ST. JAMES'S PLACE
WEALTH MANAGEMENT

Discover the new year ahead

5 reflections from 2021

Looking back at 2021, it has been yet another extraordinary year. From a volatile transition to a new administration in the US, a widespread COVID-19 vaccine rollout and improving virus data, to rising inflation, an energy crisis, regulatory crackdowns in China and Omicron fears, "eventful" is perhaps an understatement when it comes to describing global markets in 2021. While S&P 500 reached record highs over 60 times this year (Bloomberg 2021), China and Hong Kong were among the weakest performers globally; but this trend is unlikely going to repeat itself in the coming years.

Looking ahead into 2022, some of the main themes such as inflation, sustainable investing and cyber look likely to persist. As always, the outlook may change with new events and renewed conditions and opportunities can present themselves amongst risks we see today.

I hope you enjoy reading some of my reflections for 2021 in this Q&A, and that it may prompt some of your own reflections in the new year.

Angelina Lai
Head of Division,
Asia Investment

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2022 New Year's Resolutions

Q: ***Before we look to the key themes and trends in 2022, taking off your CIO hat and putting on the hat of one of our clients, what would be your new year's resolutions as we enter 2022?***

Review my finances

This is a good time to conduct a review of where my money is and whether my circumstances have changed over the last year that might mean I have a new financial goal or perhaps one of the assumptions I made in last year's review needs to be updated.

Lose some weight and put excess cash holdings to work

Holding onto cash can be comforting in the short term, but is rarely good for my long-term financial health, particularly when interest rates are lower than inflation, meaning that any cash I'm holding onto is losing value as we speak.

Focus on the future

It's easy to let my fears get the better of me amongst these volatile times – human's "negativity bias" is well researched and understood. Better to focus on my long-term goals and avoid knee jerk reactions in the short term.

Be more green

There is no point in having lots of cash if my or my grandchildren's homes are underwater or at risk by more frequent and extreme typhoons. I am therefore extra keen to ensure that my money is used for good so that we could all safely transit to a sustainable world.

Learn a new language

The "metaverse", "artificial intelligence" and "cybersecurity" are all new(-ish) buzzwords that will likely have an impact on our lives.

The bottom line is that many of us would be looking at ways to better our lives as we say goodbye to 2021 and welcome 2022. The same resolutions can be equally applied to the way we manage our finances and investment to drive for a better future for ourselves and our loved ones.

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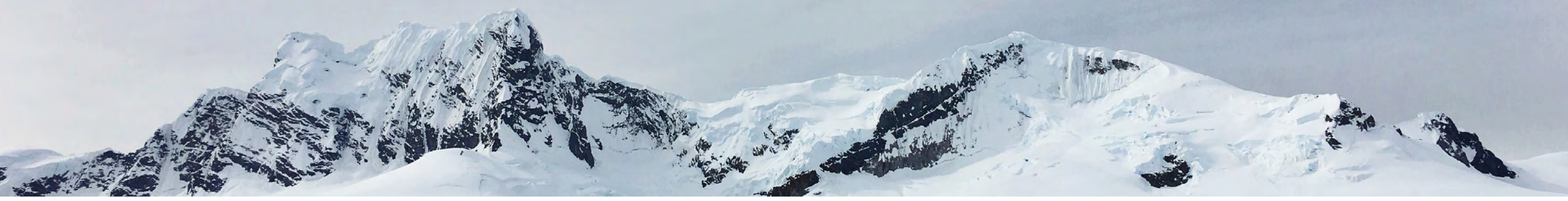
Sustainable investing



Q: ***You talked about "being more green". One of the highlights of 2021 was the COP26 summit which saw a slew of pledges made, renewed and reiterated. Putting your CIO hat back on, what are the main themes to look out for from an investor's perspective, as well as pitfalls to avoid, if any?***

Indeed, one of my favourite stats is that investing sustainably can be 27 times more efficient than reducing meat consumption, taking the train instead of the car, taking fewer flights and shortening your shower time (Source: Nordea, 2017).

Investing sustainably can be

27x

more efficient at reducing your carbon footprint.

(Source: Nordea, 2017)

Sustainable finance has gathered much momentum in recent years but much remains to be done. A key factor to achieving success will be for the private sector to play an increasingly crucial role in funding sustainable technologies and innovations – we have seen an increase in private firm pledges in Glasgow, raising our hope for ultimate success in the fight against this climate emergency. The development of carbon markets, including voluntary carbon trading, can also play an important role. There is still work needed for harmonisation of regulatory standards, especially with recent growth and new developments taking place in this space globally, but it is looking positive so far.

From an investment perspective, we caution against blanketly investing in these popular themes. As far as main themes go, we have seen particularly high growth in electric vehicles (EV) and associated industries such as battery production. Prices (valuations) of companies operating in this space already reflect the greater investor demand and interest. Additionally, new entrants are being attracted into the market to cash in on investor interest, which can pressure profit margins. From a sustainability perspective, the issues around the sustainability of EV batteries (requiring significant lithium, nickel and cobalt mining which in itself has climate, environmental and human rights impacts, and the issue of treatment of these batteries as they "retire" to become mountains of electronic waste in their short life expectancy of 10 years or so) are calling the overall sustainability impact of EVs into question.

One particular challenge in terms of the energy transition is that we should be mindful of not defunding too quickly the "lesser ideal" sources (such as natural gas – cleaner than coal but still has a "bad rep") before new energies are fully in place to maintain coverage of the world's energy needs. Concerns over rising energy costs can have unintended consequences to drive up inflation and alter the affordability of basic needs such as heating and fuel for essential transport, and indirectly rising food costs, by which lower-income earnings groups are most affected. In some cases, arguably a larger net positive may be achieved when we are investing in companies that require significant improvements and are open and willing to change – the key is to ensure these companies work in ways that are aligned to the terms that we have invested in.

Many investors are cynical in terms of investments living up to the responsible aim and motivation for investing – the concept of 'greenwashing'. It is important to gauge if relevant companies or investment managers are sincere about seeking to drive positive change wherever they may find the best opportunities to bring it about with win-win prospects for both investors financial interests and the world, while acknowledging that it might be achieved in different ways.

Ultimately, "the devil is in the details". We structure our investment and portfolios to ensure that we are looking below the bonnet, checking the details, carrying out fundamental analysis and due diligence and challenging the companies that we invest in to ensure that they really do what they say they will do.

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Inflation

Q: ***In 2021, inflation surprised many with a record-high figure in decades. What is your view on the inflation outlook for 2022 and beyond? Where do you see the highest opportunities and risks in 2022?***

One of the risks that emerged and surprised many investors in 2021 was inflation. The Fed officially retired the word 'transitory' in December and most recently central banks have been taking a tougher stance to address inflation, with Fed rate increases on the horizon for 2022 and the Bank of England already having made a first increase in December.

What should perhaps receive more attention in the inflation debate, are the two factors unrelated to COVID-19 that could make inflation more persistent in the medium to long run, namely high budget deficits in many developed economies and developments in China related to demographics and a focus on the quality of growth over quantity of growth. China had helped to keep inflation low globally for decades through a seemingly never-ending deflationary supply flood of cheap goods, but with the population peaking where birth rate dropped to an alarming 1.3 in 2020, local producer prices rising and very ambitious carbon goals, this seems to be signalling that inflation might be exported (source: Reuters, 2021).

Our view for investors is that this should be a time to be vigilant and avoid overconfidence in any type of market speculation, particularly with investments where leverage is being employed. We expect to see volatility pick up again over the coming months, with many uncertainties prevailing from central bank tapering/interest rate risks to various economic, political and geopolitical uncertainties. To be able to ride out potential volatility and drawdowns, investors should also diversify widely, and be mindful of the impact of growing inflation on holding cash.

Investments that can protect from inflation over time include physical assets and equities, noting that companies with an edge in the market will typically be passing on rising costs to customers in the form of higher prices charged for their goods and services. Warren Buffet explained it neatly this way back in April 2021: "*We're raising prices, people are raising prices to us, and it's being accepted*", though passing on of costs may not always happen in a linear, time-congruent way and clearly equity prices can still be volatile and subject to correction risks.

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China economy

Q: ***Two of the bigger market scares in 2021 came out of China, firstly the regulatory crackdown centred in the technology and education sectors, then the Evergrande crisis. What is your view on China from here going forwards, and how might it impact global markets?***

We tend to observe that, whenever certain markets or sectors have done well in the recent past, we receive the highest number of investor inquiries about investing there, and vice versa, with markets or sectors that had not done so well. In behavioural finance, this phenomenon is called “recency bias”, and it can often be damaging in terms of long-term investment outcomes, as it can lead to investors buying high and selling low since asset prices will often already reflect good or bad news coverage and investor views on trend continuation.

We are not confident that we will see a trend continuation in China markets. In fact, some of the triggers for events such as Evergrande were intended for reducing moral hazard and risks, for the benefit of more sustained longer-term societal and economic development.

For example, many investors were concerned about the outlined measures targeted at income regulation and wealth redistribution. Yet, when putting this into context, China’s Gini coefficient (a measure of income inequality in a country) sits exactly in the middle of the global average at 38.5. Several European countries are notably lower, with Germany at 31.9, i.e. more “socialist” (Source: Index Mundi, 2021).

One of the biggest challenges China currently faces is the ageing demographics and decreasing birth rates. China is tackling this in leading automation and efficiency, as well as higher workforce education, to manage the impending wave of retirees, who fortunately do have a good amount of household savings for spending in retirement.

High living costs and related pressures are being seen as related to this demographic challenge, and therefore allowing one to rationalise the crackdowns on property speculation, high private education costs, anti-competitive practices resulting in a higher cost to consumers, and gaming concerns in a bid to focus on long-term economic stability.

Against this backdrop, our longer-term outlook on China is optimistic and we think that Chinese economic stabilisation will likely benefit many regional assets too.

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Other opportunities and threats

Q: ***Do you see any other opportunities and/or threats in 2022?***

COVID-19 has continued to drive market reactions even as we close off 2021, but the hope is that this will diminish over time as we learn more about the virus and its variants and how effective vaccines are against all variants.

Artificial Intelligence and technology, including the vision of the meta-verse and the rise of NFTs all point to development in the technology space. Recent cyber vulnerability discovered in relation to Log4j, a utility that runs in the background of many software applications that expose an organisation’s computer network to attackers has also highlighted the need for a longer-term need for better cyber security, highlighting opportunities in this space.

To be able to ride out potential volatility and drawdowns, investors should also diversify widely, and be mindful of the impact of growing inflation on holding cash.

Wrapping 2021

2021 has been an eventful year, with the emergence of inflation globally, and regulatory developments in China being among the main concerns for investors.

For 2022, we may see somewhat tougher action by central banks in terms of tapering and rate increases, which should warrant a degree of caution generally, particularly with regards to using leverage. However, in our view, inflationary pressures could well be more persistent than thought nonetheless, given high budget deficits and debt levels in major economies, coupled with a peaking population and focus on quality over quantity of development in China turning the country into an exporter of inflation (as opposed to an exporter of deflation as was previously the case). Investing in assets that can provide medium to long-term inflationary protection can help to preserve purchasing power in a negative real interest rate environment.

For China, in light of the weak performance in 2021, it is not very popular with investors now, however, we suggest not to exclude it when screening the globe for opportunities, against the backdrop of relatively low valuations coupled with policymakers' most recent focus on stability and economic support vs. the focus on reduction of moral hazard in 2021, as long as exposure is held as part of a diversified portfolio.

Last but not least, in the ESG and technology space, due diligence, critical evaluation of individual company practices beyond score systems, as well as careful consideration of the attractiveness for investors when taking the price factor into the equation, should not fall by the wayside. Investors should be careful around any sectors receiving the greatest share of interest, and not overlook other areas that might attract less interest yet still play an important positive role while offering potentially more attractive risk-return profiles.

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