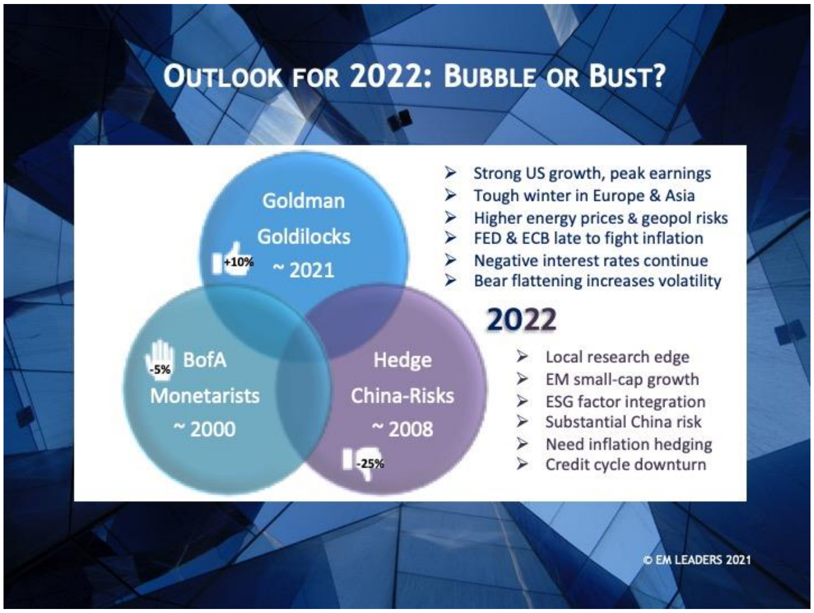


Outlook for 2022: Bubble or Bust?
Parallels to 2021 vs. 2000 vs. 2008

"Those who do not remember the past are condemned to repeat it."
George Santayana (1905)

2022 appears to become an inflection point: either the climax of a magnificent bubble or the implosion across multiple excesses. Extreme stimulus led to extreme liquidity which has led to asset bubbles and inflation. Geopolitical risks for 2022 are also high and risks for a reversal in financial markets are substantial. This article lays out three perspectives from goldilocks, monetarists, and fundamentalists with relevant parallels to financial history. Then four promising factors are presented for future investments.

Financial analysts mostly agree on the **current state** of mid-pandemic affairs: we will get to the end of the tunnel, but we will have a difficult winter ahead, while we are also facing rising market volatility and elevated geopolitical risks. Massive stimulus has created strong growth, while excess liquidity created asset bubbles and inflation, notably in energy, commodities, credit, private equity, and real estate. Evergrande revealed the deflating Chinese real estate bubble which will depress Chinese growth. US and EU policy makers will keep negative real rates and be rather late in fighting inflation. US equity markets gained over 40% in two years and even optimists project at most an additional 10% upside, while the downside from record high valuations could be substantial when liquidity starts tightening and interest rates start rising.

We illustrate three stylized views for financial markets (chart 1): **Goldilocks** such as Goldman Sachs suggest a continuation of the 2021 new market heights with a delayed path to higher rates. **Monetarists** such as Bank of America believe that next year will be a mirror of the year 2000 when rising interest rates punctured the tech bubble and payback for stimulus excesses will arrive. **Fundamentalists** such as macro-hedge funds believe China's real estate bubble will deflate substantially, and nationalist policies will exacerbate global reverberations, worse than what we had experienced in 2008.

So how do investors position themselves for elevated uncertainty ahead? Do you keep dancing for another year as long as the music keeps playing? Or do you rotate into value stocks as interest rates puncture the strong recovery and technology excesses? Or do you focus on capital preservation as multiple bubbles could implode and lead to global fallout? In other words, do you follow the **playbooks of 2000, 2008, or 2021**? When uncertainty is high, the average of market forecasts becomes meaningless, but contingency planning for at least three probable scenarios is required. This article lays out details of three probable scenarios and respective portfolio positioning and concludes that passive momentum strategies would be most risky next year, whereas active quality defensive strategies would do better in such an environment.

A> Goldman Goldilocks: 2022 continuing 2021 expansion

Goldman does not have a history of predicting train-wrecks in its public research, and its latest macro-outlook remains optimistic with **strong global growth forecasts** of 5.9% for 2021 and 4.5% for 2022 and tailwinds from a procrastinating Federal Reserve that is expected to raise rates only gradually by 100 basis points until the end of 2023. But its baseline case is quite weak as it projects US equity markets upside of only 10%.

Goldman economists assume a normalization of supply chains, as the US and East Asia are reopening, and the pandemic is largely controlled with rising immunizations and new medicines. Goldman's goldilocks scenario foresees continuing accommodative monetary and fiscal policies in developed markets and moderating demand growth. Any slowdown is delayed into late 2022 when inflation and rising rates may reduce growth in the US, Canada, and the UK, by up to two percentage points for 2023. But the Goldman team has added two caveats: inflation could rise faster than predicted (more supply constraints and/or stronger demand) and Chinese growth could weaken by three percentage points during 2022 from a declining property sector.

In this optimistic scenario, investors would remain on auto-pilot risk-on mode until late 2022. Momentum for technology and growth stocks in the US and Europe would continue with a bear-flattening yield curve, and high-yield credit would outperform, similar to 2021. Slower growth in China and Latin America would weigh on emerging market equities and would moderate commodity prices and inflation. Real estate and alternative assets would continue to do well as inflation hedges. Beta, cyclical, and momentum factors would again outperform again, especially in developed markets.

B> BofA Monetarists: 2022 resembling 2000 correction

Bank of America strategists are more bearish on equity markets and predict a **"rates shock" for 2022**, following an inflation shock in 2021 and a growth shock in 2020. They see many similarities between markets today and the dot-com-bubble in 2000. Massive liquidity has pushed one trillion dollars into equities in 2021, more than in 19 years combined, but global tapering has started with the credit cycle turning, and BofA is expecting three FED hikes in 2022, while US earnings have peaked and will moderate to 10% growth. Despite projecting strong US growth, BofA is "bearish and believe that capital preservation will grow as a theme in the year ahead" and suggests that falling credit and equity markets and lower fiscal stimulus may cause a recession. Besides risks from a hawkish FED, BofA also points to risks from credit events, a crypto-derivatives crash, and geopolitical event risks related to China and Taiwan.

BofA is contrasting its forecast to its monthly institutional fund manager survey, where the most crowded trades remain long crypto and long mega tech. Many survey respondents rationalize their risk-on positions with a dovish FED and inflation being capped by a continuing pandemic. The dangerous consensus appears to be “stocks go up, bonds go nowhere, and the FED does nothing.” Hence, crypto assets have been the top-performing assets this year with gains exceeding 100%, while US tech stocks have risen by 80% over two years with valuations exceeding fair values by at least two sigma. If the analogy to 2000 holds, then these most crowded trades will experience the largest downside, and credit markets will also correct substantially. BofA is advising clients against momentum trades and expects volatility and commodities to rise next year; and a dollar peak in 2022 may end the outperformance of US equities.

C> Hedge Fundamentalists: 2022 resembling 2008 crash

Hedge funds are more circumspect in publishing their forecasts, but not unlike 2008, they closely follow academic studies with respect to **Chinese real estate**. Ferguson takes a historical perspective in arguing that the Evergrande default represents a new tipping point, which is corroborated by analysis of Rogoff (Harvard), Aliber (Chicago), and Pettis (Carnegie/Beijing). Even JP Morgan’s recent alternative asset forecast for 2022 is recommending higher hedge fund allocations, both to protect against inflation and against a shock from China. Public investment bank forecasts for Chinese growth project a decline from 7.8% this year to 4.8%...4.0% in 2022, which all are based on a real estate “slowdown”, with optimistic assumptions on strong domestic consumption, receding trade tensions, and accelerating export growth. Chinese authorities already are not pleased with these publications and may not appreciate the private analysis.

Hedge funds make their own assumptions and piece the evidence together. Chinese real estate prices will fall and the consumer will painfully learn that their real estate investments are not safe, which will fundamentally alter market expectations. When consumers suffer from real estate losses, where 70% of their wealth is allocated, then consumption will inevitably decline. Capital flight will increase, and foreign investors will withdraw from high-yield markets. Banks will suffer higher non-performing loans and may be bailed out. Local governments will suffer from lower land sales and may have to cut back on public investment projects. Stimulus policies may be ineffective and may worsen pressures on capital outflows and reduce banks net-interest margins. Hence, China is going to become a big headwind during 2022, while global tapering is widening credit spreads, and it may “start to feel a bit like July 2008” (SocGen).

Notably, none of these projections incorporate any **geopolitical risk**. However, political risk experts have pointed to extra-ordinarily high risk for 2022, including a potential conflict over Taiwan, an invasion of Ukraine, and an escalation involving Iran or North Korea. Any one of them would substantially increase market volatility and boost energy prices and inflation even further. And in a world of probabilities, any conflict over Taiwan would become more likely if authorities need to distract from severe economic problems or can take advantage of other geopolitical conflicts. Investments in China may best be positioned into their separate sphere, rather than passively as part of global indices, given massive economic and political uncertainty. Even among leading hedge fund managers, the debate points to binary outcomes, either withdrawing Chinese investments (Soros) or doubling up on China (Dalio).

D> New factor framework: promising sources of alpha

Investors prefer to focus on a longer-term framework to generate outperformance across cycles. The current US-centric cycle is quite extended: the US dollar index appreciated by over 30% since 2011 and the real exchange rate is overvalued by at least one sigma. The US equity markets have outperformed EAFE markets by 240% since 2011 and are overvalued by at least two sigma. Moments of crisis (i.e. 2000 and 2008) often coincide with a turn in long-term cycles; 2022 may well be similar. Looking ahead, **emerging markets** are expected to generate most innovation and growth, and are currently priced at half of US markets (CAPE of 40 US vs. 20 EM).

Active management is essential in emerging markets: while the average US equity fund underperformed its index by 1% through the cycle, the average local manager in Brazil or India or China outperformed its benchmark by at least 3% through the cycle. However, global EM managers delivered barely 0.5% alpha through the cycle, although global EM small cap managers have added an additional 1%. EM Leaders has extensive experience in collaborating with **leading local managers** across emerging and frontier markets, which have added substantial alpha, especially in smaller-cap growth stocks. Our equal-weighted sandbox of top holdings from local managers has consistently added 10% alpha over the benchmark during the past three years (chart 2).

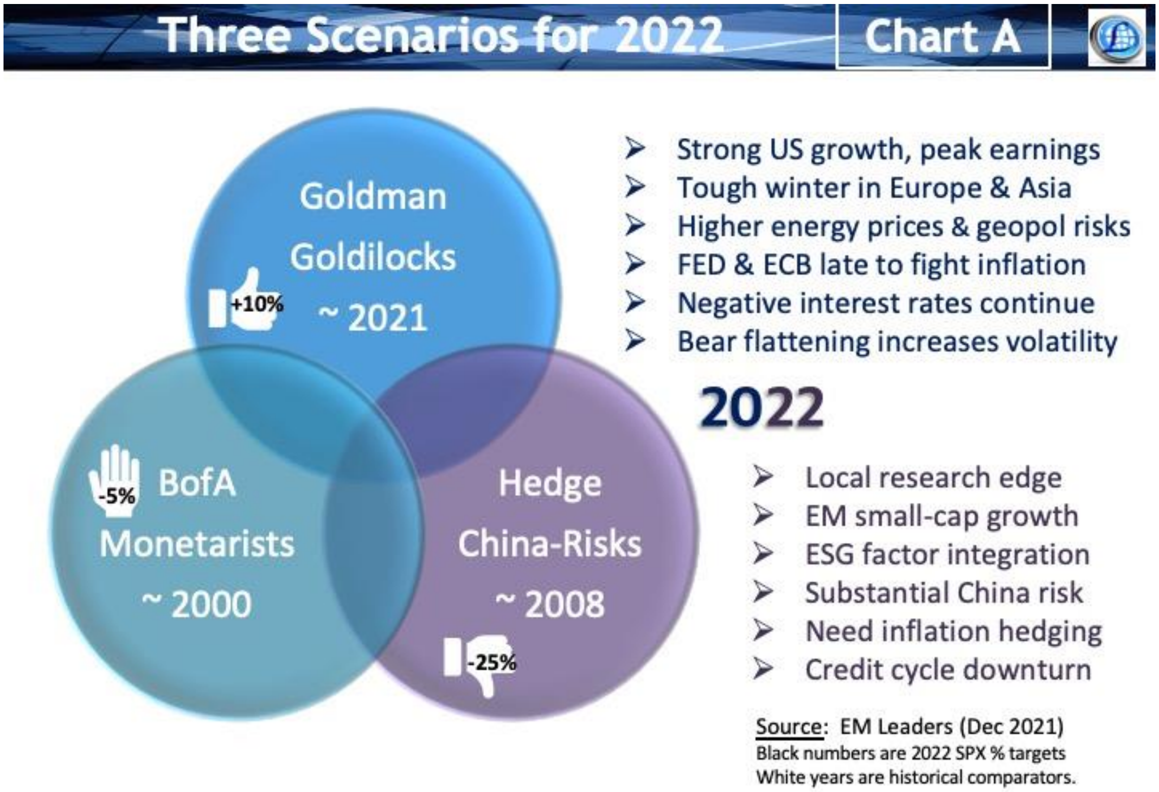
Emerging market investors do appreciate the advantage of active management and local research insights. However, they may not wish to allocate to multiple local managers, both to keep flexibility over country allocations and to reduce oversight and the need for local due diligence. While a multi-manager platform can offer more flexible one-stop solutions, they can also increase costs with two levels. EM Leaders therefore developed a **best-ideas portfolio** that is building on a unique local sandbox and then uses active management by adding factors and discretionary scoring models. While there is some overlap, active management (based upon sandbox holdings) has added 7% alpha and factor adjustments have added 4% alpha over three years.

Some global emerging markets managers have focused on ADR issues and have added mostly momentum factors and higher beta to their portfolios. EM Leaders has taken the opposite approach of avoiding ADR issues, minimizing momentum, and keeping beta well below one, which has proven to be more successful and less risky. Our **factor model** has evolved over the years and is currently focusing on four dynamic factors (chart 2) that appear most promising for the next investment cycle:

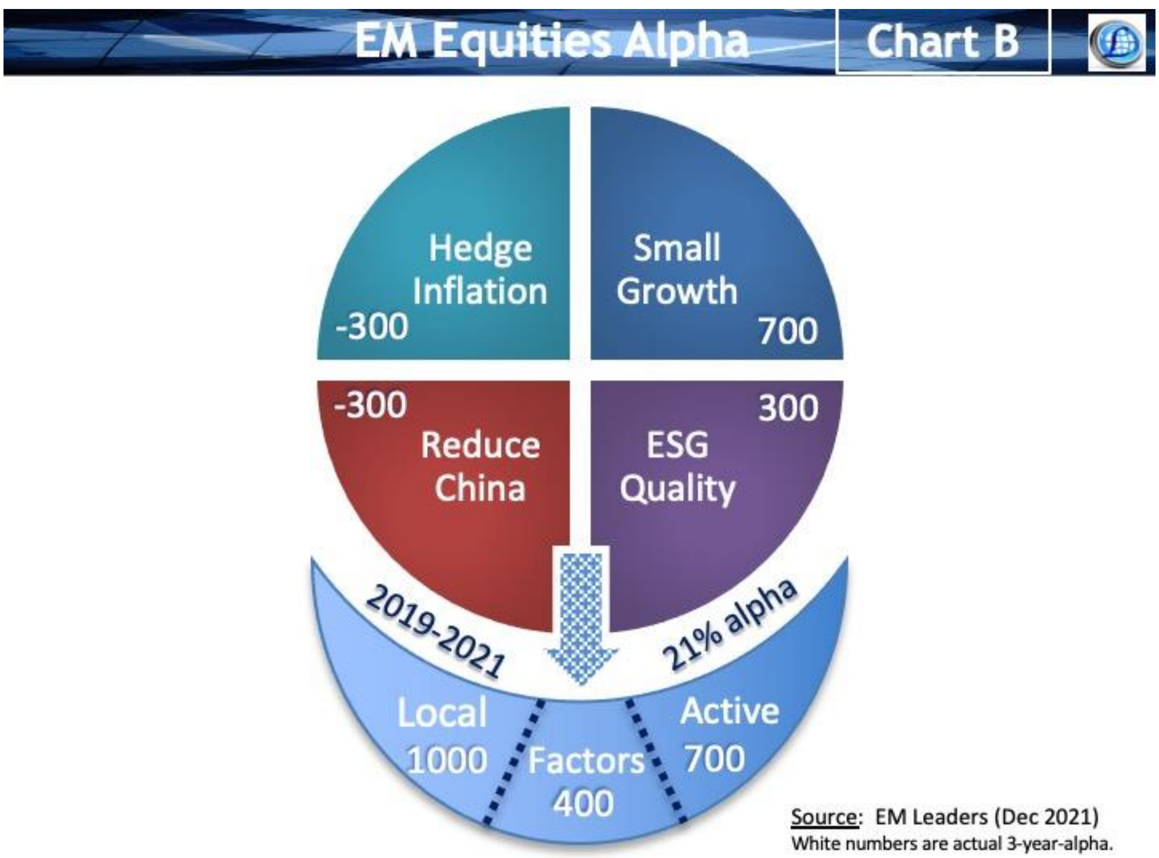
- i> small- and mid-cap growth stocks, wide moats, domestic market focus
- ii> quality firms with sound ESG policies, sensitivity to rising carbon prices
- iii> firms with limited exposure to China, substitution with frontier markets
- iv> companies with robust earnings during inflation, sensitivity to rising rates.

EM Leaders aims to manage institutional portfolios with superior long-term returns for emerging and frontier market equities. Insights from local research are extracted into the unique sandbox, which then is refined through our dynamic factors and scoring models. Results over the past three years illustrate the robustness of our investment process. We will be actively managing our portfolios to address and mitigate various risks for 2022 that may be arising from inflationary pressures, excessive US credit and equity valuations, deflating Chinese real estate markets, and uncertainty from the ongoing pandemic, plus some potential geopolitical risks. Exciting times continue!

http://www.emleaders.com/pdf/eml-outlook-2022.pdf



Three Scenarios for 2022
Chart A
Goldman
Goldilocks
+10%
~ 2021
BofA
-5%
Monetarists
~ 2000
Hedge
China-Risks
~ 2008
-25%
➢ Strong US growth, peak earnings
➢ Tough winter in Europe & Asia
➢ Higher energy prices & geopol risks
➢ FED & ECB late to fight inflation
➢ Negative interest rates continue
➢ Bear flattening increases volatility
2022
➢ Local research edge
➢ EM small-cap growth
➢ ESG factor integration
➢ Substantial China risk
➢ Need inflation hedging
➢ Credit cycle downturn
Source: EM Leaders (Dec 2021)
Black numbers are 2022 SPX % targets
White years are historical comparators.



EM Equities Alpha
Chart B
Hedge
Inflation
-300
Small
Growth
700
-300
Reduce
China
300
ESG
Quality
2019-2021
21% alpha
Local
1000
Factors
400
Active
700
Source: EM Leaders (Dec 2021)
White numbers are actual 3-year-alpha.