



HEALTHIER, LONGER,
BETTER LIVES

Thriving in times of Transition

—2022 Global Market Outlook



EXECUTIVE SUMMARY

“

From an asset allocation perspective, we continue to favor risk assets over risk-free bonds and cash

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Shrikant Bhat

Head of Funds, AIA Investment Management



2021 HAS BEEN A YEAR OF RECOVERY FOR MOST ECONOMIES AFTER THE FIRST GLOBAL COVID OUTBREAK.



In our view, peak recovery has probably been reached in Q3 while economic and business activity data in developed markets continue to show a moderate deceleration from the unsustainably high levels in Q2. **Imbalanced recovery is another feature we observed throughout 2021** – strong demand for goods and weak demand for services, especially in countries with high fiscal transfers to the private sector. Looking ahead into 2022, the pace of growth, although still above its long-term trend, will largely depend on the rebalancing between goods and services consumption, in addition to the ongoing supply chain disruptions, labor shortages, heightened tensions on energy markets as well as weak domestic demand in China, which will increasingly drag growth momentum down throughout 2022. Geopolitical risks could also be an important driver to asset performance in the year.

While progressive recovery has given some major central banks enough confidence to start pulling back their supportive policy, the rising inflation expectation, primarily from the imbalance in consumption of goods and services, has prompted the central banks and markets to price in more aggressive policy normalization than initially expected. We expect the overall policy normalization to continue course even though inflation remains transitory, i.e. not self-sustained, in our view. The divergence of policy stance between central banks – the hawkish Federal Reserve (Fed), compared to the more neutral European Central Bank (ECB) and Bank of Japan (BoJ), and the modestly easing People's Bank of China (PBoC) – will be key to differentiate relative performance and drive higher volatility across markets and asset classes.

CHINA STANDS OUT AMONG THE MAJOR ECONOMIES.



After being the first major economy to recover from covid recession in 2020, the window of growth had provided the government to embark on a series of regulatory and structural reforms this year with impacts across various sectors. The lackluster services consumption has been another drag to China's growth given the zero-covid approach in response to any local outbreak. We expect this to continue to at least early half of 2022. With policy signals turning to marginal easing, **we expect the overall downcycle to bottom out in first half of 2022.** Hard economic landing remains a tail-risk in our view although structural reforms are likely to stay on course, especially on the property developer's leverage.

FROM AN ASSET ALLOCATION PERSPECTIVE, WE STILL FAVOR RISK ASSETS OVER RISK-FREE BONDS AND CASH.



Slowing but still above trend growth will continue to support risk assets going forward, but the **outperformance of equities relative to bonds is expected to narrow compared to 2021.** Ample liquidity injected into the system and historically low (albeit rising) interest rates are two other factors that support risk sentiment in general. Within equities, we prefer Developed Markets (DM) over Emerging Markets (EM) – the strengthening dollar for one should put some pressure on EM flows, China's slowdown and the uncertainty surrounding reopening of ASEAN economies are other factors weighing on EM performance. However, since DM equities are at expensive valuation and earnings growth is expected to slow down going forward, the margin of outperformance of DM equities over EM equities is expected to shrink from the level registered in 2021.

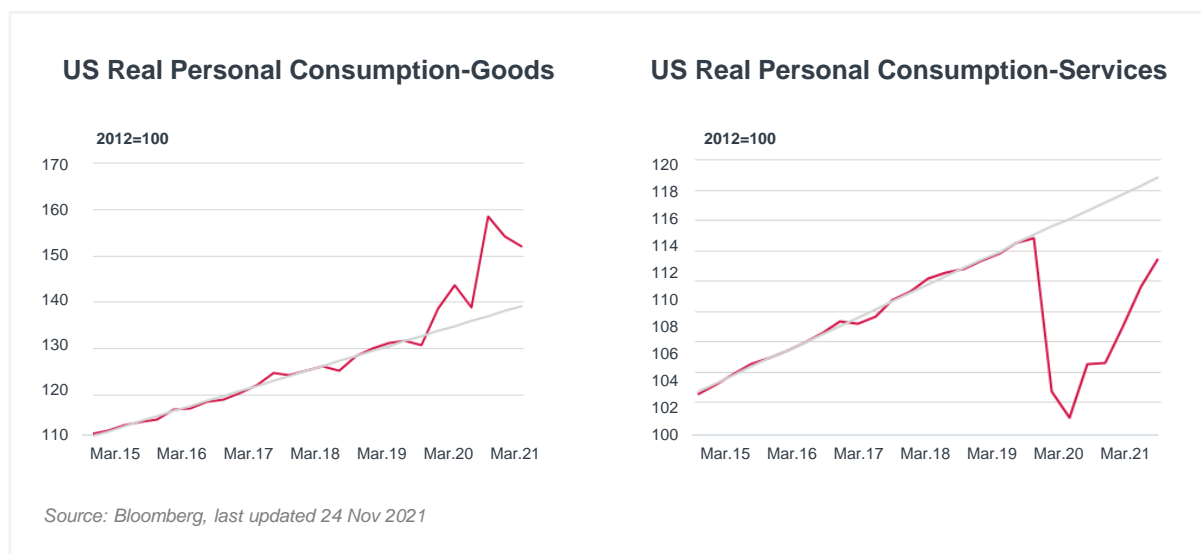
Top risk on our radar is the policy mistake from overly aggressive normalization of central banks. The recurring covid waves from new variants could delay the rebalancing of goods and services consumption, weighing on growth momentum and driving higher inflation. Lastly, geopolitics between US-China on various fronts, US-Europe-Russia on Ukraine, could also derail market performance and warrants attention.

RECOVERY AND GROWTH – REBALANCING THE IMBALANCES

2021 HAS BEEN THE YEAR OF GLOBAL RECOVERY AFTER THE GLOBAL COVID OUTBREAK. PEAK RECOVERY HAS PROBABLY BEEN REACHED IN Q3.

Economic and business activity data in DM showed a moderate deceleration from unsustainably high levels in Q2. Although ongoing supply chain disruptions, labor shortages, heightened tensions on energy markets as well as disappointing domestic demand in China are increasingly dragging growth momentum down, **global Gross Domestic Product (GDP) growth will likely still stay above potential throughout 2022.** Indeed, towards the later part of 2021, progressive recovery has given some major central banks enough confidence to start pulling back some of their supportive policy.

The economic recovery thus far has been an imbalanced one where we saw strong demand for goods and weak demand for services, especially in countries with high fiscal transfers to the private sector. The pace of recovery into 2022 will largely depend on the rebalancing between goods and services consumption. **Two possible scenarios may play out in 2022.**



1. DEMAND FOR GOODS AND SERVICES CONTINUES TO BALANCE OUT

Pent up demand for goods gradually reducing and the reopening of borders allow for higher demand for services as tourism and traveling

gain pace with Covid-related restrictions easing. Global supply chain disruption will improve as logistics and infrastructure bottlenecks ease, alongside a gradual reduction in demand for goods and improved logistics services, leading to inflation moving closer towards central bank target and a less aggressive pace of normalization from central banks. Risk sentiment will likely be supported in this environment.

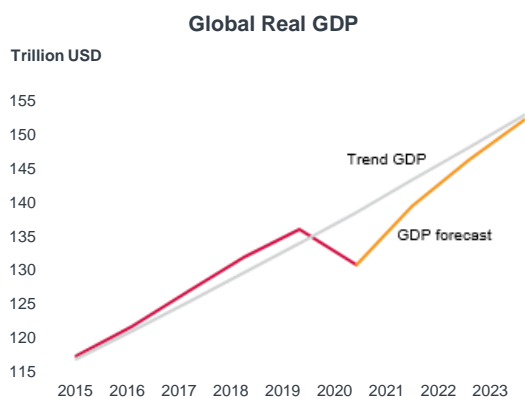
2. SHOULD THE DEMAND FOR GOODS AND SERVICES CONTINUE TO STAY IMBALANCED

This could lead to stickier inflation that remains above central bank targets. Although it is argued that monetary policy is not entirely effective to manage supply side driven inflation, central banks would still have incentive to step up their pace of normalization (faster and more aggressive interest rate hikes) to anchor inflation expectations amid the adjustments of supply side imbalances. Overall, risk sentiment would be dampened and volatility would increase accordingly in this case.

| Economic Recovery | Labor marker | Inflation | Monetary policy | US yield curve | Equities |
|------------------------------------|-------------------------------|---|--|-------------------------|--|
| Goods/services rebalancing | Reduced labor shortage | Converges quickly to central bank target | Slower pace of normalization | Gradual bear flattening | Stronger equity outperformance over bonds |
| Goods/Services limited rebalancing | Longer lasting Labor shortage | Remains above target for an extended period | Relatively rapid pace of normalization | Rapid bear flattening | Sector rotation main driver of performance; expect more volatility |

Global GDP Recovered Quickly in 2021

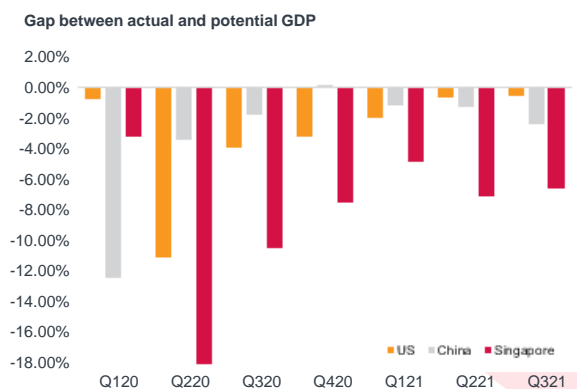
The global economy returned to end-2019 levels of production in 2021 and is still catching up with pre-Covid trends



Source: Macrobond, AIA

Output Gaps as of Q3 2021

Recovery has been uneven across countries Singapore lagged while China lost some of its advance



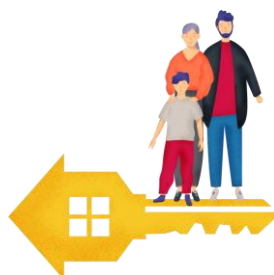
INFLATION – PARTLY TRANSITORY, PARTLY STRUCTURAL

HIGH RATES OF INFLATION HAVE BECOME FREQUENT HEADLINES IN THE SECOND HALF OF 2021.

However, we observe that many countries in Asia still have below average inflation. We also note that, where high inflation exists, factors driving inflation are transitory in nature (base effects, massive and unsustainable demand shock on goods) and will converge towards central bank targets by the end of 2022, amid goods/services rebalancing and as productivity gains continue to offset cost increases.

INFLATION SURGED IN SPECIFIC PARTS OF THE WORLD IN 2021, ESSENTIALLY IN THE US, EUROPE, AND A FEW EMERGING COUNTRIES OUTSIDE OF ASIA.

US headline inflation has been trending upwards from sub-2% levels at the beginning of 2021, to most recent prints of above 6%. Similarly, US core-Consumer Price Index (CPI) inflation climbed from 1.4% in Jan to hitting 4.9% in November. In



the near term, lingering upward pressures (eg. used cars, owner equivalent rents) are still pushing US core-CPI higher while import prices, more reflective of global inflation pressures, have started to edge up moderately. In Europe, from 1% in January, German CPI inflation has reached levels above 5% yoy in November, its highest reading since 1993. However, there are also exceptions. China for one has seen CPI inflation mostly below 2.0% yoy since the beginning of 2021, despite strong growth in PPI inflation, suggesting a lack of pricing power among Chinese retailers and manufacturers.

THE INFLATION NARRATIVE IS WELL TELEGRAPHED. DUE TO THE MASSIVE FISCAL STIMULUS PACKAGES OF 2020 AND 2021, ALONG WITH REDUCED CONSUMPTION OF SERVICES DUE TO SOCIAL

DISTANCING MEASURES, DEMAND FOR GOODS HAS INCREASED SUBSTANTIALLY MORE QUICKLY THAN EXPECTED AT THE BEGINNING OF THE PANDEMIC.

While production capacities could meet this demand shock, logistics, especially maritime containerized freight, couldn't adjust quickly and the delays in delivery time have resulted in disruptions in the supply-chain.

RIISING COMMODITY PRICES ALSO POINT TO PERSISTENT INFLATION.

Strong industrial activity involves higher levels of energy consumption as the energy intensity of heavy industries is much higher than in services. As demand for energy increased quickly, supply adjusted more slowly, due to inventory reduction and time mismatch between the expansion of renewable energy production capacities and the decommissioning of coal-fired power plants.

LABOR SHORTAGES HAVE BEEN DRIVING WAGES HIGHER SINCE THE ONSET OF THE COVID CRISIS.

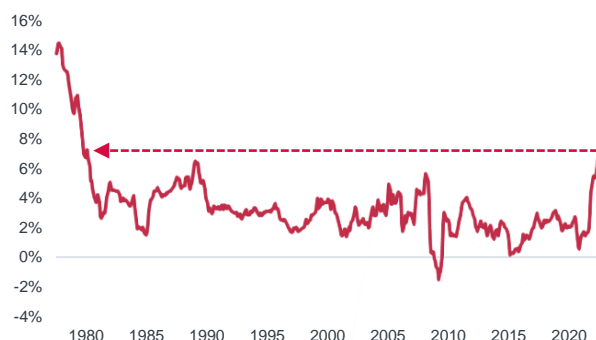
While wage growth is a key factor contributing to self-sustained inflation, labor cost increases are offset to a large degree by labor productivity gains in our view. Labor shortages in the US is partly transitional as Covid keeps some workers at home, but is also partly structural as the positive wealth effect from stock markets prompts some people to retire early. Indeed, in the latest US CPI report, although there were some signs of pass-through from strong wage growth for low-paid workers, it is still not conclusive whether wages will spiral upwards for the broader economy.

THE COUNTERARGUMENTS TO THE INFLATION NARRATIVE ARE ESSENTIALLY CENTERED AROUND BASE EFFECTS AND STRONG PRODUCTIVITY GAINS.

In terms of base effects, the maximum impact of Covid on prices was in 2020Q2 and, starting in Q3, with the reopening of the economy, inflation picked up again. In other words, high levels of inflation are going to decline in the first half of 2022, and the downtrend is expected to continue in 2023.

US Headline Inflation Hit 38-Year Highs

Post Covid economic recovery saw an unusual surge in inflation, especially in countries where consumption is strong and fiscal transfers to the private sector are elevated

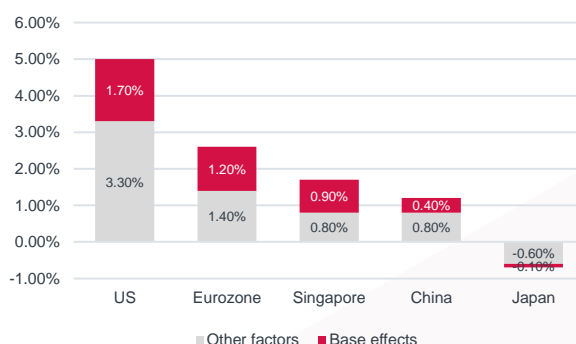


Source: Macrobond, AIA

Base Effects Are Key

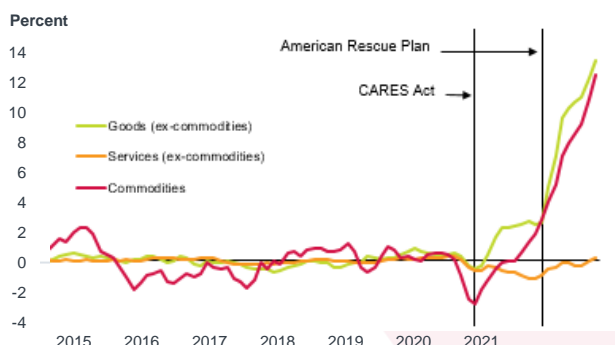
Between one third and half of current inflation is related to base effects (low levels in 2020, upward correction in 2021 inevitable and transitory)

Core inflation in Nov 2021



High Inflation Driven by Goods and Commodities

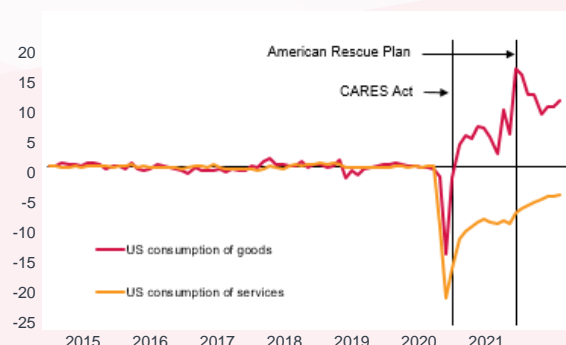
Price of manufactured goods and commodities are much higher than their pre-Covid trajectory; services prices are still in line



Note: both charts show the gap, in percent, between actual level and long-term trend
Source: Macrobond, AIA

Imbalanced Recovery Between Goods and Services

US consumption has predominantly been tilting towards goods as social distancing dampens demand for services



MONETARY POLICY – NORMALIZATION CONTINUES

AS THE GLOBAL ECONOMY CONTINUES TO RECOVER WITH PEAK RECOVERY MOST LIKELY BEHIND US, SEVERAL CENTRAL BANKS HAVE ALREADY ANNOUNCED THE BEGINNING OF POLICY NORMALIZATION.

In our view, the overall policy normalization trend will continue course, barring some notable exceptions (eg. Japan's BoJ, China's PBoC), but the recent inflation fear triggered by high headline readings, has added an extra layer of risks as to how markets are pricing in the normalization impacts.

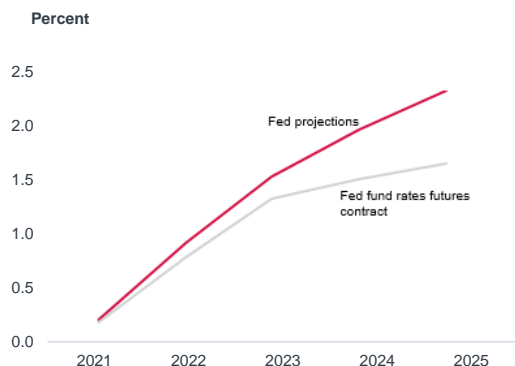


STICKIER THAN EXPECTED INFLATION IS NOW BECOMING A MATTER OF CONCERN TO A GROWING NUMBER OF CENTRAL BANKS, WHO HAVE EITHER STARTED TO TIGHTEN THEIR MONETARY POLICY OR ARE CONSIDERING DOING SO. IT IS OFTEN ARGUED THAT MONETARY POLICY IS INEFFECTIVE AGAINST SUPPLY-SIDE DRIVEN INFLATION, SO CENTRAL BANKS SHOULD NOT ADJUST THEIR POLICY.

Central banks' objective is to anchor inflation expectations and, in that sense, given the generally high level of expected inflation in consumer surveys (especially in the US), **the Fed has turned significantly hawkish by accelerating the tapering of its Quantitative Easing (QE) program and opening the room for hiking rates sooner than initially expected.** The Fed has started tapering its QE program in November 2021 and is expected to taper off to zero by the end of March 2022. Meanwhile, the latest December dot-plot showed 3 hikes for 2022, and investors are expecting the first hike to come as early as April 2022. Similarly, the Bank of England (BoE) has surprised the market by hiking its Bank Rate to 0.25% in December meeting, despite the ongoing uncertainty from the Omicron outbreak in the country. Apart from the two central banks mentioned, Bank of Korea, the Antipodean Reserve Bank of Australia (RBA) and Reserve Bank of New Zealand (RBNZ) and selective EM central banks have also embarked on a hiking cycle.

Fed vs Market Policy Rate Expectations

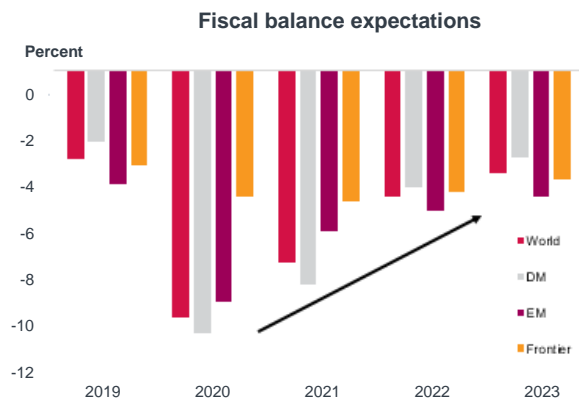
Investors are still doubting the Fed can raise rates to 2.5% by the end of the current economic cycle



Source: Macrobond, IMF, AIA

Fiscal Balance Expectations

Both monetary and fiscal policies are expected to become more restrictive in the foreseeable future



IN CONTRAST, THE ECB AND THE BANK OF JAPAN ARE TWO MAJOR CENTRAL BANKS STILL IN DOVISH STANCE, AND UNLIKELY TO CHANGE COURSE MEANINGFULLY IN THE NEAR TERM.

Additionally, China's PBoC is on the other side of the spectrum as it has begun an easing cycle of rate cuts to counter the economic slowdown. **The divergence between central banks' policy stance will become a major factor driving relative performance across markets and asset classes in 2022.**

CHINA – POLICIES SHIFT TO STABILIZATION

China saw a series of regulatory and structural reforms in 2021. Their impacts have been felt in various sectors including internet, e-commerce, education, online gaming and the property sector.



CONSTRAINTS ON THE PROPERTY SECTOR, NOTABLY UNDER THE “THREE RED-LINES” POLICY, HAVE TRIGGERED A SERIES OF CREDIT DEFAULTS AMONG PROPERTY DEVELOPERS.

Looking ahead, although we continue to expect more small, low credit quality developers to run into liquidity issues, higher-rated developers should remain relatively healthy and presenting a low risk of default. Therefore, the spillover risks to the broader property sector and consequently the financial sector should remain minimal in our view, given the healthy non-performing loans reserves and core tier-1 capital in the banking system will be more than enough to absorb the isolated shocks. That said, tight regulations on developers’ leverage will likely stay in 2022, and the structural reform for “Houses are built to be inhabited, not for speculation” will continue its course. We expect a property downcycle in the next 12-18 months given both developer and home buyer activities remain subdued.

ANOTHER MAJOR DRAG TO THE ECONOMY THIS YEAR HAS BEEN THE SERVICES SECTOR.

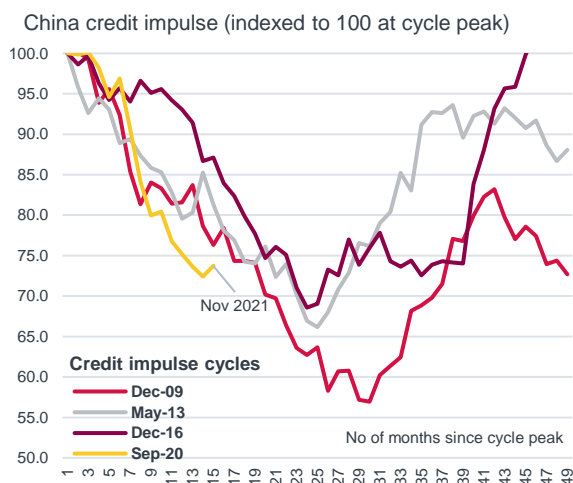
As China continues to adopt a zero-covid approach, social distancing measures and travel restrictions have resulted in lackluster services consumption. After the covid wave from the Delta variant with over a thousand cases reported in more than twenty provinces, the Omicron variant has triggered another wave of infections centered in Xi’an city as we go to print. Although we are confident that the government will bring the outbreak under control within weeks, the recurring waves of covid are likely to support the continuation of zero-covid strategy. **As a result, high-touch services, such as restaurants, tourism-related sectors, are very likely to stay subdued at least in early half of 2022.** As Covid evolves from pandemic to endemic, our view is that the benefits from transiting to a higher tolerance approach will eventually outweigh the costs. But given the population size of China and the upcoming winter Olympic in February, there remains a high hurdle for the government to change the approach for the time being. The pace of booster shots, with the development of homemade mRNA vaccines, will be key for investors to monitor in gauging the turning point of covid approach in China.

AS REGULATORY RECALIBRATION, POOR SERVICE CONSUMPTION, TOGETHER WITH PROPERTY SECTOR DOWNTURN AND ITS RELATED INVESTMENT AND CONSTRUCTION ACTIVITY CONTINUE TO DRAG ON THE MACRO ECONOMY, EXTERNAL TRADE HAS BEEN THE ONLY ECONOMIC BRIGHT SPOT THANKS TO THE STRONG GOODS DEMAND GLOBALLY.

However, high base effects and the rebalancing of goods and services consumption going forward, will likely dampen the contribution to growth. Combined, it has prompted some concerns on the risk of economic hard landing in China. This remains as a tail risk event in 2022 in our view. **Overall, we continue to expect that China's economic slowdown remains transitory and cyclical, with the trough of the downcycle likely in first half of 2022.**

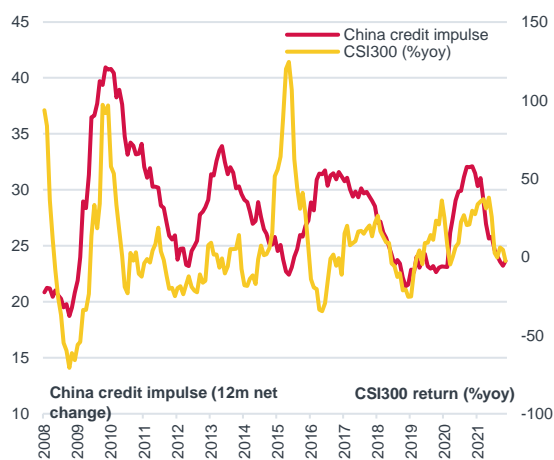
Indeed, the latest policy signals from the PBoC via rates cuts and the policy statement from the Central Economic Work Conference are turning less negative and are gradually tilting towards the easing side, with a focus on preventing a severe economic downturn.

Credit impulse cycles rebased from peak – likely another 10-12 months before bottoming out in the current cycle



Source: Bloomberg, AIA

Credit impulse cycles (lhs) and CSI300 return (rhs)



ASEAN – REOPENING BEFORE NORMALIZATION



2021 was a tough year for ASEAN economies as recovery paused.

The peak impact of covid to the region has been through the Delta variant during the summer, causing a re-imposition of stringent movement restrictions and business closure amid the relatively low vaccination rates during this period. To mitigate the shock to the economy, fiscal transfers, subsidies and loose monetary policies have been extended in several ASEAN countries. Looking ahead in 2022, although we are not in a position to forecast the evolution of the pandemic, the accelerated vaccination pace, along with the introduction of booster shots, look set to underpin a broader reopening of the economy, domestically and internationally. However, we do note there are certain headwinds that could slow down the ongoing recovery, especially in the second half of the year.

EXTERNALLY, BARRING A WORSENING EVOLUTION OF COVID, THE FED'S POLICY NORMALIZATION IS PERHAPS THE BIGGEST HEADWIND TO THE REGION IN 2022.

The Fed's faster tightening pace could disrupt and destabilize capital flows in a fashion similar to the 'taper tantrum' in 2013 when capital flows retreated as investors sought for higher yields elsewhere. To be sure, ASEAN economic fundamentals are stronger than before, while central banks also have larger reserves positions – implying the impact this time round could be less significant. It is a risk to watch out for nevertheless, especially since the Fed is pivoting to be more hawkish than markets have previously anticipated. Secondly, China's property-led economic slowdown will likely continue to weigh on regional demand at least for some time. But more importantly, China's zero-covid strategy is almost certain to last for longer, reducing the odds of any tourism revival which is particularly important to South Eastern countries such as Thailand.

Within the region, the reversal of fiscal stimulus (both on- and off-budget), which aimed to cushion the impact of covid, will become a drag to offset some of the recovery-led growth on the margin – many ASEAN governments have already announced lower overall budget for

2022, including Malaysia, Thailand, Indonesia and the Philippines. Similarly, monetary policy in the region, which is currently accommodative compared to other regions, looks set to change direction towards the later half of 2022. The reason is the upward trending core inflation – fueled by the combination of, closing output gaps as economies continue to reopen, reversal of covid subsidies, indirect tax hikes, and higher administered prices (e.g. transportation fares). Ahead of its ASEAN peers, Singapore's central bank (Monetary Authority of Singapore - MAS) has already started the tightening cycle amid mounting inflationary pressures and ongoing above trend growth – by raising the SGD nominal effective exchange rate (S\$NEER) "slightly" in its policy meeting in October. We expect the MAS to continue to tolerate gradual appreciation of the SGD in 2022, and that policy normalization will begin with the remainders of the ASEAN central banks, likely in second half of the year – among which, Malaysia's Bank Negara Malaysia (BNM) and Indonesia's Bank Indonesia (BI) are likely to be on the hawkish side by starting earlier, while Philippines' Bangko Sentral ng Pilipinas (BSP) and Thailand's Bank of Thailand (BoT) would be lagging slightly behind.

LOCAL ELECTIONS COULD ALSO RISK THE RECOVERY IN THE REGION BY INTRODUCING EXTRA POLICY UNCERTAINTY, ESPECIALLY DURING THIS COVID PANDEMIC, AND HEIGHTENED GEOPOLITICS BETWEEN CHINA AND THE REST OF ASIA AND THE US.



Notably, the Philippines will hold its General Election on 9th May 2022 as President Duterte is stepping down. The latest tentative list of candidates includes fifteen prospective candidates running for President, and nine running for Vice President. In Malaysia, after the appointment of PM Ismail Sabri Yaakob in August 2021, the country may also hold a general election in 2022 – although the next election will be held no later than July 2023, the earliest possible date is August 2022 according to the memorandum of understanding between the government and the opposition party.



ASSET CLASS IMPLICATIONS AND PREFERENCES



Asset allocation decision remains one of the largest drivers when determining the range of portfolio outcomes.

Being in the market and invested in equities have proven to be the optimal strategy since the dramatic market correction during the onset of Covid in March 2020. As we transition into 2022, we continue to hold the view that risk assets such as global and Asian equities would continue to shine against government and corporate bonds as well as low interest-bearing cash investments.



Although GDP growth in 2022 will likely slowdown compared to the impressive rebound we have witness thus far, developed and certain emerging economies should continue to deliver growth well above potential at least in the first half of 2022.

This economic backdrop should bolster risk assets going forward, although the **degree of outperformance we have experienced in 2021 is likely to narrow moving into 2022**. The amount of liquidity injected into the system in the form of household savings, strong corporate issuances and record-breaking Federal Reserve balance sheet should remain in place to support real economic growth and financial assets. While a structurally low, albeit rising, interest rate environment should also support elevated valuations -- although that is increasingly becoming a risk as mega-cap growth names such as the FAANGs (Facebook, Apple, Amazon, Netflix, and Google) occupy almost a quarter of the market-cap weight in the S&P 500 index.



US equities outperformed most other asset classes in 2021. And while we believe that should likely continue due to strong corporate results and record-breaking profit margins, the peaking of these indicators usually means a narrowing of relative performance against Asian equity counterparts such as Chinese offshore equities.

ROE (or return on equity) in the US is plateauing at around 18% and as long as it remains above c.16% which was the highs of prior cycles, we continue to express our overweights in risk assets by tilting more in favour of US and DM equities. Amid the risks in the system (as discussed in the next section), **we believe the economic and fundamental backdrop justifies the strategy of "buy-on-dips"** as long as markets have access to sufficient liquidity and continue to show strong corporate results.

Equity Risk Premium (ERP) and Business Cycle

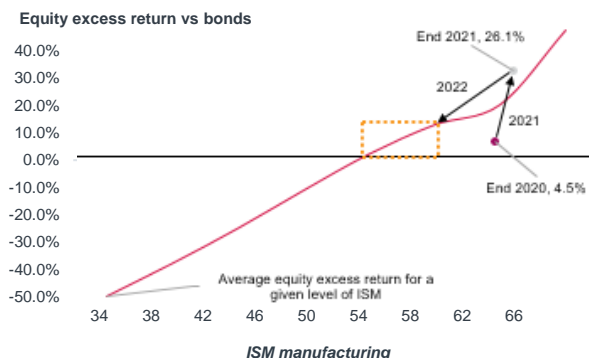
The relative performance of equities against bonds is explained by the ups and downs of the real economy. Bonds outperform only at times of recession



Source: Bloomberg, AIA

Expected ERP in 2022

Global growth is expected to slow down in 2022 but remain positive. However, after 3year of double-digit positive equity returns, 2022 will likely see positive single-digit only



Compared to DM equities, we maintain an underweight call to emerging market (EM) and Asian equities. Accelerated tightening from the Fed, China's regulatory recalibration and economic slowdown, and the potential stronger dollar driving outflows from EM markets are the key factors for our less bullish view on EM equities.



In addition, further delayed reopening and start-stop economies within EM due to new variants, and the possibility of limited or delayed easing by Chinese authorities in the next few quarters should also weigh on EM equities performance. However, following the c.37% peak-to-trough correction of Chinese offshore equities since February 2021, Chinese equities are starting to become more appealing as the upside potential for a rebound is quite significant -- although the timing of the turning point will depend on credit growth in China, monetary policy and regulatory decisions moving forward. In ASEAN, the reopening story in the first half of the year is a strong catalyst to support fundamentals, and hence, an overweight of local equities over respective local bonds in many of the markets. That said, the region looks set to face two notable headwinds in the year ahead, namely the Fed's more aggressive policy and China's economic slowdown. Consequently, **the risk-reward of ASEAN equities as a whole, warrants an underweight compared to DM equities.**

Credit investments, such as investment grade corporates, remain well bid and supported by strong credit fundamentals.



With strong free cash flow generated by firms coupled with low corporate downgrades and defaults, credit spreads should continue to remain tight. However, in a rising rates environment, the price performance of some of these bonds might suffer as we do not expect material tightening of credit spread from the current level. Overall, we still prefer Asian credit over US credit given the credit spread premium from Asian counterparts, especially against the backdrop of diverging monetary policy by key central banks in the West versus in the East.



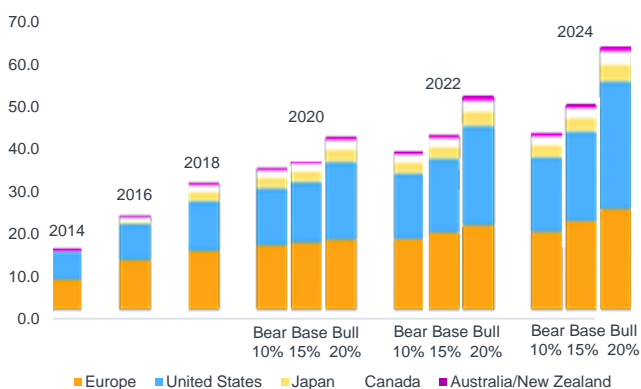
Lastly, investing in Environmental, Social, and Governance (ESG) themes across assets will continue if not accelerate as the awareness and capital flows from global investors will stay uptrend.

We are a long-term investor and we see the merits of investing in the future of society sustainably, hence we have a responsibility to use our scale and influence in the investment community, to help respond to climate change and promote sustainable investing. **AIA have successfully divested our entire directly managed equity and fixed income exposure to coal mining and coal-fired power businesses, seven years ahead of schedule.** Moreover, AIA as a company, have also committed to achieving net-zero greenhouse gas emissions by 2050, this means that our targets will be therefore aligned with the United Nations' Paris Climate Change Agreement.

ESG Investing has become a core investment trend

Global ESG assets are on track to exceed USD53 trillion by 2025, representing more than a third of the USD140.5 trillion in projected total assets under management.

ESG projected global AUM

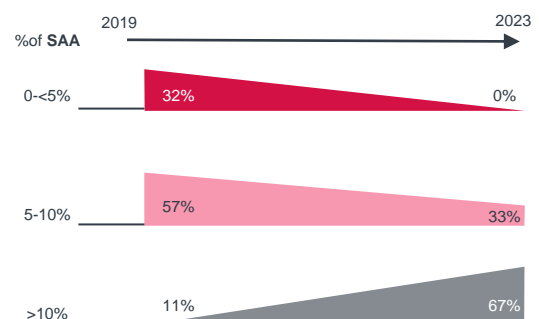


Source: GSIA, Bloomberg Intelligence

Increasing allocation to private assets

Compressed risk premium on public assets and the pursuit of diversification pushes investors to increase allocation to private assets

Historical evolution of strategic asset allocation (SAA) to private market assets



Source: Blackrock Global Insurance Survey

RISKS WE WATCH OUT FOR

Our top risk to watch out for in 2022 is the potential policy mistakes by overly aggressive normalization, which could derail the economic recovery, as well as sending interest rates much higher to tighten financial conditions and rocking markets.



The reason is that stickier-than-expected inflation is becoming a matter of concern to a growing number of central banks despite uncertainty, as evidenced by the Fed's hawkish pivot and the surprise rate hike from the BoE.

As of printing, the market is expecting the first interest rate hike by the Fed either at the March or May Federal Open Market Committee (FOMC) meeting in 2022. Moreover, the divergence of central banks policy stance – notably between the hawkish Fed, Bank of England, Bank of Canada and selective EM central banks, the relatively neutral ECB and Bank of Japan, and the dovish People's Bank of China – will lead to more relative performance difference of risk assets, and inevitably more volatile markets.

Secondly, the recurring waves of Covid new variants is certainly another risk we monitor closely. As the coronavirus continues to mutate, forecasting its evolution is more guesswork than rigorous analysis.

Many studies are underway looking at vaccine effectiveness against Omicron, and the World Health Organization indicates that even without a complete picture, we do know

it is preferable to be vaccinated than not. Irrespective of future Covid trends, we believe that the global economy has adapted and has learned to operate more efficiently under different social distancing scenarios. In light of this, we build our investment strategies, based on the macroeconomic scenarios and the respective market implications, instead of speculating based on anecdotal news and evidence. This also allows us to continuously navigate the markets under this prolonged pandemic period. **Our base case for 2022 remains that the impact on markets from new variant alone, will be short-lived, as investors have already experienced different waves of covid and know how to position against the risks.** In addition, governments around the world are also getting more effective in containing outbreaks, and accelerating vaccination programs.

Consequently, new variants and the associated stop-and-go mobility restrictions will further delay, but not derail, the recovery of services consumption, resulting in stickier high inflation and in turn contributing to the higher risk of policy mistakes from the central banks.

Yet we continue to expect a rebalancing between goods and services in 2022 thanks to the easing of supply-chain disruptions and energy prices. The current balance of risk is tilting to a slower rebalancing process than expected.

Escalating geopolitical tensions, between US and China on various fronts, and between Europe/US and Russia on Ukraine, could also derail market performance in 2022.

Although military conflicts remain a tail risk in our view, the risks of more diplomatic clashes, such as Winter Olympics boycott, and economic sanctions are increasing going forward, driving volatility and weighing on risk sentiment. Notably, with the finalization of the Holding Foreign Companies Accountable Act (HFCAA) from the US Securities and Exchange Commission (SEC), markets will look out for SEC enforcement activity focused on disclosures from Chinese companies listed in the US, which could trigger higher volatility among offshore Chinese equities.

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