GLOBAL LONG-TERM UNCONSTRAINED

MARTIN CURRIE

MAY 2022

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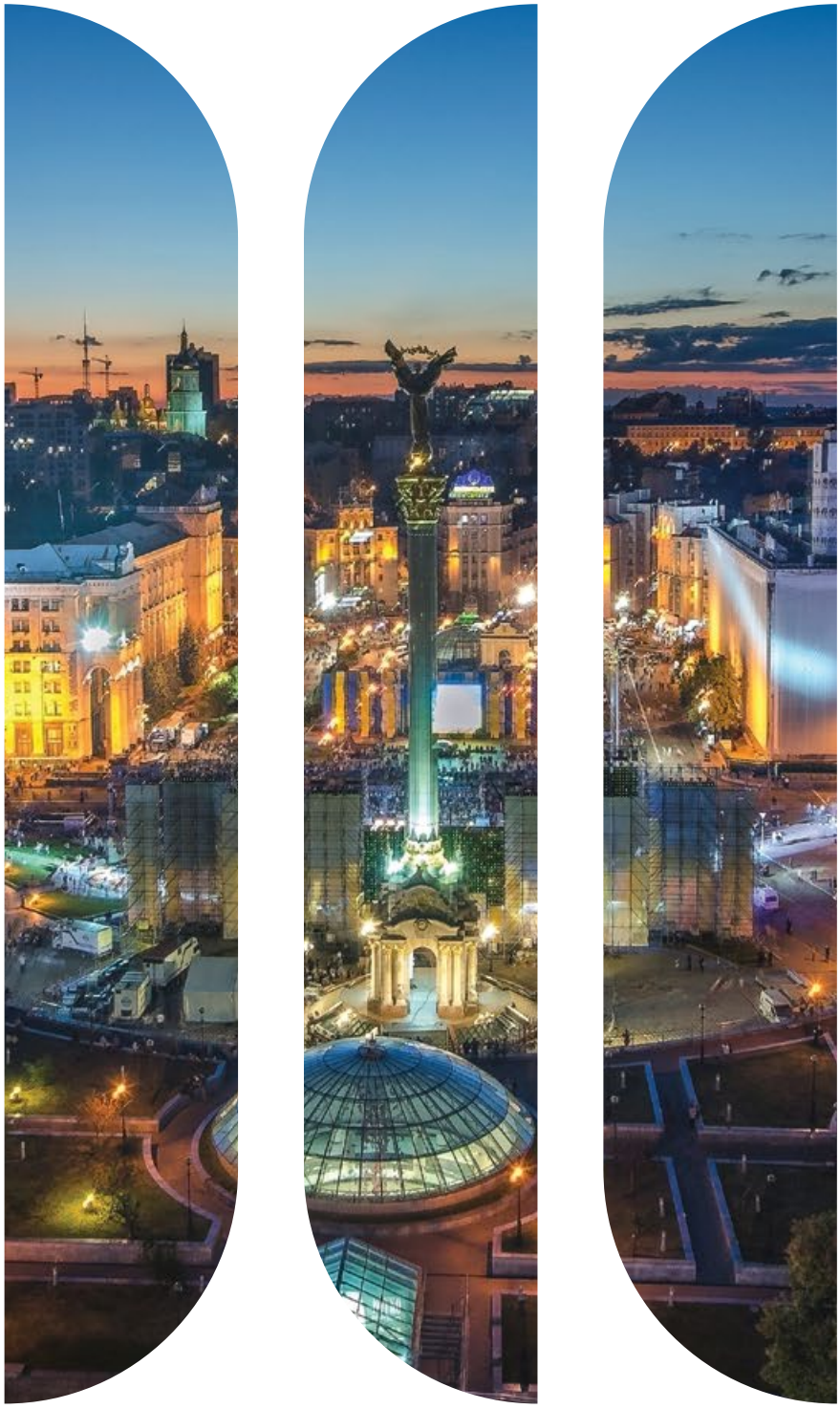

2022 INVESTMENT OUTLOOK UPDATE

Increased geopolitical tension and further lockdowns in China are increasing the risk of an economic slowdown. However, in a world transitioning towards sustainability, exciting opportunities remain for long-term investors.

Zehrid Osmani

Head of Global Long Term Unconstrained Equities and Senior Portfolio Manager

Investors focused on geopolitics with Russia and China seen as key uncertainties

The Russian invasion of Ukraine is leading to a tragic crisis for the Ukrainian people and is resulting in:

- increased geopolitical risks across the world,
- higher risk aversion amongst investors, and
- a potentially negative impact on macroeconomic momentum.

The outcome of Ukraine-Russia conflict is highly uncertain, with the potential risk of the conflict both escalating and widening, which could further push the market into risk aversion. There is the likelihood of a growing focus on China's territorial claims in the South China Sea, with the second half of the year bringing the focus on President Xi Jinping's likely third term as leader, and potentially beyond. This could unleash a more pronounced territorial ambition around Taiwan, in turn leading to a flare up in tensions, and adding further geopolitical risk that the market is not currently factoring in.

Cyber security attacks could also lead to an increased focus on the digital Cold War which is at risk of escalating. All in all, as mentioned in our 2022 outlook, geopolitical risks are now coming out in the open, which is in our view something that investors should increasingly focus on for the remainder of the year.

The macro-economic outlook is deteriorating due to the double-supply shock triggered by the Ukraine conflict and China's zero tolerance Covid policy

Despite the supportive fiscal policy initiatives, notably the infrastructure programs that have been announced around the globe but not deployed yet, the macro-economic outlook we are facing in 2022 is increasingly uncertain. This is as a result of the Ukraine-Russia conflict. The conflict is increasing the risk of deteriorating business and consumer confidence, which could lead to weaker economic momentum.

In addition, China's zero tolerance policy on Covid outbreaks is leading to the lockdown of significant regions and sizeable cities. This is likely to further disrupt economic activity, bring in more supply chain bottlenecks and production disruptions, which again will have additional negative consequences on global economic momentum. The tragic Ukraine conflict is also leading to a sharp flare up in energy, soft and hard commodity prices, all of which are likely to contribute to further boosting already elevated inflationary pressures. This will in turn force central banks to remain on their path towards monetary policy normalisation, despite the risk of weaker economic momentum. The Ukraine conflict's impact on resources, and the supply chain disruptions from the Chinese lockdowns is bringing in a double-supply shock that will likely lead to deteriorating economic momentum, and in our view, a shift of the economic cycle from expansion into slowdown.

Inflationary pressures likely stronger and to persist for longer, exacerbated by Ukraine-Russia conflict – stagflation risk still low but rising

Inflationary pressures have been stronger and longer lasting, as a result of supply chain bottlenecks, disruptions in production lines, and logistic issues. This is in conjunction with the sharp rise in energy and commodities prices resulting from the Ukraine-Russia conflict. Similarly, China's zero tolerance Covid policy could bring additional bottlenecks across supply chains. Wage inflation remains the important measure to watch, given that this has the potential for a more long lasting impact on inflation expectations, and there is now a rising risk of higher wage inflation that could push inflation up further. Stagflation risk remains a low probability event, although as a result of the Ukraine-Russia conflict we are increasing that probability to 10-15% from less than 5% at the start of the year. This risk is higher in the European region, and we expand on this overleaf.

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Europe's focus on reducing dependence on Russia energy supply could lead to higher risk of stagflation

The Ukraine-Russia conflict has brought to the forefront the important strategic consideration of energy supply in Europe, and the dependence on Russian energy supplies, notably gas, for many EU countries. There is now an ambitious plan to considerably reduce this dependency, with the aim of diversifying energy supplies away from Russia. This will lead to some important alternative energy infrastructure programs notably in Liquid Natural Gas (LNG) infrastructure, but it could also bring some temporary disruptions in energy supplies. This is the result of Russia deliberately reducing its supplies, and/or Europe deciding to pro-actively reduce its demand despite not having a fully secured alternative supply.

We could see energy rationing in parts of the EU, which could have the risk of impacting economic activity in Germany notably, but also Italy, Poland and the other EU countries – the EU gets c.38% of its gas supplies from Russia[1]. Should this happen, there would clearly be a higher probability of stagflation in the EU region, brought about by energy supply-shock. This is an important geopolitical aspect to monitor, given the direct impact it would have on the macro-economic momentum in the region.

Supply chain and logistical bottlenecks to persist in the first half of 2022 and potentially beyond, due to China's zero tolerance Covid policy, further fuelling frictional inflation, and pressure on margins

Supply chain and logistical bottlenecks have been a headwind for economic momentum in 2021. We expect these bottlenecks to persist into the first half of 2022, and to be at risk of being further exacerbated by the Omicron variant and China's zero tolerance response to outbreaks. This is likely to continue to both push companies to increase their investments in robotics and automation, and diversify their production bases in the medium term.

Nearer term, these bottlenecks are also fuelling the frictional inflationary pressures that we have already seen in 2021. As previously mentioned, these inflationary pressures are likely to be further exacerbated by the sharp rise in energy and commodity prices resulting from the Ukraine-Russia conflict. This could lead to stronger and longer lasting inflation, forcing central banks to continue tightening, despite the weakening economic momentum.

[1]Source: Statista and Eurostat, eurostat.ec.europe.eu , February 2022. Gas imports for EU27 countries in 2020.

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Monetary policies normalising, with central banks raising rates despite the likely economic slowdown

The stronger and longer-lasting inflationary pressures, even if frictional rather than structural, are likely to force central banks to maintain their interest rate hiking cycle. Raw material and energy prices flaring up as a result of the Ukraine-Russia conflict are pushing central banks to maintain their path towards normalisation of monetary policies. Rates hikes will likely need to be more pronounced and more rapid, given the risk of accelerating inflation, however there is an increased risk of over tightening rather than simply normalising in our view. Interest rate increases in the US, UK and Europe, typically lead to increased volatility in equities, as markets speculate about speed and magnitude of the tightening cycle. The market will continue to have a sanguine bull/bear debate between those who think that central banks will need to tighten more aggressively, and those who think that the tightening is premature, based on the belief that growth remains fragile.

Movement in yield curves, and shape of the yield curve, will be an important focal point that will drive market volatility, and intra-market volatility in terms of style leadership between Growth and Value. Investors will need to be mindful that flattening yield curves, whilst historically a good predictor of an upcoming recession, might have lower predictive power in the current cycle when rates have been close to zero, and when central bank actions and investors searching for yield have been weighing on the long end of the curve. Nonetheless, rising rates due to stronger inflationary pressures at a time of weakening economic momentum, could have a negative impact on equity markets, whilst investors digest such scenario.

China is likely to pursue more supportive monetary policies given the deteriorating economic momentum and the recent weak leading indicators. This will lead to a monetary policy divergence versus the Western economies, which has the potential to create a more attractive geographic backdrop for investors, notwithstanding the geopolitical risks related to China.

Economic cycle is likely to be moving into slowdown, favouring Quality and Growth companies

2021 was a year of recovery, which led to an extremely supportive economic and corporate earnings environment. In 2022, the Ukraine-Russia conflict is likely to lead to weakening economic momentum, notably in Europe, through weaker business and consumer confidence, and higher raw materials and energy prices.

We believe that we are now highly likely to be moving from the recovery to the slowdown phase of the economic cycle, and we ascribe a 60-65% probability of such outcome. This phase typically favours Quality and Growth styles, with an important emphasis on supportive earnings momentum, in an environment of earnings downgrades. We believe that this should favour companies with consistent earnings growth profiles and exposed to long term structural growth drivers, rather than deep cyclical profiles, which have done well during the recovery phase.

Downward earnings revisions: a low growth year could turn into a no growth year

The recovery in 2021 came in much stronger than expected, fuelling a highly supportive positive earnings momentum and upgrade cycle. 2021 global earnings growth expectations moved from +21% at the start of 2021, to now c.+48%. The year 2022, however, is facing many headwinds, not least the more demanding base effect of 2021, but also the inflationary pressures weighing on corporates' cost bases. The current consensus Earnings Growth estimates are shown in the table below:

Earnings per share calendar year on year growth

	2022 year on year Earnings Growth
MSCI AC World	6%
MSCI AC World ex USA	5%
MSCI North America	9%
MSCI Europe	4%
MSCI Europe ex UK	3%
MSCI United Kingdom	11%
MSCI AC Asia ex Japan	7%
MSCI Japan	15%

Source: FactSet as at 31 March 2022.

We believe that the deteriorating macroeconomic outlook is likely to lead to downwards revisions in earning growth expectations, and are likely to be entering a period of earnings disappointments in the next few quarters. This is the result of a combination of lower growth and higher margin pressures. We have revised down our top-down forecasts for 2022E to +4% at the MSCI AC World Index level from +7% previously, and are now two percentage points below consensus. For both Europe and Europe ex UK we now project 0% growth in corporate earnings for 2022E. A year of low growth in corporate earnings in 2022 is increasingly more likely to turn into a year of no-growth.

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In an environment of lower corporate growth and higher downgrade risks, focus on companies with supportive earnings and consistent growth profiles

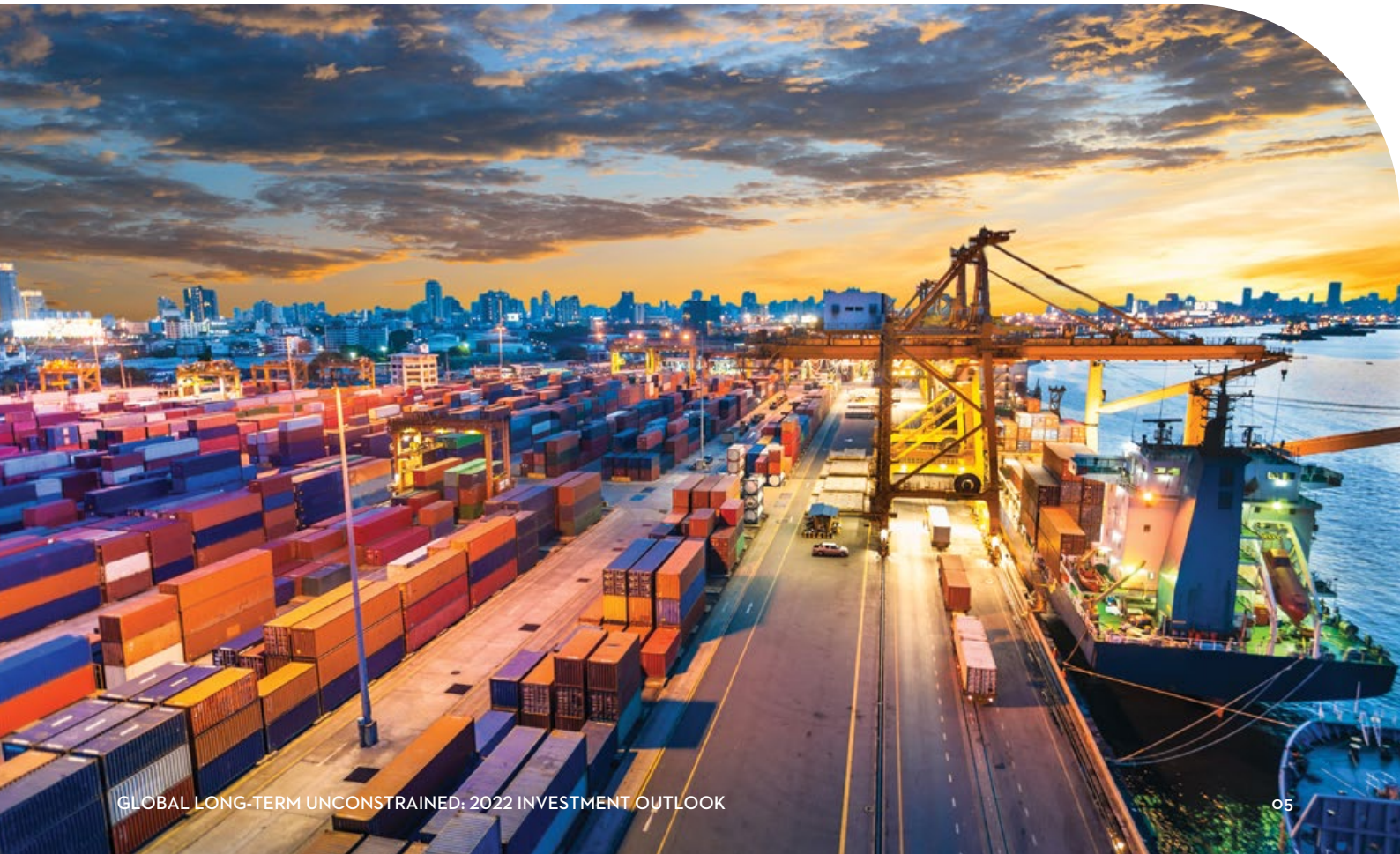
Given the lower earnings growth expected in 2022 (and for that matter 2023[2]), the rising risk of downgrades to capture the Ukraine-Russia conflict and higher input costs, we believe that companies with steady, consistent and superior earnings growth profiles will constitute an area of attraction for investors. Additional downside risks to earnings could come from rising corporate tax rates. This remains a likely scenario in our view, given the need to part fund the highly expansionary fiscal policies in place since the Covid crisis began. Our estimates for the companies that we cover and are invested in, already anticipate a three percentage point increase in corporate tax rates worldwide. Stronger and longer lasting inflationary pressures could also put further downside risk on corporate margins. This pressure on corporate margins could be exacerbated by the Omicron variant disrupting supply chains and logistics, and exacerbating bottlenecks in the economy, as is currently happening in China.

Pricing power remains critical in 2022 as margin downside pressures increase

As discussed, stronger and longer lasting inflationary pressures are likely to further accelerate, and with a year of low growth expected in 2022, corporates will not have the same operational leverage from which they benefited in 2021. As such, there is likely to be growing margin pressures coming from rising input costs and higher wages. This will be acute in certain sectors, particularly those employing low skilled labour where wage inflation pressures are highest. Sectors that are more sensitive to energy and raw material costs will also be at risk from the rising prices. We continue to predict that 2022 will see more differentiation between corporates with genuine pricing power that will be able to protect their margins, and corporates that lack pricing power who will see some margin pressure . In this environment, stock picking focusing on strong franchises with strong pricing power will be an important focal point.

[2]Source: FactSet as at 31 March 2022. 2023 earnings growth expectations are +8% for the MSCI AC World.

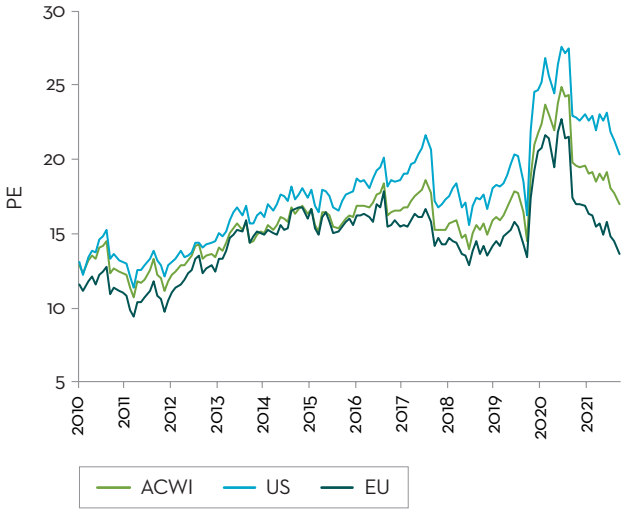
"Pressure on corporate margins could be exacerbated by the Omicron variant disrupting supply chains and logistics, and exacerbating bottlenecks in the economy, as is currently happening in China."



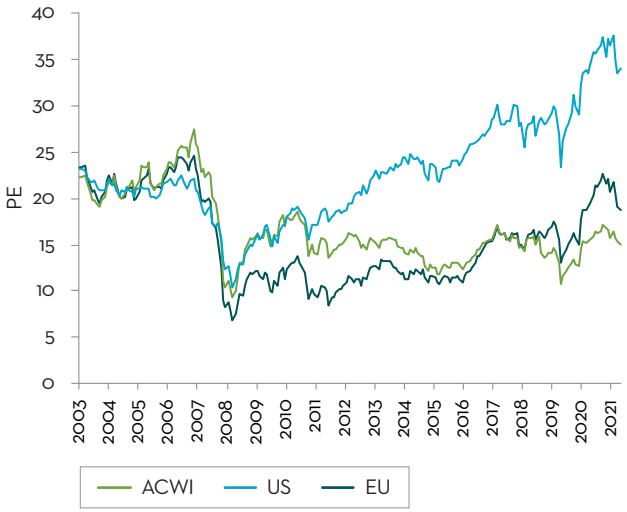
Valuations are more supportive after the pullback, and still attractive versus bond yields but stock picking and a valuation discipline remain paramount

With the pullback in markets since the start of the year, valuations are more supportive, although we need to factor in different economic growth prospects into our assessments, as explained above. Based on cyclically adjusted Price Earnings (P/E) ratios, Asian equities appear to have the most support, followed by EU equities, whilst US equity valuations are more demanding. Equity valuations are generally still attractive in terms of earnings yields versus bond yields, despite the latter rising. The uncertain geopolitical climate is likely to weigh on equities for the time being - prolonged tensions or escalating conflict will have the potential to put more downside risk to equities, whilst a successful resolution to the conflict could trigger a sizeable recovery given the sell-off year-to-date. In our view, there is a compelling risk/reward to markets for long term investors now, given the pullback since the start of the year. Importantly, a focus on stock picking and valuation discipline, given the downside risk to earnings, will be critical for investors. In terms of style leadership, the Growth versus Value valuation spread remains elevated, which could lead to more style volatility, notably as monetary policies transition towards normalisation. Earnings growth consistency and positive momentum, in a lower and reducing earnings growth environment, will however be an important driver of leadership in our view.

Forward PE (FY1) of given markets



Shiller PE



Source: FactSet as at 31 March 2022.

> In our view, there is a compelling risk/reward to markets for long term investors now, given the pullback since the start of the year. Importantly, a focus on stock picking and valuation discipline, given the downside risk to earnings, will be critical for investors.

Volatility in markets has increased and is likely to remain elevated while geopolitical risks remain present

Investors should expect higher volatility during a phase of transitioning monetary policies from accommodative towards normalisation leading to movement in yield curves. The level of volatility also depends on whether the market views central banks actions as either too severe (over-tightening) or still being too loose given the higher inflationary pressures. Geopolitical risks are bringing a high degree of unpredictability, and pushing investor risk aversion higher. Fiscal policies are becoming less supportive, and there is ongoing execution risk on some of the infrastructure programs announced globally, which could also add to volatility. Supply chain bottlenecks and logistical disruptions could further fuel frictional inflationary pressures, which have the potential to bring additional volatility. The Omicron variant and China's zero tolerance policy potential disruption to economic momentum could also bring more volatility across markets. Periods of elevated risk aversion, as is the case at the moment, coupled with a sharp market pullback as we have seen year-to-date, have tended to be good entry levels in equity markets for investors with a longer-term time horizon, providing that we do not head into a stagflation or recession phase of the economic cycle.

Thematics opportunities remain plentiful in a world transitioning towards sustainability

For us, as long-term investors, we believe that we are facing an exciting period of higher investment opportunities and strong innovation rates, in a world transitioning towards a more sustainable approach to operating. This therefore brings opportunities in the following areas:

- Green & Alternative Energy
- Cloud Computing & Cyber Security
- Electric transportation – High Speed Railways & Electric Vehicles
- Robotics & Automation
- 5G Telephony
- Metaverse & Online Gaming
- Healthcare Infrastructure
- Quantum Computing

Some of these areas, those related to infrastructure, are supported by the sizeable infrastructure spending initiatives that have been unveiled since the pandemic crisis, some of which are still to be deployed in any meaningful way. As ever, a structured and disciplined valuation approach to assessing these thematic areas of structural growth is key to finding attractive opportunities.

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An ever more disruptive decade continues to affirm itself

With the ongoing focus on investing for a world transitioning towards net-zero, innovation rates are likely to continue to increase, and with it, disruption risk to traditional businesses is likely to continue to rise. For long -term investors, this opens up good areas of opportunities, but it also highlights the need to be vigilant in terms of disruption risk, and to ensure this is assessed in a detailed and structured analytical way. Equally important is the ability for companies to remain innovative, to both fend off competitive pressures, and to stay ahead of the disruptive trends that could challenge their market positioning.

Macro and Market Risks in 2022

Policy mistakes around initiatives – fiscal stimuli and infrastructure initiatives are critical to supporting the economic recovery. There is therefore execution risk to these initiatives which could disappoint the market.

Monetary policies hiccup – we believe the risk on the monetary policy front is not one of acting too late, but one of acting too aggressively, and being reactive to the higher inflationary pressures that we are going through at the moment. If rates expectations were to increase too rapidly, we could be seeing a rapidly flattening yield curve, which could unsettle markets.

Tax rates increasing – we continue to predict a period of rising tax rates, as a way to part fund the expansionary fiscal policies that have been pursued to recover from the pandemic crisis. Whilst the market should be able to digest such developments, it will put downward pressure on earnings estimates.

Lower long term growth outlook – periods of increased indebtedness have tended to be followed by periods of lower growth, which therefore does not bode well for the long-term growth outlook in our view, beyond this current cycle.

Style rotations could remain omnipresent – whilst we expect less violent swings in styles, as monetary policies move firmly into normalising mode, there will still be periods of rotations that could unnerve some investors.

Localised pandemic relapse risk – localised pandemic flare ups, and therefore temporary lockdowns could continue to disrupt both short-term economic momentum, and supply chains, which could unnerve some investors willing to find signs of an economic cycle reaching exhaustion. Omicron or any other Covid variant could risk bringing a higher pandemic relapse risk, should any new variant prove to be of significant concern to healthcare authorities, which would trigger more stringent lockdown measures globally.

Stronger and more prolonged inflationary pressures – we believe that inflationary pressures should ease into the summer of 2022, but stronger inflation prints, and a more prolonged duration of higher inflation could bring the need for more rapid interest rate increases, which would unnerve investors and could put downside pressure on market levels.

Margin pressure from higher inflation – the higher inflation period could lead to a secondary effect, putting further pressure on margins in 2022, which will be more apparent than we have seen in 2021, given the lack of operational leverage in what is a lower earnings growth backdrop in 2022.

Geopolitical tensions broadening – geopolitical risks that we flagged above, could broaden, should there be a widening in the Ukraine-Russia conflict. China's ambitions in the South China Sea could be another friction area, with any rise in tensions in that area which could lead markets to come under significant pressure in our view.

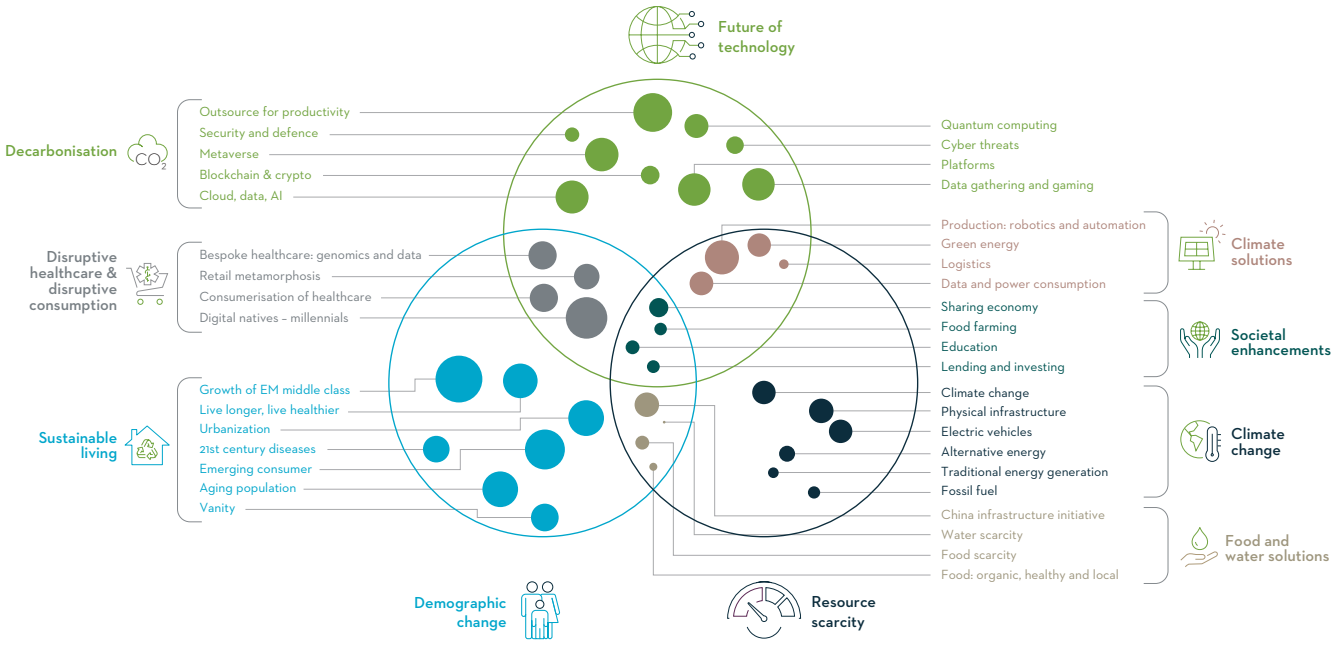
Energy supply shock in Europe impacting economic activity – the EU's ambitious plan to reduce its energy-dependence on Russia could lead to energy supply disruptions during the transitioning phase of such plan. This is turn could lead to energy rationing and therefore an energy-supply shock induced impact on economic activity in the EU region. This would in turn further increase the probability of stagflation.

Overall, with the flare up in geopolitical risks and uncertainty, risk aversion in markets has increased. The risk of weakening economic environment is bringing a higher risk of downgrades to earnings estimates, which can weigh on parts of the market that could be more vulnerable to such downgrades. The market pullback does however offer some attractive entry level for longer-term investors, although we expect that volatility could remain elevated given the tightening monetary policies due to higher inflationary pressures. Valuations are most supportive in European and Asian equity markets, but a selective approach based on stock picking is going to be critical in the context of growing geopolitical and economic uncertainties.

The lower earnings growth expectations in 2022, risk of downgrades and of margin pressure from the higher frictional inflationary pressures, do emphasise the need to focus on companies with superior pricing power and therefore lower downside risk to margins. This is in conjunction with more consistent growth profiles harnessing long term structural growth dynamics. The increased focus on sustainability is likely to speed up innovation rates in sectors focusing on solutions, and therefore potentially bringing some attractive opportunities, but also risks to companies not able to evolve rapidly enough.

Our research continues to focus on finding undervalued companies operating in industries with high barriers to entry, and that have dominant market positions, strong pricing power and low disruption risk. They will have high structural growth prospects, generating high returns or with the potential to do so over time, with solid balance sheets and compounding cash flows. Finally, they will also need to have a strong corporate culture, quality management and sustainable business models to be well positioned in a transitioning world.

Our three mega-trends, **(i) Demographic Changes**, **(ii) Future of Technology**, and **(iii) Resource Scarcity**, provide us with opportunities to capture long term structural growth themes, which are aligned to a world transitioning towards a more sustainable future. Demographic Changes is about Sustainable Living, Future of Technology is about Decarbonisation, and Resource Scarcity is about Climate Change. Within these mega-trends, there are thematic opportunities with supportive structural growth prospects, such as the eight mid-term opportunities that we have listed above.



Source: Martin Currie as at 31 March 2022. Representative Martin Currie Global Long-Term Unconstrained account shown.

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