

Investment Views



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Strategy:

New Cold War

Fixed Income:

Between a Rock and a Hard Place

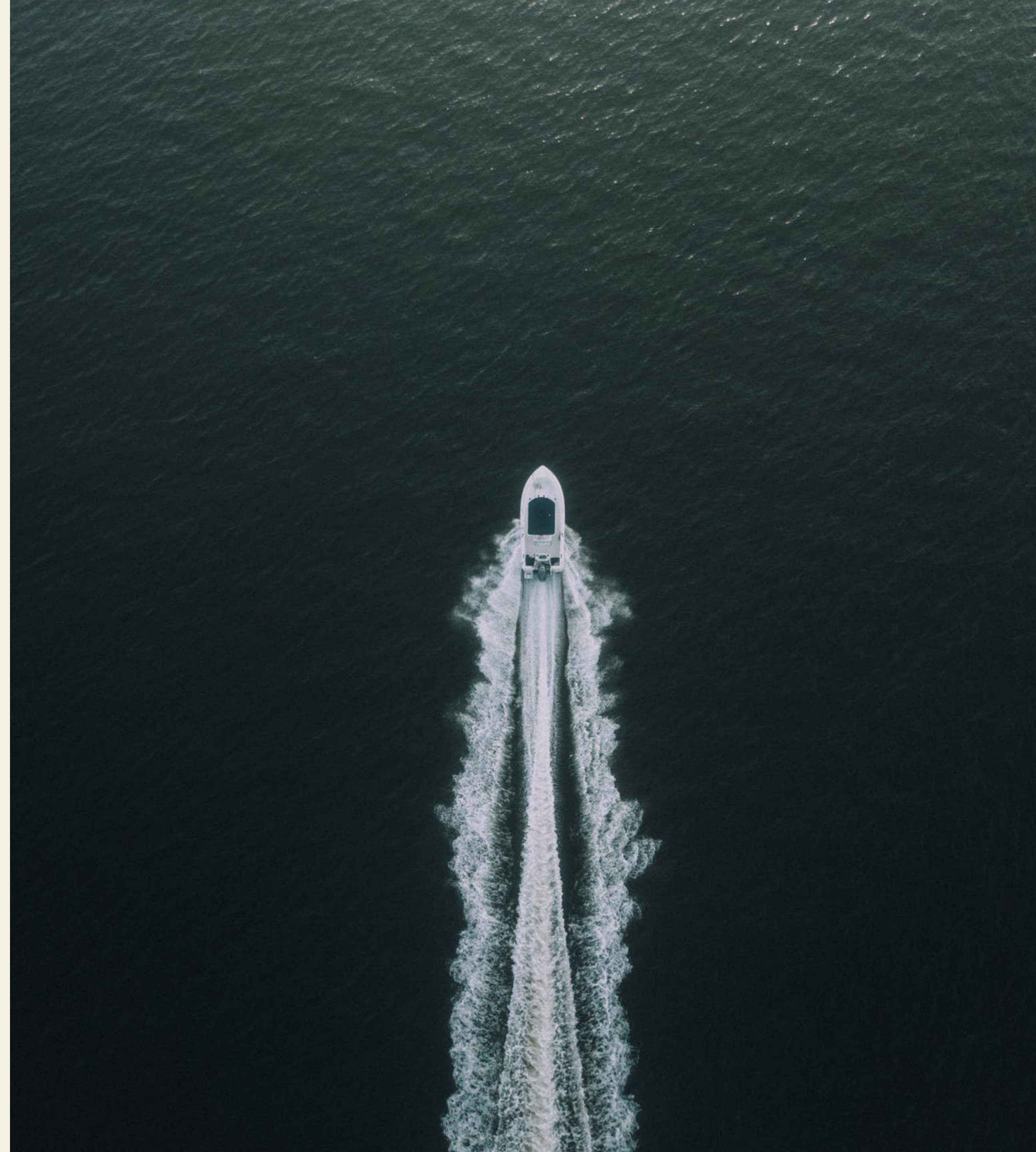
Equities:

Commodity Price Shock

New Cold War

Russia's full-scale invasion of Ukraine has caused both a humanitarian disaster and a geopolitical crisis that will cast its shadow for years to come. The invasion has shattered a range of Western Europe's long-held political and economic assumptions and has consigned Berlin's policy of treating commercial links with Russia as separate from politics to the history books.

Russia represents 1.7% of global GDP, 0.22% of the MSCI All County World Equity index and 2.75% of the MSCI Emerging Markets Index, so direct risks are fairly low. However, Russia and Ukraine together have sizeable commodity exports spanning energy, metals and agricultural goods. A commodity price shock is the major risk threatening to inflict damage on the global economy.



It is a particular issue for Western Europe given its dependence on natural gas, oil and coal imports from Russia, which supplies between a fifth and a quarter of the region's primary energy supply. Russia's share in global commodity production is large for major energy sources such as oil (17%) and gas (11%), but also for precious metals (11%), industrial metals (9%), as well as wheat (11%), and fertilisers (8%). Ukraine's share in global exports is large for wheat (7%) and corn (22%). Rising food and energy prices will also take a particularly heavy toll on Emerging Market countries and low income consumers in Developed Markets.

Commodity price shocks can be particularly damaging for both economies and markets as they adversely affect a number of variables simultaneously. They put upward pressure on inflation, constrain growth, reduce corporate profitability (for non-commodity producers), and the input price volatility causes risk premiums in markets to rise. Coming into the year, the global growth backdrop was strong but with two main challenges: the pandemic and inflation. The pandemic situation has improved rapidly outside of China and Hong Kong and the world is in the process of re-opening. Meanwhile, inflationary pressures were expected to peak this spring, but a commodity price shock has now adversely compounded an existing inflation issue.

Stepping back, while the long period of relative peace and prosperity since the Second World War has felt like a normal state of affairs, in a historical context it is an exception. The US-led global system that has existed for over 70 years resulted from a unique set of factors which included the strength and size of the US economy relative to the rest of the world. By helping to re-build Europe after the war, the US benefitted from shaping important global institutions with their view of how the world should operate. This historical context is important when understanding how the investment environment may evolve.

17%

Russia's share of the
global oil market.

22%

Ukraine's share of the
global corn market.

The pandemic situation
has improved rapidly
outside of China and Hong
Kong and the world is in
the process of re-opening.



630bn

Russia's foreign exchange reserves – over half of which have been frozen by sanctions.

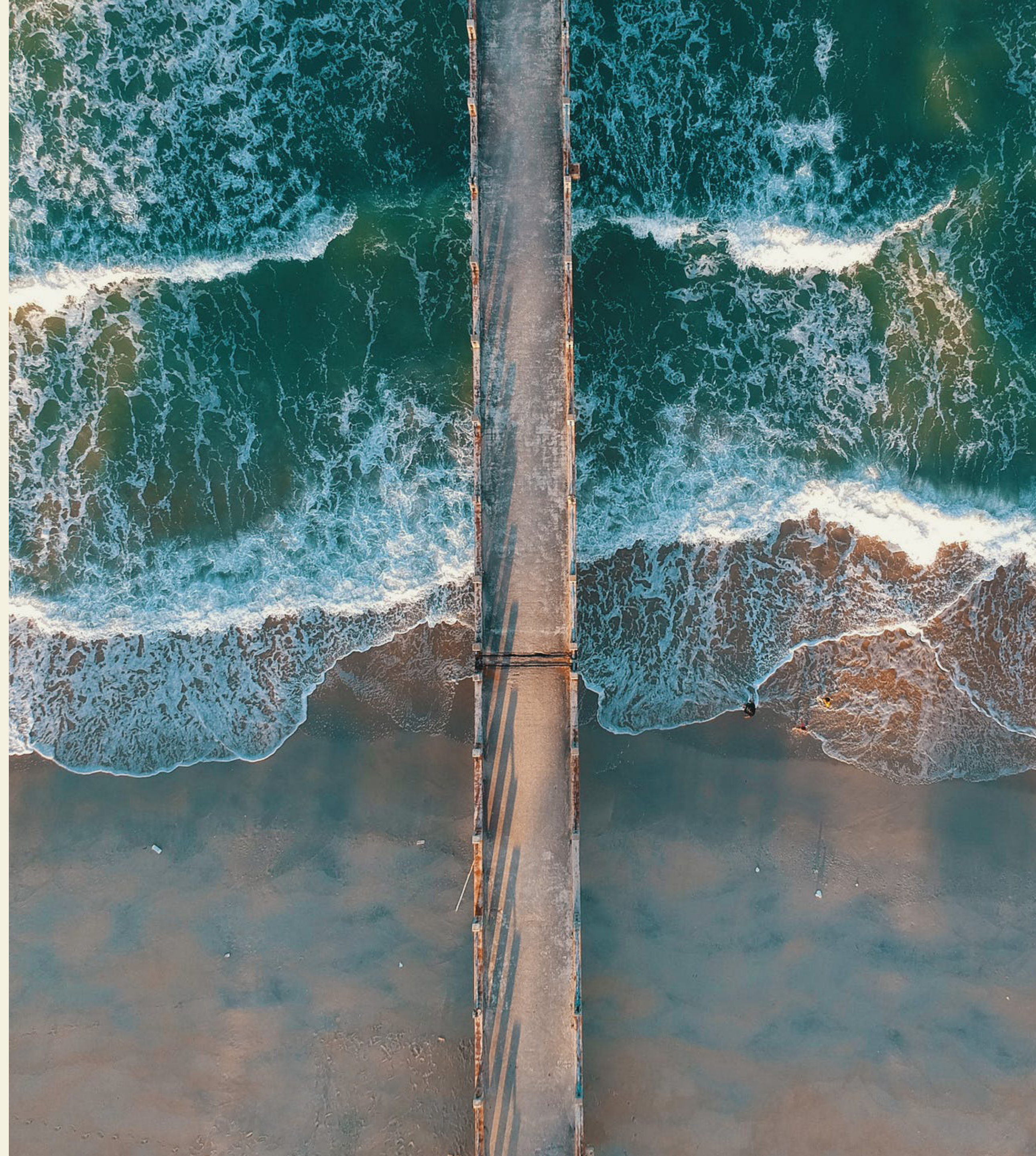
STRATEGY

The West has responded to the invasion by providing military equipment to Ukraine and an unprecedented range of economic sanctions towards Russia to cut access to the global economic system. The decision to impose sanctions on Russia's central bank – effectively freezing over half of the \$630bn of foreign exchange reserves it had amassed as part of the “Fortress Russia” policy – will be significantly disruptive to its economy, limiting the central bank's ability to support the ruble. The US has banned imports of crude and oil products, coal and liquefied natural gas and has also banned American companies from investing in Russia's energy industry. The UK has said it will also phase out Russian oil imports with companies being given until the end of the year to cut off shipments.

Russia's invasion of Ukraine is a jarring wake-up call for the West. The war has overturned the comfortable status quo that has prevailed across Europe since the fall of the Berlin Wall. Gone are the days of ever-falling defense budgets and gone are the days of relying on Russia for cheap energy imports. Globalisation was already on the ropes and this crisis will only accelerate existing trends; investors need to factor in the consequences of these changes for years to come.

Between a Rock and a Hard Place

With Fixed Income markets consumed by news of a hawkish Federal Reserve, February looked set to be another negative month for bonds. 10-year US Treasury yields rose from 1.79% to 2.05% and markets priced in six 25 basis points base rate increases during 2022 in addition to a 50 basis points move at the March policy meeting. The invasion of Ukraine, an enormous geo-political event which shocked commodities and inflation markets (two-year breakeven inflation rates reached 4%), had a limited impact on US Treasuries – the traditional risk-off asset. This is surprising and highlights the degree to which inflation dynamics are guiding monetary policy.



Against this current backdrop, we expect more market volatility as the Ukraine invasion continues and the bond market expects a 25bps increase in the US base rate. With January's core US CPI reading at 6% and financial conditions tightening sharply, Jerome Powell finds himself between a rock and a hard place.

To add further pressure on the Federal Reserve, economic data in the US improved in February with strength seen in consumer confidence, manufacturing and retail sales. However, with monetary policy tightening aggressively, commodities approaching levels not seen since 2013 and 30-year mortgage rates up 40% in six months (reaching 4.3%), the odds are rising that US growth slows considerably throughout 2022. Emerging Market, European and Japanese economic data was weak and will likely worsen in coming months for Europe and oil importing countries. Given the US is largely isolated from the turmoil in Europe due to energy and food independence, US dollar assets could receive further haven flows as growth is likely to outperform most developed markets in the short term but, as the world is interconnected, growth will slow. This is why the bond market continues to believe the terminal base rate remains below 2%, which in turn caps how high longer maturity yields can rise.

In corporate credit, where we moved to neutral in January, spreads have continued to rise with the CDX investment grade index now at levels that previously prompted the Federal Reserve to abandon monetary tightening. Volatility is rising rapidly and liquidity in risk assets is falling. Taken together, alpha opportunities await, but for now uncertainty remains too high to add risk and we remain comfortable with our high allocation to government bonds. Within foreign exchange, the Australian dollar benefitted from a massive increase in commodity export volumes - increasing their terms of trade surplus substantially - while the Euro weakened as multiple risks impacted sentiment.

40%

The percentage 30-year mortgage rates have increased in six months.

6%

January's core US CPI reading.

Looking ahead, we expect short-term inflation to rise even further over coming months as pressures within the commodities market remain elevated.

However, we are now firmly in the realm of 'demand destruction' where higher prices choke off consumer spending. This is clearly shown by the price of US regular unleaded gas, which already exceeds \$4.00 per gallon, its highest level since 2014. The prices of other staples such as natural gas and food have also climbed substantially. Inflation expectations are rising again making it incredibly expensive to hedge out inflation risk. So, with global growth entering a slowdown, we remain cautious on inflation-protected securities. Given the heightened geo-political and growth uncertainty, we remain neutral duration across the curve and continue to have low conviction to position portfolios otherwise.

Commodity Price Shock

Global equity markets declined further in February. Growing concerns about persistently high inflation were compounded by Russia-Ukraine tensions escalating into armed invasion, elevating uncertainty around market projections for both economic growth and corporate earnings.

Most global economic sectors and regions declined during the month, with notable exceptions being the energy and materials sectors, which gained +5.2% and +2.1% respectively. Developed Markets held up better than Emerging Markets and Australia stood out with a +6.1% gain due to its high concentration of companies in the mining and financials sectors. Consumer Staples, Utilities, and Healthcare also held up well. The largest declines were experienced in Consumer Discretionary (with Tesla down -7.1%) due to its sensitivity to potential slowing of economic growth.





EQUITIES

-7.1%

The amount Tesla stocks
fell by in February

Information Technology (including market heavyweights Microsoft -3.7% and Apple -5.4%) and Communications Services (Meta Platforms -33%) came under increased pressure as interest rates continued to rise. Meta Platforms, the parent of Facebook, plummeted after projecting “a significant slowdown in advertising growth while embarking on an expensive, uncertain, multi-year transition to the Metaverse”. Competition from TikTok, along with Apple’s changed privacy policy, will both “have a bigger impact than expected in 2022”.

The events which unfolded throughout February trumped a positive stream of fourth quarter 2021 earnings reports and subsiding fears around the Omicron variant.

-33%

The amount IT Meta-
Platforms declined
in February

The message from most companies was that demand remains strong and continues to exceed their ability to meet it. While supply issues are becoming less severe, most companies do not expect to see a normalisation until later this year or even into 2023. Companies are making investments in expanding capacity, however expansion projects themselves are challenged due to supply and labour issues. Geopolitical events and sanctions compound those challenges.

Europe has been at the epicenter of the Russia-Ukraine crisis and this has been reflected in significant outflows from European equity funds. Scaled by assets under management, recent outflows have been comparable to the worst seen around the European financial crisis but not quite as severe as those seen during the Global Financial Crisis.

From a global perspective, inflows have remained resilient, especially in the US, and the Energy and Materials sectors have benefitted.

Overall, sentiment and positioning indicators remain mixed. While inflows into equities have remained strong, survey-based indicators are much more downbeat. The AAI Investor Sentiment Survey (a widely followed measure of the mood of individual investors) fell to -22, which is the 7th percentile based on historical readings. Valuations are now more attractive as prices have fallen, which bodes well for long-term investors. In the near term, markets will continue to be driven by news around the Russia-Ukraine conflict.



-22%

The amount the AAI
Investor Sentiment
Survey fell by in February.

Europe has been at the epicenter of the Russia-Ukraine crisis and this has been reflected in significant outflows from European equity funds.

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