Mirova Sustainable Equities Team

2021 Investment Team Year-End Review & Outlook[1]

December 2021

2021 was generally a very positive year for global equity investors, albeit with high levels of volatility. Low interest rates and central bank support through bond buy-back programs provided an almost endless level of money supply for the economy and markets. This has pushed up valuations in equity markets, especially in high growth sectors and the U.S. market in general. Inflation and concerns that this favorable low interest rate environment may soon come to an end have led to a sector and style rotation during 2021. Traditional energy companies and banks benefited the most, also helped by the higher oil prices and higher interest rates respectively. Renewable energy stocks underperformed significantly, having entered the year with relatively high valuations. Increased competition from oil and gas companies, combined with supply chain issues (raw material price inflation and transportation issues), further impacted margins negatively in the wind sector, and a less favorable proposed regulation in California had an adverse impact on solar companies. Growth stocks posted generally strong results, but we also saw that many of the large technology stocks are not immune to wage inflation and supply chain issues either.

In the real world, natural disasters caused human and economic tragedies. Wildfires in southern Europe and California, floods in Germany, Austria and Belgium, and Hurricane Ida are major examples of this year's climate change-related disasters, with a combined economic cost of well over $100 billion USD. Markets didn't blink, at least not until September when it became clear that Chinese property developer China Evergrande, a group with $260 billion USD in debt, was in financial trouble; fears of another Lehman scenario led to a quick correction in equity prices globally. Elsewhere in the market, oil and gas prices continued their upward trajectory as demand increased while supply did not follow the same path. This even caused some bankruptcies in the U.K. utility sector. A shortage of drivers in the transportation sector and a general lack of employees in many sectors created shortages and wage inflation. Despite all of this, earnings growth in developed markets was, on average, stronger than expected in 2021, pushing global equity markets to all-time high levels in November. However, the year ended as it started, with high volatility as some economies found themselves again in lockdown because of concerns around the Omicron variant of the COVID-19 virus.

Outlook

We believe 2022 looks like it will be another positive but volatile year. While the global economy is expected to continue its recovery, many uncertainties remain the same, with no real improvement in sight for probably another six months. COVID-19, inflation and supply chain issues, central bank action, and geopolitical issues (Russia/Ukraine and U.S./China) are expected to be main sources of bad news for equity markets.

The Omicron variant drives the number of COVID-19 cases past previous peaks in most countries, despite higher vaccination rates. The severeness of the variant is not yet fully known, but the fact that it is far more contagious than any previous variant is expected to put more pressure on health care systems, which may lead many countries to take restrictive actions. While many sectors are now adjusted to working from home, others need clients and employees to be on-premises to function properly, and will no doubt feel the financial consequences. Eventually, we will need to learn how to live with the presence of COVID-19, but even if and when things go back to some level of normality, many of the sectors which have been hit hardest may find it difficult to secure enough employees, and even if they do it will likely be at much higher wages. Shortages in the labor market mean that there will not only be a war for talent, but high competition for employees in general. Wage inflation will put pressure on margins, especially in areas where wages

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are traditionally relatively low, which means that the expected economic recovery may not translate into similar earnings growth. Inflation and supply chain issues (bottlenecks in production and transportation) are expected to ease somewhat during the second half of 2022 but will likely continue to have a negative impact on revenue and earnings growth during the first half of the year across most sectors.

Much of the strong equity market performance of the past few years has been driven by a combination of low interest rates and central banks injecting money into the economy. Higher valuation levels in all asset classes were the result, but we expect this support to be weaker in 2022. A slowing of the rate at which central banks buy back bonds (tapering), combined with higher inflation for longer should create upward pressure on interest rates. This in turn could push equity valuations lower, reversing the trend of the past few years. On a relative basis, this could benefit the traditional energy and financials sectors. Regionally, this could be short-term bad news for the U.S. market. The U.S. has significantly outperformed Europe and emerging markets during the past few years, and its valuation premium over those markets is at a very high level. Even considering that the U.S. economy is more flexible than the European markets and may show higher growth, one needs to be aware that many U.S. companies are active globally, and equally that many European companies are generating revenues from the U.S. as well.

We do expect that many of the issues which may impact 2022 will ease in the second half of the year. COVID-19 vaccination rates and the development of vaccines that are more effective against the new variants should allow economies to fully reopen. This in turn may ease the pressure on inflation and the supply chains more generally. With interest rates expected to stabilize or normalize at that stage, we expect that the focus will return to structural, less cyclical growth. The recent COP26 climate conference may have been disappointing in terms of hard short-term commitments, but it still provided a strong pathway for growth in renewable energy for decades to come. Many fossil-fuel companies are now entering the space and creating more competition, but the pie is more than big enough to share with additional players. Renewable energy companies have significantly underperformed in 2021, due to a combination of high valuations coming into the year, less favorable regulation in some key markets, and supply chain issues impacting margins in the wind sector. These issues are expected to persist somewhat during the first half of the year but should ease during the second half. The underperformance during 2021 and resulting lower valuation levels provide in our opinion an excellent opportunity to add to those positions. Health Care remains another high conviction sector. Political pressure on drug prices has eased during the COVID-19 pandemic, and a greater focus on R&D provides many growth opportunities, including for manufacturers of analytical and testing equipment. Many traditional pharma companies have not benefited from the higher general market valuation levels during the past few years, which could also offer some protections during a period of rising interest rates. We do expect the transition of our economy to a more digital model to continue and anticipate e-retail and digital payment solutions to continue to benefit. We also expect that supply chain issues in the car manufacturing sector will ease during the year, and that the transition of the car fleet towards more electric cars will continue to offer good opportunities for manufactures of energy-efficient car components. But generally, given the expected high volatility and continued high risks to a quick but sustained economic recovery, we remain prudent, and prefer companies with high quality characteristics such as relatively low levels of debt and high visibility on recurring revenue streams.

Disclosure

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