2022 Markets, PE and M&A Outlook

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1 Equity Markets Outlook

1.1 V-Shaped Recovery and Strong Rallies in 2021

In 2021, the economy was slowly returning to normalization but the stock market was not recovering: it had already done so in 2020 when the infections were surging and governments started issuing more lockdowns and draconian measures. Instead, 2021 was a year of record performance on top of a trailing economy.

Figure 1: Source: Bloomberg. After initial sell-off, equity markets shrugged off a worsening pandemic in 2020 and kept climbing during 2021

Different sectors were hit differently by the pandemic, with airlines and leisure companies taking the first hit. Throughout 2021, they underperformed significantly against other sectors. Service companies that were particularly restricted due to strict measures were next such as hotels and restaurants. As expected, companies that benefit from people staying at home for lengthy periods such as food delivery, online shopping and tech enjoyed a record year of performance, both on the stock market and actual earnings.

One sector which has finally proven to become dominant in the decade ahead is the EV sector. The valuations are baffling. Michael Burry tweeted that we are in the "Greatest Speculative Bubble of All Time in All Things. By two orders of magnitude", before he decided to delete all of his tweets (he seems to do this all the time). Charlie Munger believes the current market to be crazier than the dot-com rally of the late 90s. Tesla's enterprise value at its peak exceeded $1 trillion in October. Its valuation was greater than all of its EV contestors combined and weight in nearly all EV indeces exploded.

A key driver for this - as is often the case when the economy starts doing really badly - are dovish central banks. A look at the the Fed's balance sheet shows what has been pushing the equity markets.

Figure 2: Source: Bloomberg, The Fed's balance sheet during 2021 and consequently the excess liquidity drove the markets

The liquidity pumped into the markets needs to be invested. Most professional investors and portfolio managers, hungry for returns, had no choice but to invest in equities ("TINA", There Is No Alternative). A look at the performance of equities against bonds shows equities' outperformance over 2021.

Figure 3: Source: Bloomberg, With the exception of a "risk-off" sentiment after Omicron, equities have outperformed bonds in 2021

A zoom into the last month reveals a strong equity sell-off: both the Omicron variant and news that Jerome Powell wants to retire the word "transitory" were the culprits. Most notably, while neither the new variant nor the headline report on November non-farm payroll is particularly encouraging news to carry into 2022, at least we can do so with a reasonable assurance that inflation is definitely here to stay and not just a transitory blip.

Nearly all indicators on inflation, including the Dallas Federal Reserve Trimmed Mean index which removes outliers conclude that the Fed was definitely right to retire the debate about transitory inflation.

Figure 4: Source: Bloomberg, Inflation even after adjusting for "transitory" elements still looks like inflation

1.2 Monetary Policy Overview and Expectations

As anticipated, 2021 has been a challenging year when it comes to economic and financial stability as the repercussions of the Covid-19 pandemic perpetuated. To better understand and forecast what 2022 will hold, is, therefore, necessary to evaluate the most relevant events which occurred during the past year and identify their implications for the near future. In this economic environment, central banks played a significant role in supporting the economy by implementing or reviewing their strategies. Narrowing the focus to the activity of the European Central Bank and the Federal Reserve, they both adopted expansionary approaches to be able to deliver the medium-term symmetric two percent inflation target for the former, and the 2 percent long-term target for the latter.

European Central Bank

During 2020, the ECB has performed a monetary policy strategy review incorporating two innovations that justified a modification of the bank's forward guidance on interest rates; the first being the redefinition of the price stability objective and the second being the conditional commitment to consider the implications of the effective lower bound in a structurally low nominal interest rate environment.

The redefinition of the price stability objective to a symmetric 2% inflation target over the medium term is intended to provide a sufficient margin to safeguard the effectiveness of monetary policy while the introduction of a symmetric target is intended to signal that both positive and negative deviations of inflation from the target rate are equally undesirable. The conditional commitment to consider the implication of the effective lower bound in an environment characterized by low nominal interest rates mirrors the asymmetry of the effective lower bound constraint. With the interest rates on the marginal lending facility and the deposit facility being at 0.25% and -0.5% respectively, the ability to further lower such rates is limited. To address this concern, the ECB is committed to persistent monetary policy action to support the anchoring of long-term inflation expectations at two percent.

Through forward guidance, the Governing Council of the ECB suggested that key interest rates are going to remain at their present or lower levels until inflation will reach 2% under three conditions. The first being: "well

ahead of the end of the projection horizon"- reassuring that inflation should have progressed closer towards the new target before an interest rate increase - and "well ahead of the end of the projection horizon"- to hedge monetary policy against reaction to forecast errors. The second being: "durably for the rest of the projection horizon"- meaning that the target should not be just momentarily reached but rather persistently. And the third being: "progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilizing at two percent over the medium term.

In January 2021, the Governing Council decided to reconfirm its accommodative stance leaving the interest rate on the main refinancing operations and the marginal lending facility and the deposit facility at 0.00%, 0.25%, and -0.5% respectively. At that time, the ECB also decided to continue the purchases under the pandemic emergency purchase program (PEPP) for a total of €1,850 billion signalings that it would have continued to pursue such program at least until the end of March 2022. In addition, the Governing Council also communicated that the monthly net purchases under the asset purchase program (APP) would have continued its net monthly purchases at the pace of €20 billion. Finally, the ECB decided to provide additional liquidity through its targeted longer-term refinancing operations (TLTRO III). In September 2021, the ECB decided to maintain the accommodative stance on monetary policy but to lower the pace of the net asset purchases under the PEPP compared to the previous two quarters. Similarly, the Governing Council decided to slow the PEPP down further in October 2021 compared to the second and third quarters of the year.

Federal Reserve

Throughout 2021, the Federal Reserve maintained its commitment to using its full range of tools to pursue its maximum employment and price stability mandates. The pace of the recovery in economic activity and employment continued to be a concern during this year as a low demand and oil prices have been holding down consumer price inflation.

In January 2021, the FED continued adopting an accommodative monetary policy stance to pursue its long-term inflation target of 2%, aiming to reach inflation moderately higher than 2% in the short run. The Committee deiced to maintain the federal funds rate target between 0% and 0.25% and signaled its intent to maintain it at that level until labor market conditions of maximum employment. The interest rate on excess reserves balances was maintained at 0.10%. In addition, at that point, it was deemed appropriate to continue to increase its holdings of Treasury securities by at least $80 billion per month and the holding of agency mortgage-backed securities (MBS) at least $40 billion per month.

In June 2021, the FED decided to raise the interest rate on excess reserves balances to 0.15% to support trading in the federal funds market at rates well within the target range and to support the smooth functioning of short-term markets. In addition to this, the Committee opted to conduct overnight reverse purchase agreement operations at an offering rate of 0.05% raising this rate from the previous 0.00%.

In November 2021, the FED decided to begin reducing the monthly pace of net asset purchases by $10 billion for Treasuries and by $5 billion for MBSs. This decision was based on the elevated inflation which although considered transitory, when combined with supply and demand imbalances related to the pandemic and the reopening of the economy, needs to be addressed.

Overview and Expectations for 2022

Monetary policy expectations for 2022 are largely dependent on further developments of the Covid-19 pandemic and its effect on the economy which are not easily predictable. However, taking into consideration the current economic environment, the consensus seems to be that the ECB will wind down its PEPP in the first quarter of next year leaving interest rates unchanged in 2022. On the other hand, according to Reuters, the FED is expected to raise interest rates by 25 basis points late next year to 0.25%-0.50% to fight the recent significant surge in inflation, which reached a 30-year high in October. In 2022, the FED might have to address the increasing concerns about the potential stickiness of inflation. Its monthly asset purchases are likely to proceed at a slower pace and end earlier than the established June 2022 date. Similarly, the ECB forecasted the end of the PEPP in March 2022 which, however, is not likely to be followed by an interest rate hike in 2022.

1.3 Cryptocurrencies Overview and Expectations

This past year has been an eventful year for cryptocurrencies. From regulatory talks to institutional purchases, investors' interest in this asset class has skyrocketed. As crypto is still to be considered in its infancy, it is difficult to predict a trend for the foreseeable future. However, there are a few likely

trends to consider for 2022. The first deals with an increased discussion about regulatory action. Governments across the world are considering establishing laws and guidelines to make cryptocurrencies safer. From China already banning crypto transactions to the USA signaling no intention to do so, what seems to be a reasonable expectation is that cryptos have been and will be under strict scrutiny. Recently proposed legislation could make it easier for regulatory agencies to find cases of tax evasion and to report transactions. This is important for investors to consider because increasing regulation could have a significant impact on these assets valuations which are already very volatile.

One of the breakthroughs of 2021 has been the introduction of the first Bitcoin ETF on the New York Stock Exchange. Even though this fund does not directly hold Bitcoins, but rather Bitcoin futures contracts. This is important for investors to consider because even though these options are highly correlated with the price of Bitcoins, they might not track it directly. Besides, the more accessible crypto becomes among traditional investment products, the more likely it is that investors will find it attractive.

Additionally, it is worth highlighting how interest on the side of institutional investors has been rising during 2021. For instance, companies such as AMC, PayPal, and Square have been betting on crypto by allowing payments with and trading cryptos. While it is expected that during 2022 the interest for crypto will increase, it is also likely that paying for things using these currencies daily will not be the case at least for the next few years due to high transaction costs.

As Bitcoin is a good indicator of the larger crypto market, its trend is representative. After reaching an all-time high of 68000 dollars in November 2021, and currently sitting around 44,600 dollars valuation, this crypto has experienced increasing volatility, making large holdings of this asset as a share of the total portfolio quite risky. For this reason, investors should focus on the long-term growth potential and weight less momentarily swings. In addition, it is fundamental to remember that when it comes to assets such as crypto, which are not backed by any real assets and with no intrinsic value, investors should be ready to invest only sums they are prepared to potentially lose while also hedging the risk of such holdings.

2 Going forward in 2022, a Few Ideas

2.1 Value vs Growth, Omicron and asset allocation for 2022

Over the past five years, growth has crushed value in terms of performance. In this period, growth returned almost twice as much as a value. Of course, value and growth are always dependent on how we define them. The MSCI World Value Index uses the traditional book value to price ratio (B/P), 12-month forward earnings to price (E/P), and the dividend yield. MSCI World Growth Index focuses on a mix of EPS growth variables.

Figure 5: Source: Bloomberg

In 2021 however, the performance looked much better. In fact, YTD both have returned almost the same (although growth was still ahead). The narrative was that economic recovery (higher growth) and higher interest rates will be conducive to better value performance. There was a brief moment in 2021 1Q where the strong efficacy data of vaccines lead to an inflow into a value with a short period of outperformance.

Figure 6: Source: Bloomberg, By 2021 3Q, Belief in vaccine-led recovery slowly faded and growth ended up outperforming value by a thin margin since "Vaccine Monday".

As a general criterion, higher rates benefit value overgrowth, as the latter generates more cash flow in the future and are more sensitive to the discount rate. Another argument is that value tends to be more cyclical. By definition, value is stocks that look cheap, and cheap they do become when the economy runs into a recession. If this is true, then 2022 looks like a great year to rotate into value.

Given what we discussed, higher interest rates are very likely to come. The market prices two hikes in 2022, which combined with the increased pace of tapering should be enough to fulfill the first interest rate criteria for investors to rotate into value.

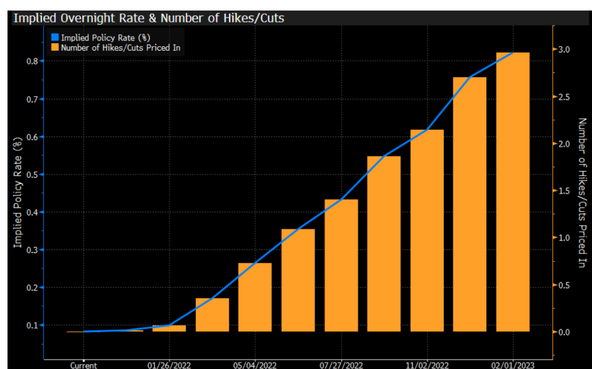

Figure 7: Source: Bloomberg, The market prices two hikes in 2022, one in June and one in November

The second criteria depend on how the Omicron variant proceeds. The November report on unemployment was arguably one the most "confusing" reports to read through. November non-farm payroll grew the slowest in 2021 (a huge miss of 210K against 550K consensus), but the unemployment rate fell to 4.2%, beating the consensus of 4.5%. Added to this is the Omicron variant, where we still do not have enough data to determine its impact. Any hard evidence on vaccine resistance of the new variant may be a deal-breaker.

Consensus forecasts for growth are down, with the biggest headline being Goldman's cut to 3.8% from 4.2%. Overall, the second criteria are highly ambiguous, but slowly skewing to the lower end with a belief that a large part of the recovery has already been completed and fears that the highly mutated new variant may be resistant to vaccines.

Discounting Omicron, the value looks like the place to be for 2022. An intriguing research report published by Rob Arnott of Research Affiliates claims that both on absolute and relative levels value indeed looks cheap. Another focus is quality stocks. They are typically defined as companies that are robust and able to thrive in both a market upturn and downturn. For 2022, we are looking at characteristics such as the ability to pass on costs to customers, strong and consistent margins, sufficient liquidity and adequate leverage, strong CapEx throughout 2021 including the build-up of inventories to keep up with fast-growing demand amongst consumers, and ability to hire personnel (if any) without excessive wages.

In particular, if 2021 was the year for strong consumer demand for durable goods, 2022 looks like a year for services. Again, discounting Omicron, we believe a strong shift to services is imminent as the pandemic wanes and the economy normalizes. The historical and current trend is that services continue to dominate a larger portion of our economy in the developed world, and we believe the current situation will mean revert, with services picking up once we exit the pandemic.

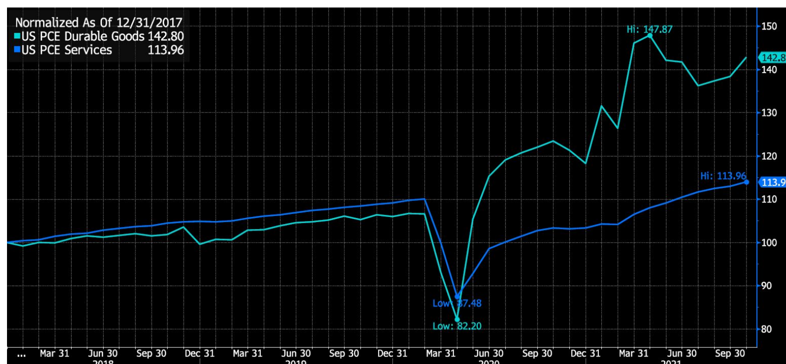

Figure 8: Source: Bloomberg, Services have lagged behind as lockdowns prevailed throughout 2021

Another big trend in the labor market we believe is likely to continue are wage growths. In particular, lower-skilled labor for the first time reported a higher nominal growth than high-skilled labor since the start of the Atlanta Fed Wage Growth survey.

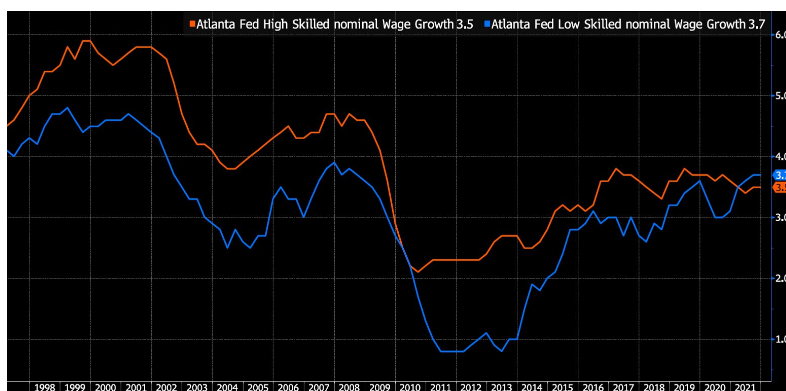

Figure 9: Source: Bloomberg, Atlanta Fed's Wage Growth tracker shows that for the first time since the start of the survey, low skilled reported a higher nominal growth than high skilled

Wage growth adds additional fears to an inflation spiral. One movement coined "the Great Resignation" referred to unusually high quit rates during 2021. Most of this happened in lower skilled jobs and are overweight in leisure and hospitality or manufacturing and not - as many have thought - in white collar jobs like finance and tech. While discussions about mental-well being and burnouts, most notoriously a leaked PowerPoint by junior analysts at Goldman were flaring up throughout 2021, the employment numbers look strong (November unemployment was at 4.5%) and a mass exodues (which the wording "great resignation" evokes) looks unlikely to us. This also explains the rising wage growths for unskilled labor, with employers struggling to fill open positions.

This may be a caveat to our previous recommendation to overweight services over goods. After all, the former is all more reliant on labor and often exatly those which have been difficult to convince to work during 2021.

Another idea is to play with the yields. Yield curves remain flat. Given inflation and unemployment, the current environment should expect the curve to be much steeper. CPI inflation released on Friday 10 December was 6.8% YoY as anticipapted (the consensus was around 6.8%). This is the highest it has been since the Reagan administration. Treasury yields still remained flat, most likely because the market expects the tightening to lead to lower growth or policy errors from the Fed, but also because it did not overshoot the 7% mark which was more worrying. This was again exacerbated by a report that the Omicron variant may be 4.2x more infectious, but less deadly. Mohammed El-Erian makes the point that the biggest issue is that the Fed is not fast and aggressive enough now and will be forced to hike rates much more aggresively later, throwing the US economy into a recession.

With this in mind, a possible idea bet on a steepening curve for those who have faith in the US economy. The particular catalyst will be the meeting on December 14-15 at the FOMC (or will have been). At the time of writing this article, Gold prices have already started to surge on the belief that the Fed may follow El-Erian's warning.

Low rates and even negative real yields also meant companies were eager to lock in the articifially cheap funding early. Not many companies benefit from higher interest rates since borrowing is more expensive and the required return on equtiy increases with the exception of financial companies. Financial companies make money buy lending at higher rates than borrowing (apart from M&A and investment banking fees, which were at their record highs during 2021). In a higher rates environment, we are also optimistic in this sector.

3 Buyout Trends

After a challenging second quarter, deal count, and money invested soared in the second half of the year. Overall, deal volume was 1,473, down 5% from the previous year but still higher than the six-year (2015-2020) trailing average of 1,459. Meanwhile, the value climbed by 14% year on year to € 179.7 billion.

As mobility limitations went into place and the reality of the pandemic sunk in, the activity took a hit in Q2. The second quarter saw the lowest volume and value of deals since 2015. As the world's economy began to loosen up in the second half, buyout activity resurfaced with vigor:

The greatest quarter for buyout value since 2015 was Q1, while Q4 had the most deals of any quarter in the previous five years. This increase is since funds still have plenty of dry powder to invest in. Due to the pent-up demand for transactions resulting from the delay in the second quarter, there was a rush in the second half of 2020 before more lockdowns were implemented.

Cinven and Advent International acquired the elevator sector of German industrial group ThyssenKrupp for € 17.2 billion in the year's biggest deal, helping Germany beat France as Europe's second-largest buyout market in 2020. In a €7.7 billion agreement, KKR, and Fastweb acquired a 37.5 percent ownership in Fibercop alongside Telecom Italia. TDR Capital and the Issa brothers' € 7.5 billion buyouts of UK grocery giant ASDA from Walmart came in third.

All of these agreements have one thing in common: they're all strategic spin-offs. This is a trend that is expected to continue in 2021, as companies have been compelled to examine their goals and operations over the last year to see if they are truly aligned. Businesses are focusing on what is most important to their business model and how they might leverage the M&A market to sell and buy assets to secure their future in a post-COVID world. PE stands to gain from this huge reorganization period since it has record dry powder.

4 ESG Considerations in M&A

In the post COVID world, potential targets need to qualify high health and ESG standards for investors during the due diligence process. ESG due diligences are a required competence in the M&A industry. Most financial investors use ESG as an additional parameter for M&A transactions.

In an ESG due diligence, the compliance of the target with international frameworks and non-codified expectations from stakeholders are analyzed which increases the transparency between the company and its stakeholders. Analyzing ESG data and information through the transaction process allows for better comparability across companies and improved identification of opportunities and threats. ESG is a strong value driver as buyers screen targets with better sustainability standards and are well-positioned in this area and therefore improve their own ESG score and their corporate image.

Better technology and a larger data set enable companies to narrow their M&A deal sourcing to sustainability-focused companies and therefore meet shareholders' and stakeholders' expectations to contribute to global environmental goals, act socially responsible, and become more inclusive and diverse. Also, policy objectives like the EU Action Plan on Sustainable Finance are an important factor of sustainability-focused M&A transactions, as the EU taxonomy defines criteria for ecologically sustainable investments, impacting investors' business.

Overall, not meeting ESG values has a vastly negative impact on businesses as it affects the image of a company, their attractivity as a target, and therefore its value. Conducting an ESG due diligence at the earliest stages is critical for larger transactions to mitigate any concerns whereas, for smaller transactions, ESG is often a post-merger matter. ESG due diligence differs in different industries, as ESG KPIs are industry- and target-specific. The chemical industry can have a focus on environmental factors whereas a target in the textile industry can have an emphasis on social factors. One example, where an ESG due diligence is particularly important is the real estate industry, as the sector is monitored by governmental bodies and prudential authorities over its environmental impact, especially in the EU.

Other than the qualitative benefits, there are also quantitative benefits of high ESG scores. In contrary to the common assumption, companies with high ESG standards do not necessarily have a low financial position.

Figure 10: Source: Dow Jones ESG Data and FactSet, Sum of top 100 ESG scores by industry of companies listed in the Dow Jones and with a share price of over $10

Among the top 100 companies ranked by the ESG score with a share price of over $10, large technology corporates like Microsoft, Hewlett Packard, Salesforce.com, Oracle, and Qualcomm all combine high ESG standards (ESG score above 75) with a great financial position. M&A transactions

like Hewlett Packard Enterprise's acquisition of Cray, whose supercomputers provide pharmaceutical research to healthcare, are key drivers for ESG scores in the fourth quartile. Further non-tech companies like Linde, J.B. Hunt, and Gildan Activewear also rank amongst the top companies where profitability is mixed with high ethical and social responsibility. Overall, many financial service providers and retail companies are among the companies with high ESG standards. Therefore, from the financial aspect, high ESG values do not mean a trade-off with strong profitability and growth, as it is commonly falsely presumed.

Additionally, strong ESG focused buyers and targets benefit financially from a lower cost of capital, as companies with lower ESG standards have a higher debt pricing and more restrictive covenants. Carlyle for example arranged more than USD 6 billion in ESG-linked financing that ties the price of debt to the diversity of a firm's board, which saved the company more than USD 15 million.

Overall, in the context of M&A transactions, ESG due diligence contributes to financial and reputational benefits for acquirers as well as for potential targets.