

# Investment Views



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# Another Inflationary Shock

The first quarter of 2022 was an eventful one. The sharp hawkish turn by global central banks - particularly the US Federal Reserve - and Russia's invasion of Ukraine dominated the landscape, with inflation being a common thread.

It was hoped that the pickup in inflationary pressures seen last year would start to abate as the world returned to normality after the pandemic and demand shifted from buying durable goods back to services. However, late last year it became clear that inflationary pressures were broad based and not purely confined to the sectors most exposed to the pandemic, such as used cars, computer hardware and furniture. Central banks had characterised the rise in inflation as “transitory” but at a Congressional testimony in November, Federal Reserve Chair Jerome Powell admitted that it was “probably a good time to retire that word”.





Russia's invasion of Ukraine in late February has been a humanitarian tragedy, a significant wakeup call for the West and an untimely inflation shock in the form of higher commodity prices. This shock is a global one. While Russia represents only around 1.7% of global GDP, Russia and Ukraine together have sizeable commodity exports spanning energy, metals and agricultural goods. Europe is the region of the world most exposed to higher energy costs given their reliance on Russia for oil and natural gas and rising food prices will hit Emerging Market consumers and those on low incomes particularly hard. It is estimated that the bottom quintile of earners in the US spend around 27% of their after-tax income on food. In a letter to shareholders, Blackrock CEO Larry Fink recently wrote: "the ramifications of this war are not limited to Eastern Europe... they are layered on top of a pandemic that has already had profound effects on political, economic and social trends. The impact will reverberate for decades to come in ways we can't yet predict."

Geopolitical experts and Russian-focused academics both failed to predict, or assigned a very low probability to, a full-scale invasion. Occupying Ukraine and toppling the government was not seen as a realistic prospect. The invasion therefore came as a shock to financial markets and the initial response was somewhat calculable: the US dollar appreciated, US Treasury yields fell (prices rose), equities sold off and commodity prices jumped higher. After these initial moves, the bond market began to appreciate the Russia-Ukraine conflict was unlikely to derail the Fed's plan to move interest rates higher, especially as it has added to inflation expectations.

Unlike Europe, the US economy is relatively well positioned to cope with supply disruptions to energy, agriculture and other commodity exports from Russia and Ukraine. The US has a balanced to modest surplus in both energy and agriculture trade in addition to the world's largest defence sector, which is likely to see increased orders from Europe. The sanctions imposed by the West on Russia have been designed to inflict maximum economic pain on the country

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# 27%

The estimated amount of their after-tax income that the bottom quintile of earners in the US spend on food.

“the ramifications of this war are not limited to Eastern Europe... The impact will reverberate for decades to come in ways we can't yet predict.”





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# 1.7%

The approximate figure Russia represents of global GDP.

## STRATEGY

and minimum cost on the West, meaning natural gas has continued flowing into Europe which is critical for German industry. However, there are now growing pressures to increase sanctions and move away from reliance on Russian energy supplies.

The decision by the US and its allies to freeze Russia's foreign reserves, stockpiled to guard against inevitable economic sanctions, has been hugely significant. It has also unleashed an intense debate about the future of the international monetary system and the role of the US dollar at its heart. Importantly, all G7 countries moved to freeze Russia's foreign currency reserve assets, so while the US dollar may now be less attractive as a reserve asset, the alternatives with sufficient liquidity and allowing for the free movement of capital are extremely limited.

Overall, financial markets bounced back strongly in the last three weeks of March. While Russian equities only account for around 0.2% of the MSCI All Country World Equity index, the spillovers from high commodity prices increase the risk of an economic slowdown or potential recession in Europe. Real incomes were already under pressure from inflationary pressures. Economic growth forecasts have been revised down while inflation forecasts have been revised higher; not a good mix. This means earnings growth will come under pressure this year.

We took some steps to reduce risk at the beginning of the year: reducing credit risk in bonds and cutting Consumer Discretionary exposure in Equities while adding to Consumer Staples. Portfolio turnover since the Russia-Ukraine invasion has been low but our portfolios are designed to be resilient to a range of shocks. Our underweight to Fixed Income and overweight to Alternatives (especially commodities and gold) were very beneficial in the first quarter.



# A Perfect Storm Brewing

The first quarter served as a good reminder that fighting the Federal Reserve is a dangerous venture. The setbacks witnessed across the board were a rare event resulting from a confluence of several negative market conditions at the worst possible time. The Bloomberg US Aggregate Total Return index returned -5.93% for the quarter; its worst performance since 1980. Shorter dated bonds were not immune, with the Bank of America 1-5 year US Treasury and Corporate index returning -3.24% for the same period. While the past few weeks have been dominated by Russia-Ukraine, it's important to note that the Federal Reserve, after signaling in September that they were pivoting towards inflation fighting, has for months been attempting to tighten financial conditions and thus prevent the economy from overheating.





The events in Europe simply accelerated a process that had already started towards a more challenging macro backdrop. With the Federal Reserve now determined to regain their inflation-fighting credibility and increasingly willing to compromise on growth and employment in order to break the spiral in broad prices (the annual change in the US consumer price inflation reached a 40-year high of 7.9% in February), we expect policy makers to stay the course until price pressures normalise.

The bond market has been aggressively shifting its expectations on how many base rate increases will be delivered in the US this year. At the beginning of the year, the market expected just three 25 basis point moves this year; however, this has now shifted significantly to a potential nine hikes. The velocity of monetary tightening and likely deceleration of credit creation is very large and dwarfs the last time that tightening was attempted in 2017-18. The market is assigning a 70% probability of another 50 basis points hike at each of the upcoming May and June FOMC meetings, with quantitative tightening also expected to start imminently. In the initial aftermath of the invasion of Ukraine, bonds rallied as risk-off sentiment took hold with 10-year US Treasury yields falling to 1.73%. However, once it became clear that commodity prices were likely to surge even higher this year, bonds resumed their negative trend ending the quarter at 2.34%. This is the highest since mid-2019 and leaves the 2-year versus 10-year part of the US yield curve now inverted; this is a closely watched recession indicator.

Although we saw disruption to the global economy in the first quarter, US economic growth continued to surprise to the upside.

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–5.93%

The Bloomberg US  
Aggregate Total Return  
returned for the quarter.

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7.9%

The US consumer price  
inflation reached a 40-  
year high in February.

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4.9%

The average US 30-year  
fixed mortgage rate.

Data releases have been much better than expected so far this year and this provides further impetus for the Federal Reserve to act swiftly. In Europe and Emerging Markets the outlook is less rosy. Classic signs of stagflation are seen in almost every non-energy exporting country. While the US economy is largely isolated from the events in Europe, we must remember that in this globalised world, if an economy the size of Europe falls into a recession this increases the potential of spill over into the US.

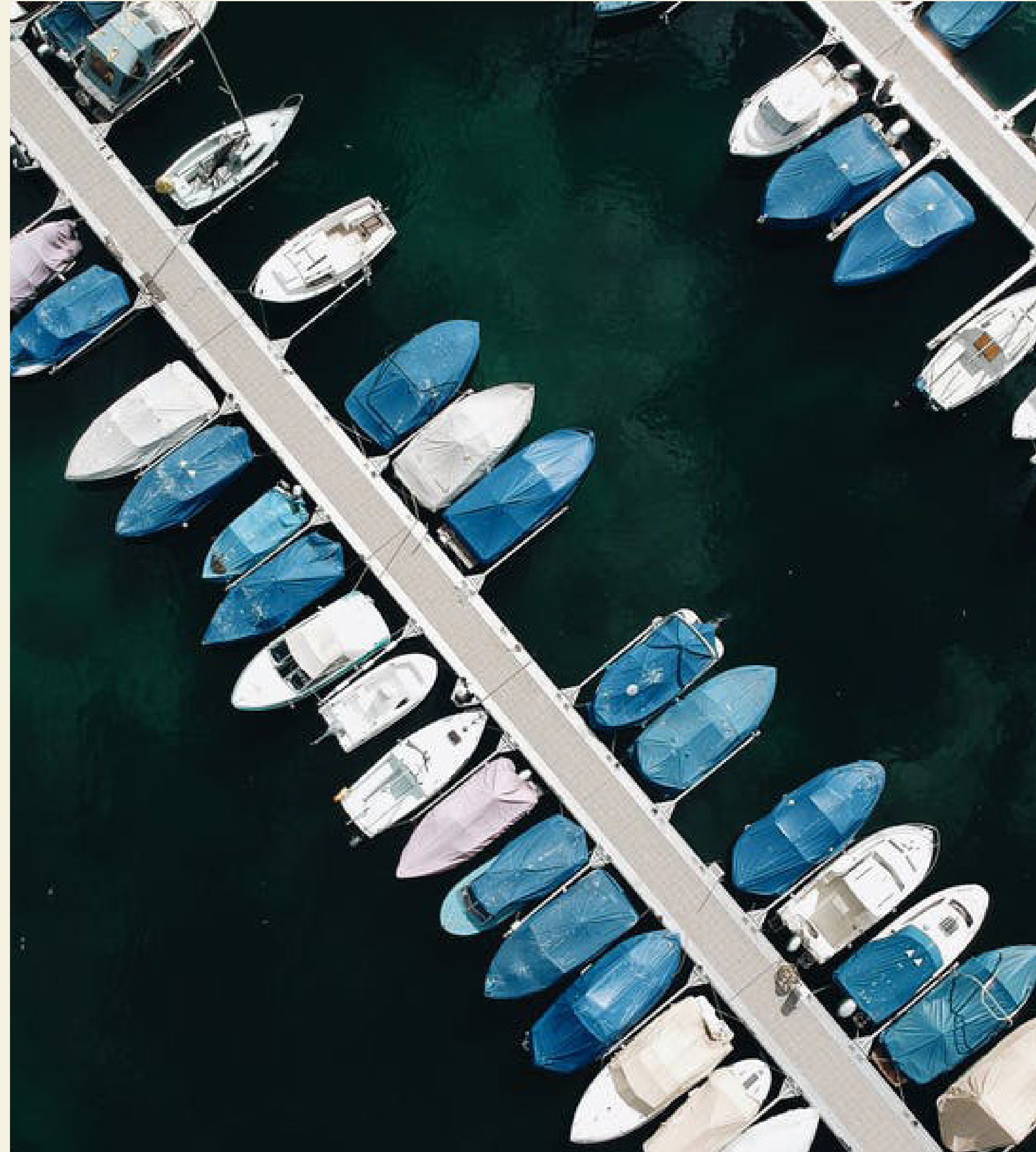
If we then add the significant degree of monetary tightening and the near doubling of energy prices (WTI is currently \$100 per barrel) the economic backdrop becomes more challenging. One area that we are watching, which has historically been a good leading indicator, has been the housing market. With the average US 30-year fixed mortgage rate reaching 4.90%, up from a low of 2.82% last year, US housing is at its least affordable since 2006. While housing inventories remain low, negative real wages, a surge in houses under construction and weakening consumer sentiment lead us to expect a broad weakening in prices over the next 12 months.

Looking ahead, we remain neutral US duration exposure and lightly exposed to corporate credit risk, which we reduced in January. This was in response to the existing slowing macroeconomic trends and we continue to be happy playing defence at this time. Although credit spreads rallied in March, we do not think this is sustainable with a broad slowdown in growth approaching and therefore will remain on the sidelines until inflation shows signs of reversing, which will reduce the risk of accelerated balance sheet tightening by the Federal Reserve. There are currently many uncertainties for us to contemplate and we will continue to monitor developments and the potential economic impact closely.

# Surprising Resilience

Global equity markets gained +2.7% in March to finish the quarter down -5.2% in US dollar terms, recovering from a significant -12.9% intra-quarter drawdown. Markets recovered in March despite rapidly rising interest rates, with the US Fed looking to combat ongoing inflationary pressures by hiking rates for the first time since 2018 and raising expectations for both the pace and magnitude of tightening to come. Oil and gas prices spiked as the Russia-Ukraine conflict escalated before declining towards the end of the quarter with an announced release of one million barrels per day from America's Strategic Petroleum Reserve.

Emerging Markets were mixed with Russian assets seeing precipitous declines, other commodity exporters such as Brazil and South Africa benefiting, and Chinese equities experiencing significant volatility. In March, China's top economic official intervened with a rare wide-ranging statement suggesting the government would take measures to "boost the economy" and introduce "policies that are favourable to the market".







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# 2.7%

The amount Global equity markets gained in March.

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# -5.2%

Global equity markets finished the quarter in US dollar terms.

## EQUITIES

The comments were made after a special meeting of the State Council's Financial Stability and Development Committee, which oversees the country's main financial regulators, including the central bank and securities watchdog. Investors in Chinese companies had been buffeted by slowing economic growth, inflationary aftershocks from the war in Ukraine, a long-running government crackdown on companies in the Technology, Education and Property sectors, and China's zero-tolerance policy on COVID-19 despite the more transmissible Omicron variant.

A common market narrative has been that high equity valuations were supported by ultra-low interest rates, especially for companies with low or no current earnings but the potential to generate higher earnings in the distant future. It is interesting to note that in recent weeks, these high growth stocks have been performing well even with interest rates on the rise. While it is intuitively attractive that high discount rates reduce the value of cash flows paid out far in the future, the recent disconnect demonstrates the risk of leaning too heavily on apparent relationships and correlations between assets given that they can shift quickly. This is especially the case in a world where global events are moving so fast and rapidly impacting both newsflow and sentiment. The more recent narrative has been that equities are an inflation hedge, supported by a company's ability to raise prices. It's worth being wary of shifting narratives that both environments support high stock valuations.

A backdrop of higher commodity prices and broad based inflationary pressures is one in which there is a lot of dispersion between the winners and losers of such an environment. Most obviously, commodity producers benefit from higher commodity prices, while companies using commodities as an input see profit margins pressured. The Energy sector significantly outperformed the overall market in the first quarter and continued its recovery



## EQUITIES

from the depths of the COVID-19 crisis in March 2020. This also demonstrates the importance of diversification and building portfolios resilient to withstanding a range of different economic shocks. The Materials sector performed well as the Metals & Mining stocks saw broad based gains, with Fertiliser and Agricultural Chemicals companies also making good progress as global commodity prices rose. From an economic perspective, the risk with higher commodity prices is that the benefits accrue to a relatively narrow range of producing companies or countries while the pain is spread widely across all consumers. This is something we are monitoring closely and this squeeze on real incomes was a factor as to why we reduced our exposure to the Consumer Discretionary sector and increased exposure to Consumer Staples in the first quarter.

Analysis of investor flows show that leveraged investors (hedge funds) have been aggressively reducing their equity exposure. Short covering by these investors can help to explain why some of the longest duration equities have recently risen sharply despite rising interest rates and a more hawkish Fed. Retail investors have also continued to buy the market dip, deploying cash holdings and reallocating from bonds into US equity funds.

Prior to Russia's invasion of Ukraine, the global economic picture was one of ongoing recovery from the pandemic. The latest data placed growth in the US, Euro area and UK above trend and the services sector recovery is moving past its Omicron setback. The Fed's view is that recession is not imminent and the US economy remains strong enough to weather higher borrowing costs. Nevertheless, the outlook for growth has become a lot more challenging as the war in Ukraine has increased commodity prices at a time when inflation pressures were already elevated.

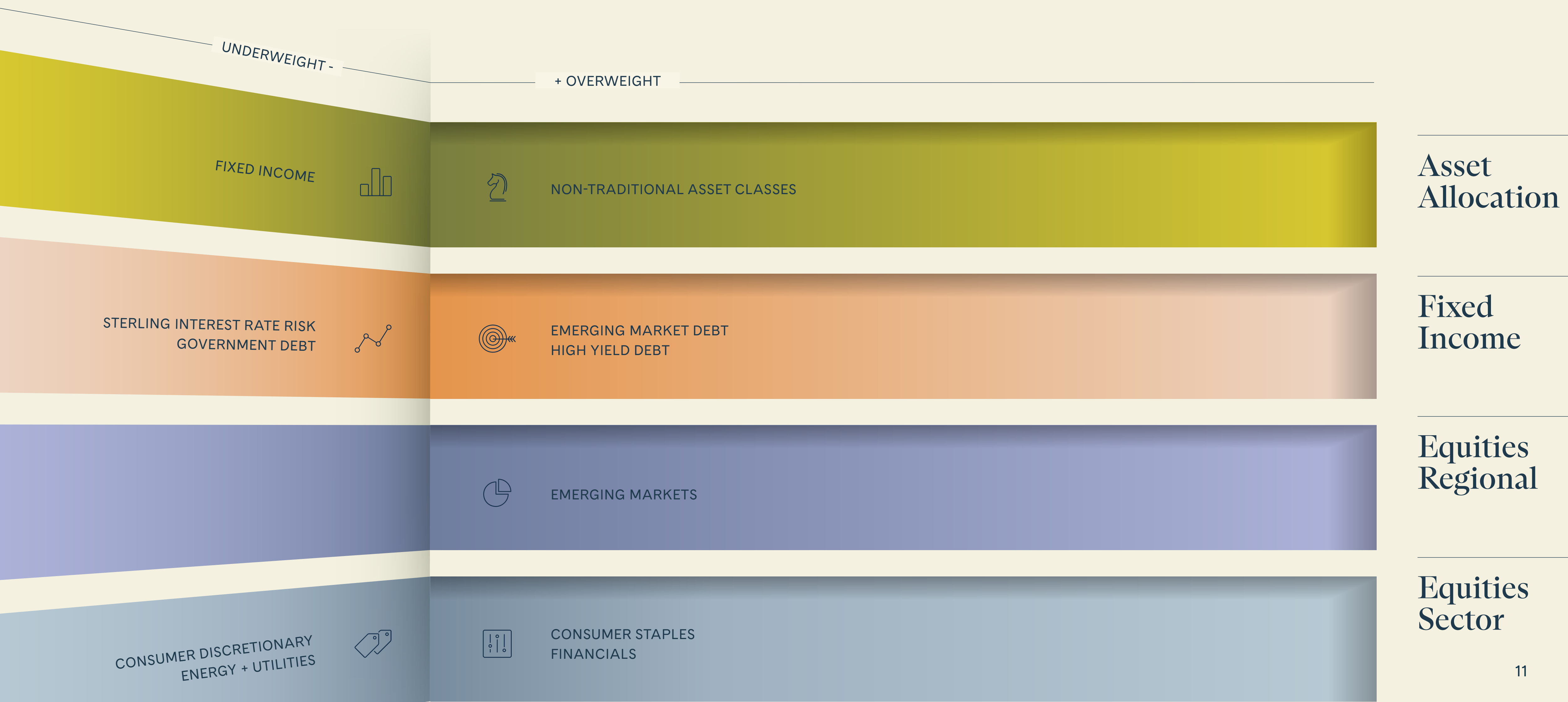


...the outlook for growth has become a lot more challenging as the war in Ukraine has increased commodity prices at a time when inflation pressures were already elevated.



# Global Asset Allocation

The chart below details our 6-12month tactical investment strategy





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