Investment Views

MAY 2022

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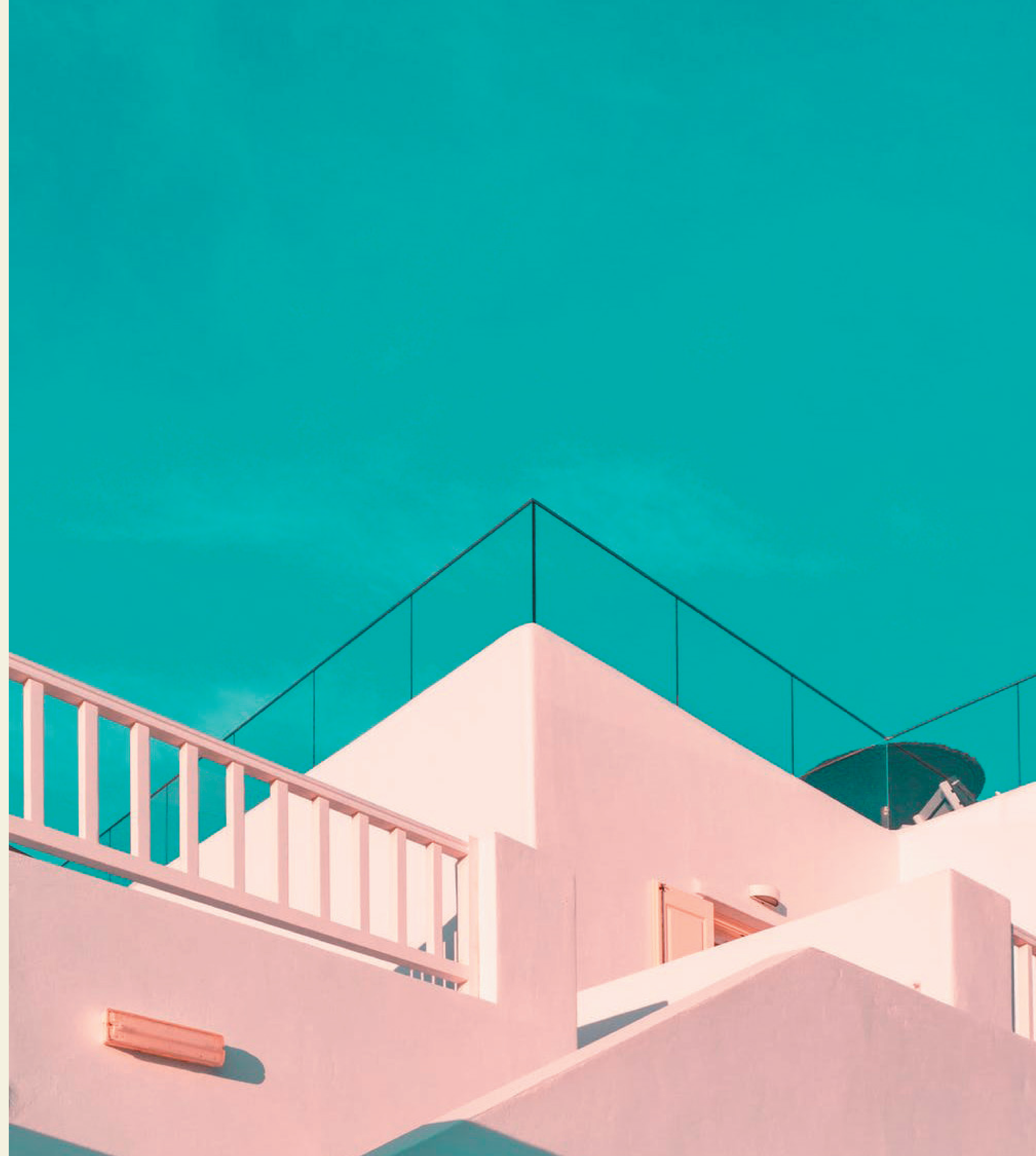
Soft Landing Getting Harder

So far 2022 has not been a welcoming year for investors. Financial markets have had to contend with slowing growth, surging inflation, impending monetary tightening, lockdowns in China, a war in Europe and soaring energy prices.

Coming into the year, a number of these factors were expected: we knew growth would slow after the breakneck pace of last year, we knew inflationary pressures were becoming more broad-based and we knew that central banks would tighten monetary policy. The issue is that all of these variables have had a more negative impact than anticipated and the tricky balancing act of removing policy support to slow inflation without causing a recession became more challenging after Russia's invasion of Ukraine and renewed lockdowns in China.



This combination of events has proved particularly difficult for financial markets, hitting both bonds and equities. For much of the past 22 years since China joined the World Trade Organization, the world has had a disinflationary bias; lots of new low-wage, productive workers meant the world could produce more and reduce costs. This backdrop was very supportive of financial markets as it meant that the correlation between bonds and equities was negative; when one asset class was performing poorly, the other asset class was usually performing well. As such, a portfolio of bonds and equities produced very strong risk adjusted returns.

The return of inflation has flipped this relationship and both asset classes have suffered this year. Commodities, on the other hand, have proven to be good diversifiers with the broad index up around 31% through the first four months of the year. However, even within commodities there has been a lot of dispersion. Commodities more exposed to disruption from the Russia-Ukraine conflict, like oil, natural gas and agricultural commodities, are rising but others more exposed to global growth are weaker. Gold performed very well as a diversifier around the time of the invasion but more recently has also struggled as real yields and the US dollar have risen.

The primary question now is whether central banks engineer a “soft landing” i.e. increase interest rates enough to bring inflation down but without causing economic growth to slow so much that the economy tips into recession. In March, Federal Reserve Chair Powell argued that the Fed had managed to achieve a soft landing in 1965, 1984 and 1994 as it was reacting to “perceived overheating”. The challenge today is not perceived overheating but actual overheating, so the Fed is playing catch up. Furthermore, in the three soft-landing cases US inflation and wage growth were not accelerating the way they are doing now. The Fed is therefore facing a more difficult challenge than those three prior cases and the risk of policy mistakes is elevated.

31%

Commodities up through the first four months of the year.

“the return of inflation has flipped this relationship and both asset classes have suffered this year.”

If the Fed is to achieve its aim then it is going to need some help from productivity growth. The good news is that the pandemic crisis forced many businesses to innovate, particularly in their use of technology, so they should see the longer-term benefits of this. Furthermore, the rise in wages provides an incentive to invest in cost saving technology, which should also bring future benefits. One major challenge is that deglobalisation means there is a risk that the supply side of the economy won't ride to the rescue and bring down inflation. With risks mounting, we took additional steps in April to increase the defensiveness within Equity allocations, by increasing our exposure to Health Care and reducing exposure to the Financials sector.

A Series of Disorderly Events

With the war in Ukraine and hawkish rhetoric from the Federal Reserve continuing unabated, Fixed Income markets witnessed another torrid month. The Bloomberg US Aggregate bond index recorded a -3.79% loss, taking the year-to-date total return to -9.50%. Given that, at the start of 2022, the yield for this index was 1.75%, these extreme moves have effectively wiped out five years of carry and severely damaged confidence in the asset class.

As real interest rates start to rise into positive territory (10-year real rates have risen +110bps YTD) and close in on the natural rate of interest (the theoretic rate that is neither stimulative or contractionary), risk assets such as corporate credit are now starting to experience some turbulence. The US dollar has reached a six-year high and the price of US natural gas has reached levels not seen since 2008, both of these for different reasons but nevertheless intricately connected via global financial market dynamics.

Over the past month, economic data in Emerging Markets and Europe (including the UK) continued to weaken as consumers struggle with the rising cost of living and reduce their demand for discretionary products. German bunds are at their highest yield since 2013, which equates to much tighter financial conditions, with the Euro looking set to test parity versus the US dollar. In China, pressure to devalue the Renminbi is growing, as domestic growth stalls and the sharply depreciating Japanese Yen, now -13% weaker versus the US dollar since February, leads to competition for exports. If China chooses this path, global goods inflation will fall further, partially offsetting stickier prices for energy and food and easing pressure on central bankers across the world.

At the May Federal Reserve meeting base rates were increased by 50 basis points taking the upper bound to 1%. The market is fully pricing a further 200bps in base rate increases for the remainder of 2022. These increases will be front loaded with another 50bps in June and July, followed by 25bps at each remaining meeting. We also expect an announcement on the start of quantitative tightening with US$60bn in US Treasuries and US$35bn in US agency mortgage backed securities being allowed to mature without reinvestment. Although these numbers pale in comparison to the US$9 trillion size of the Federal Reserve's balance sheet, and with the US Treasury likely to cut their funding

–9.50%

The Bloomberg US Aggregate bond index year-to-date total return.

2.94%

The US 5-year Treasury yields.

requirements, the effect on financial markets and US Treasury yields remains uncertain. However, with the short end of the yield curve already priced for a rise in the base rate to around 3.25% in 2023, it is becoming likely that if inflation continues to surprise to the upside, some of the additional heavy lifting will shift to accelerated quantitative tightening in the months ahead.

We have been surprised by the velocity of the move in US Treasury yields given the geopolitical uncertainty, slowing global growth and potential for inflation to peak very soon (if only due to favourable base effects). Portfolios have suffered mark-to-market losses (we haven't been sellers) in line with our benchmarks. Given where valuations are now – the US 5-year Treasury yields 2.94% - together with the high probability that China and Europe enter a recession later this year and US growth slows, we feel comfortable with this stance and will look to exchange floating rate notes for short dated fixed rate bonds.

In risk assets, our allocation to corporate credit is low and defensive. We are unlikely to witness a credit event but will experience some volatility in the months ahead. For holders of bonds, the recent repricing in government bond yields has been sharp, dramatic and disorderly; attributes Fixed Income does not typically deliver. However, given the current stage of the economic cycle, if inflation follows the path that the market and the Federal Reserve expect, the worst is likely behind us and correlations will re-exert themselves in the form of providing portfolio insurance over the next 12 months.

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Elusive Safe Havens

Investors struggled to find havens in April. Financial markets sold off on mounting fears of an economic slowdown and the Federal Reserve prioritised fighting inflation over supporting economic growth. The global equity market rout resumed, declining -8.3% in April, with a broad sell-off across both Developed and Emerging Markets, and across almost all sectors (the defensive Consumer Staples sector eked out a slightly positive return of <1%). US stocks, the only major market with positive returns in March, led major global equity indices lower with a -9.1% drop. Japanese stocks fell -8.8%, underperforming the global equity market and diverging from their historically inverse relationship with the yen, which depreciated in April. Emerging Markets declined -5.1%, benefiting from a relatively better -3.6% return in Chinese stocks following a rally at the end of the month.

The uptick in Chinese stocks at the end of the month came after authorities provided assurance they would support the economic recovery and boost infrastructure spending, and signalled a willingness to resolve regulatory issues in the technology sector.

-8.3%

The amount the global equity market declined in April.

Fresh Covid outbreaks in China, and the stringent policies applied to contain them, had spooked investors who feared shutdowns could further disrupt global supply chains, fuelling declines in China's markets and also those of developing nations that rely heavily on Chinese trade. These pledges were well received by the market, although authorities didn't abandon the stern Covid Zero policy that had sparked the panic in the first place. China's 5.5% 2022 growth target is now in question, and in turn could lower growth in countries exporting to China.

Russia's apparent decision to engage in a war of attrition in Ukraine is another supply-chain concern as shortages of some raw materials and food will likely be more persistent. Higher inflation for a longer period of time could provide further support for the Federal Reserve's plan for aggressive rate hikes, weighing on stocks whose valuations are seen as dependent on future growth.

-8.8%

The amount Japanese stocks fell.

Perceived as safe havens (even beneficiaries) from stay-at-home pandemic lockdowns, US megacap technology stocks appear to have lost some lustre as western societies reopen, exacerbated by supply-chain issues. US market indices have benefitted for years from these stocks' outperformance and growing index weights have seen them become an increasing drag this year. Six tech companies, namely Apple, Amazon, Netflix, Alphabet (Google's parent company), Microsoft and Meta (Facebook's parent company), contributed more to the S&P 500's returns than their weightings would imply. Notably, these six stocks pushed the market higher after markets fell in 2015 and 2018 but have contributed roughly half of the S&P500's drop in 2022, despite making up less than a quarter of its weight.

EQUITIES

In April, the S&P500 equal weight index declined -6.4%, in comparison to Meta's -9.8%, Apple's -9.7%, Microsoft's -9.9%, Alphabet's -17.7%, Amazon's -23.8%, and Netflix's -49.2%. Headwinds have been apparent in weaker-than-expected quarterly results, and downward adjustments in analysts' forecasts. Amazon reported slowing e-commerce growth and disappointing forecasts, Alphabet's first-quarter revenues fell short of expectations, Apple warned supply constraints would hurt sales, and Netflix had a shockingly weak subscriber outlook. Stock selection therefore remains very important in Equity markets.

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Global Asset Allocation

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

Asset Allocation

Fixed Income

Equities Regional

Equities Sector

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