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What might the future hold for equity markets in 2022 and beyond?

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Corporate earnings growth was remarkably strong in 2021 with profit margins back near record highs. Vast amounts of monetary and fiscal stimulus supported the rapid turnaround in business activity after COVID vaccines were approved late-2020.

Rising input costs, a challenge for profitability

However, 2022 may present a more challenging environment for corporate profitability. Input costs are rising, in some cases very dramatically, and this will put pressure on profit margins.

Not only are businesses contending with a tight labour market, creating competition for qualified workers across multiple industries, but drastically higher commodities prices too.

Energy prices in particular have been high and are set to remain elevated for a number of reasons. Before Russia invaded Ukraine, the economic recovery was boosting demand for oil and gas at a time when supply growth was static. As governments have encouraged energy companies to spend more money on renewables, spending on traditional exploration and production has been cut. As a result of this underinvestment, supply is not only tight but, in many cases, set to shrink quite rapidly.

The global gas market is extremely tight currently and this supply side shock has led to an extreme price rise. Unless demand falls this will remain the case for the next few years, as major new gas projects will not have any impact on supply until 2024 at the earliest.

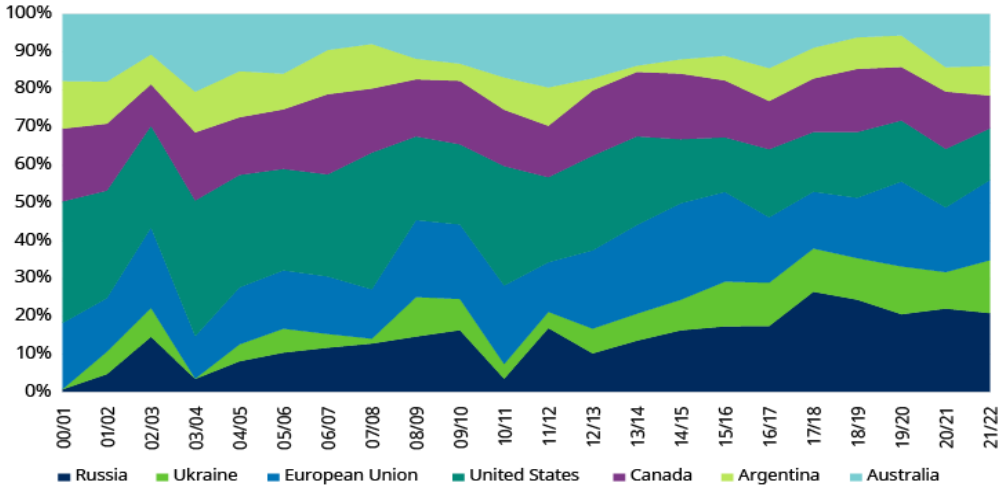
Then, of course, there is the Russian invasion of Ukraine. It is first and foremost a human tragedy and the effect on millions of people has, and will continue to be, devastating. Our thoughts are first with those suffering. As investors, our role is to interpret the market implications on behalf of our clients and Western bans on Russian oil and gas will put further upward pressure on prices.

Other commodities, like wheat, are also at record high prices which will have implications for various businesses that rely on it as a crucial input to the production of their goods and services.

Russia and Ukraine together account for around 30% of the world's wheat exports, as the chart below shows. Clearly, disruption to the export of wheat will have ramifications for consumers in terms of both availability and price. It is emerging markets that are likely to see a disproportionate impact given they have been the traditional destination of Russian wheat. In recent years, the top three markets for Russian wheat exports have been Egypt, Turkey and Bangladesh.

Russia and Ukraine represent more than 30% of global wheat exports

Wheat exports share by country %



Source: USDA, Bloomberg, Schroders, February 2022. 604303

Will companies be able to pass on price increases?

Against that backdrop, there are clear risks to equities this year. On the one hand, it is conceivable that companies will be able to muddle through the next few months by passing on higher prices to consumers, whose household finances are mostly in good shape. Such consumers may find a 5% price hike for consumer goods tolerable as wages rise.

However, many companies, especially those in fragmented industries with little or no product differentiation, will not be able to pass on higher costs. In the current environment, many consumer staples and industrial companies would appear most vulnerable to higher input costs given the sharp rise in base commodities such as grains and sugars or steel and copper.

Perhaps the best examples of positive pricing power are to be found in the technology sector, particularly amongst the dominant so-called mega-cap platforms. Although not without their own competitive and regulatory issues, a handful of very large internet platforms dominate the digital advertising market (which in turn, is becoming the dominant channel for advertisers of all sizes). Many other software, internet, and semi-conductor companies can build in regular price rises while keeping cost growth extremely muted. These areas will continue to be fertile hunting ground for growth in the coming months.

Mega-trends shaping markets further out

Stepping back from the immediate challenges, there are a number of structural drivers that are likely to have a material impact on equity markets over the next decade and beyond. Most of these trends (often known as "mega-trends") are far from new. Climate change, the energy transition, demographic change, healthcare innovation, digitisation, automation, and urbanisation have been relevant for many years. However, their relevance is increasing exponentially as populations grow. While these themes are long-term in nature, often playing out over years and decades, in some cases, the pandemic has simply accelerated the process of change.

Although there are major challenges that need to be addressed on a global scale, and quickly, there are plenty of reasons to believe that these can be addressed. As evidenced by the production of a revolutionary vaccine just nine months after the emergence of COVID-19, we are living in a golden age of innovation.

The convergence of multiple technologies from processing power, connectivity, bandwidth, and memory all the way to power delivery and software is resulting in a wave of innovation across multiple industries, most of which would not have been possible even a few years ago. The COVID-19 vaccine could not have been developed without DNA sequencing technology.

Similarly, the process of energy transition is now possible because of the extraordinary progress in battery capacity, renewable electricity generation capability, and grid technology. The process of global transformation is ongoing, and it is broad-based, pervasive, and long-lived.

Active management remains relevant

The importance of active engagement with the companies we invest in cannot be underestimated. In a complex and rapidly changing world, a regular and constructive dialogue between the providers of capital and their investees would seem essential.

A management team may not appreciate the importance of a specific issue, such as sustainability or social welfare, from an investor's point of view. Equally an investor may not appreciate the extent to which a company has committed to evolving its business model in order to meet some of the challenges we discussed earlier.

Investment does not stop at buying a share. Active engagement remains a critical component of alpha generation.

Glacier Research would like to thank Katherine Davison for her contribution to this week's *Funds on Friday*.

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