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Market Update - Thoughts on the Year Ahead

To Reflect and Consider

Two years have now passed since the onset of the pandemic and it remains the dominant factor for much of society. This has largely been the case in investment markets too, with a wide array of market driving events ultimately derived from covid. Yet, it has not been exclusively the case and while it is possible that 2022 is another year ruled by coronavirus, there are plenty of emerging topics which could draw attention elsewhere. At this point, therefore, it is appropriate to reflect on the experiences of the year just gone and to consider what may be ahead.

A Changeable Mood

2021 was a year where confidence levels repeatedly swung from pessimism to optimism and back again. A lingering lockdown to start the year, but the promise of the vaccination rollout. The emergence of the Delta variant, but continuation of financial support packages such as furlough. The speed of the Omicron wave, but the indication of milder illness.

Equity Outperformance

A difficult year to pick trends therefore. Yet, despite this topsy turvy nature, investors in balanced portfolios are likely to have experienced a positive time. While bond markets fell by small amounts, as rising inflation reduced the appeal of their fixed returns, equity markets overall delivered a strong performance. The UK and the US led the gains with the FTSE 100 delivering over 18% for the calendar year (with dividends included), while the American S&P 500 returned nearly 30%. While 2021 may have been another difficult year for society as a whole, for many investors, that discomfort may not have extended to their portfolios.

Looking Ahead

What can investors look forward to in 2022, then? While this question is hard to answer as there will be plenty of unforeseen events that dominate headlines, there are a number of known stories which are likely to affect markets over the coming year.

Covid

Covid, of course, will be one of those. As the Omicron variant has shown, the emergence of a new variant has the potential to create further disruption regardless of vaccination levels and this is likely to remain a risk over the immediate future, at least. If any future variants are found to only cause mild illness, then the economy can continue to move on, yet if a highly contagious and severe form does develop then setbacks are likely.

Inflation

Inflation is a key question for the global economy currently and is expected to be so for much of the year. At the end of 2021, UK inflation, as measured by the Consumer Prices Index (CPI), was at 5.1%, the highest level in a decade and well above the 2% target. Much of the current surge can be attributed to temporary, pandemic related, factors such as elevated car prices and housing costs. This is likely to continue for a number of months yet, but it is expect to fall later in the year. Nonetheless, even if inflation does come down it is likely to remain above target as more persistent

price pressures take hold, such as low unemployment leading to higher wages. Central banks, therefore, will be forced to act. The Bank of England raised interest rates for the first time of the pandemic in December and more rises are likely to come this year.

Politics

Political considerations are never far from the attention of markets and the current time is no exception. While we are beyond the most fractious period of Brexit negotiations and the US Presidential election, these topics have not disappeared. Brexit discussions continue over the Northern Ireland protocol and Joe Biden will soon have to have to face the prospect of mid-term elections, while he struggles with a still heavily partisan landscape. Each of these have the potential to bring greater volatility to investment markets. Furthermore, there is the potential for conflict in both the Ukraine and Taiwan as Russia and China both appear to escalate tensions. Clearly, major conflicts here would hurt investors' optimism.

Market Environment

What does this mean for markets? Well if a new severe covid variant arrives, or if sustained military conflict erupts, then equity markets are likely to be challenged. Yet, in the absence of the above, it appears that a positive economic situation will create a favourable background for investment.

Changing of the Guard

The raising of interest rates must be navigated, however, and one area in which this may play out is UK vs US equities. For a number of years, US equities have outperformed our domestic market as the high number of fast growing technology companies there have flourished, in part thanks to low interest rates. Yet, should a sustained rise in rates occur those stocks positively linked to higher rates, such as banks or other cyclical firms, will likely benefit. The UK has high exposure here and so should this scenario develop, the trend of US outperformance, which has occurred for much of the past decade, would face a worthy challenge.

The Year Ahead

As we examine the year ahead there are a number of potential flashpoints which could hit confidence, yet with economic growth rates high, inflation manageable and unemployment low there are strong positive signs as well. A positive backdrop then, but with the potential for challenges. Looking forward therefore, caution must be maintained, but for a well-diversified portfolio which is managed with a longer term perspective, 2022 looks likely to be a time for continued recovery.

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