time. The big question for this year remains the same as it was a month ago: does Omicron loosen its grip on the world economy, moving demand away from goods and back towards services, cooling inflation a bit, so the Fed can tighten at a stately rather than a panicked pace? We believe the answer is yes… The best argument against an equity crash or asset prices generally remains the same. It is that bond yields are still far enough below earnings yields that a great rush out of stocks seems unlikely.

How we see the world in 2022

In a nutshell, the outlook for Europe is as follows: promising, apart from the risks of a new energy crisis. The structural reforms such as debt mutualisation, and more digitisation seem to offer a positive underpinning to EU economies as they grow out of the last crisis. Politically, diplomatically, eyes will be on the new German government, particularly over Ukraine, energy policy and engagement with NATO. There are important elections for the Italian and French presidencies. Don't rule out an upset in the latter if a sensible candidate faces off to Macron in the second round. In France, we expect a hyperactive Macron trying to use the EU Council presidency to try to amend EU fiscal/debt rules ahead of the French election in May.

In the UK, government spending is on the rise with large infrastructure projects and the "levelling up" policy agenda. Towards year-end the UK will successfully join the Trans-Pacific Partnership, although it might not be with Boris as PM! He is certainly walking on thin ice this winter. Away from the headlines, Ann Marie-Trevelyan has been effective in adding to the basket of new trade deals, the re-setting of the geo-political and economic map and disruptions to flows of trade have left opportunities for the City of London, and the EU has extended clearing for the City for at least the next five years, as was widely predicted. On Threadneedle Street, we can expect further rate rises from the Bank of England, which said there was now "a strong case for tightening monetary policy now,

given the strength of current underlying inflationary pressures and in order to maintain price stability in the medium term".

In the US, it is all about the Fed and the Mid-Term elections. The two combine in that inflation is a political punch bag for both left and right – putting the Fed under pressure to tighten. It is unlikely that Biden will be able to push through meaningful legislation, so he will focus on regulation, executive orders and foreign policy. On current polling, Republicans should take back both houses, the simple reason being Biden is seen as a weak president, facing serious set-backs at home and abroad, especially on areas where he promised to bring back competence, and "normalcy". At the December Fed meeting, policymakers announced plans to end monthly bond-buying by March and signalled the possibility of increasing the Fed funds rate at least three times in 2022. Biden also plans to reverse Trump's corporate tax reforms, increasing tax on business and pushing equities lower. This monetary and fiscal tightening will also be particularly bad for the bond market this year. The markets have seen the end of a bull run quickly emerge.

China will want to showcase stability ahead of the Winter Olympics (Feb) and then the 20th Party Congress (Nov). With decelerating growth, we expect foreign policy grandstanding, targeted stimulus to avoid a wider financial crisis and social reforms to unleash consumer demand. Given Biden is weak and if the USA and the West are distracted over Ukraine, tensions over Taiwan may rise, but the prospect of an intervention is remote. One does not need to spend much time looking in to the abyss of a hot US China conflict to see that both sides are highly motivated to avoid such a crisis. This in contrast to the Russian adventurism in Ukraine where the cost benefit analysis for the Russian president Putin seems much more weighed towards action. Xi Jinping and Vladimir Putin do not have to try too hard to overstretch the world's only remaining superpower and use the opening gap between the ambitions of the Western alliance led by the USA and its capabilities to decisively project power to mutual advantage. We expect the coming decade to see more instability between the major powers, with regional level power struggles and wider escalation risks. Miscalculation in this realm giving rise to hot wars remains the major global financial risk against which portfolios must be measured in the medium to long term.

Outlook

These risks aside, major economies are now in a fascinating phase where investment levels are rising, by both companies and governments, productivity looks promising and reshoring is driving corporate spending, partly to mitigate these geo-strategic risks. Combine this with massive green spending kicking off as we transition to a fairer, more circular economy and corporate earnings should be able to grow in 2022. We will be watching inventory numbers very closely throughout the year as at some point supply chains are going to sort themselves out and then firms may hold too much stock, which will necessarily unwind. We expect volatility to remain elevated as markets digest the transition to slower growth and a gradual tightening in monetary policy, which will temporarily knock confidence in the factors above. However, we've said volatility is a risk for the last three years, albeit for a different reason each time! We will be prepared for this and have adopted a strategic cash allocation to take advantage of any cheap stock on offer.

After a strong year for the stock market, some investors may be tempted to switch up their investment strategies, but while a new year has arrived, many of the same dynamics from 2021 persist that currently and could continue to support higher stock prices. Stocks have a better prospect for returns than bonds, thanks to the rising interest rate backdrop. This is because even with the most conservative estimates of inflation, your real return on bonds is negative and the yield on offer from the stock market looks highly attractive in comparison, even if interest rates start to rise. This, in a nutshell, explains our confidence and if there's a dip we'd be looking to add to our holdings.

In real estate, globally, the market remains underpinned by low interest rates and strong demand for yield and a counter to inflation risk. In the UK again international investors have been returning and investing heavily. London remains the destination of choice, but regionally many major cities are attracting international investors, some for the first time, as these local economies are gaining greater focus from central government. We suspect that where there is an internationally competitive football team, this may also have a positive impact. The film studio market in the UK and Europe has become a key area of expertise, and we are working with multiple investors evaluating projects and execution teams, alongside our more traditional focus on commercial buildings and development.

The European property markets have so far faired extremely well through the period of the pandemic. Whilst the countries located south of the Alps attract investors with a more opportunistic angle, those just north of the Alps are attracting investors from all parts of the world looking for stability and growth. Arlington Capital's main focus in the real estate domain is directed towards residential multi-family dwellings in the DACH regions, primarily Germany. In 2020 & 2021 rental levels rose by 3.5%+ per square metre compared to the previous years' rates. This was once again outstripped by the sales price increases which levelled out at 8.9%+ showing a marginal decline in comparison to the previous year. We predict the current DACH real estate dynamics to be maintained throughout the year 2022 with some further yield compression to come. In the not unexpected event of an interest rate hike, we can predict a slowing of capital gains, whilst we are not expecting any serious market corrections in the short term.

Overall Arlington Capital continue to focus on risk adjusted yield investment, seeking a steady income with some capital appreciation across our investments. There may be choppy times ahead, but we see our strategies as being fit for purpose in tougher times too. In other words, we can work it out.

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