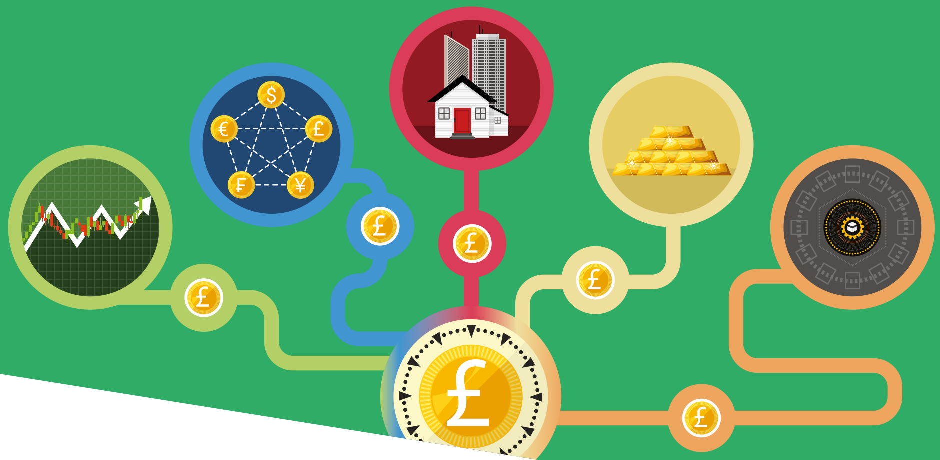
Global
Perspectives
2022



Solutions in 2022: a defining time for inflation and ESG

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As inflation runs hot and interest in ESG impacts rises, there is a fundamental shift in our institutional and sub-advisory clients' needs. We expect allocations to alternative risk assets, and to assets with positive environmental impacts, to increase.

Just as was the case in 2020 and early 2021, investors are continuing to broaden their portfolios into alternative asset classes. What is different now is the economic backdrop. At the end of 2021, major economies such as the United States and the United Kingdom reported the highest inflation levels for more than 10 years. Bond yields remain historically low despite rising since the beginning of 2022, and central bank interest rate rises are coming, even if the inflation spike eventually proves transitory. This means portfolios need to build a stronger link to inflation through risk assets, as the outlook for bonds is not so favourable.

As greater instability in inflation and interest rates tends to trigger higher currency volatility, we have been looking at how currencies should be hedged. The old dictum of hedging your bond currency exposure but leaving equities unhedged does not work in a diversified portfolio. In times when inflation and interest rates are racing away, it is important to hedge currency in an informed and clever way. But how to do so depends on whether you're a dollar or non-dollar investor. For a sterling or a euro investor, US dollars can look very attractive because they are the go-to asset in a crisis.

Dollar-based investors, by contrast, should typically hedge away overseas currency risks. There is also the issue of how yield curves are moving, with the US evidently further ahead when it comes to rate rises than the EU.

The strengthening case for alternative investments

When it comes to diversification, investors have lifted their allocations to alternative asset classes, even at a time when public markets have been performing very strongly. The logic of diversifying into infrastructure, private credit and private equity remains strong because they add stability to portfolio returns. They are especially relevant for longer-term portfolios such as defined contribution schemes – as the thinking matures around how these pension schemes approach risk, so allocations to alternative assets are likely to rise. Indeed, the Netherlands' introduction of collective defined contribution schemes is likely to favour higher allocations to risk assets and more illiquid investments, not least to private markets.

Going 'green': from exclusion to ESG

Investors are quickly shifting their approach from primarily excluding assets that are not green to actively investing in businesses that will have a long-term positive impact on the environment, for instance through better use of plastics or developing green hydrogen as a source of power. For investors such as insurers, ESG (environmental, social and governance) is becoming a portfolio's fourth pillar alongside risk, return and capital. This influences how you select the building blocks of portfolios, and we have been doing a lot of research into what we call "green capital market assumptions".

Conclusion

The outlook for inflation and interest rates will be very important in 2022. What will they mean for the role that fixed income plays in portfolios? This is a question every investor must ask. There are also implications for alternative assets and currencies. Despite their disappointing performance, alternatives will have an increasingly important role as stabilisers in long-term portfolios. With currencies, high inflation – whether transitory or not – means investors must be clear about what exposure they have and why. Finally, 2022 will be a year when ESG impacts become a key dimension of portfolios for many investors, alongside risk and return.

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