Investment Views

FEBRUARY 2022

PRODUCED BY BUTTERFIELD

Strategy:

A New Tightening Cycle

Fixed Income:

Know what you own, and know why you own it

Equities:

Pricing Power in Focus

A New Tightening Cycle

It has been a tumultuous start to the year for both global bond and equity markets.

The primary cause has been higher than expected inflation which has forced central banks to respond by signaling their intention to tighten monetary policy and raise interest rates. US headline CPI inflation soared to a 40-year high of 7.5% year-over-year in January, above expectations of an acceleration to 7.3% from December's 7.0%. Other key inflation measures offered no relief as Core CPI (inflation excluding the more volatile food and energy components) surged from 5.5% to 6.0%.

We have written a lot about inflation over the past year. The debate raged over whether inflationary pressures were transitory and would fade away as the world reopened or whether the pressures were more persistent and would build on the back of excessive government spending to support economies through the pandemic. What complicates matters is the fact the pandemic has lasted a lot longer than many had originally thought. In the US nearly 9 million people missed work in late December and early January as the Omicron variant hit the labour market and stressed global supply chains were put under increasing strain. However, since late summer last year, it has become clear that inflation is broader than just pandemic-related distortions. It is therefore understandable that central banks have decided to act decisively.

Historically, markets tend to be volatile around the time of the first rise in interest rates as it takes some time to digest the impact of the turn of the monetary cycle. However, equities are often higher a year after the first rate rise. The challenge is that this cycle is very different to a usual business cycle. Typically, when interest rates start to rise, unemployment remains relatively high and economies have a lot of spare capacity to grow without inflation. While growth has been very strong, this time the unemployment rate is low and inflationary pressures are the primary reason for the hawkish change in direction from the central banks. Investors therefore need to be careful when using historical playbooks. This uncertainty has added to the volatility, with central banks themselves saying there is a need to be “humble, but a bit nimble”.

An old adage in investing is “stock markets take the escalator up and the elevator down”. The theory is that confidence builds gradually whereas panic and fear happen quickly - selling can trigger further selling. Looking back to the turn of the century an obvious exception is the period after the dot-com bubble.

7.5%

US headline CPI inflation soared to a 40-year high in January

9m

The number of people in the US who missed work in late December and early January due to the Omicron variant.

An old adage in investing is "stock markets take the escalator up and the elevator down".

25%

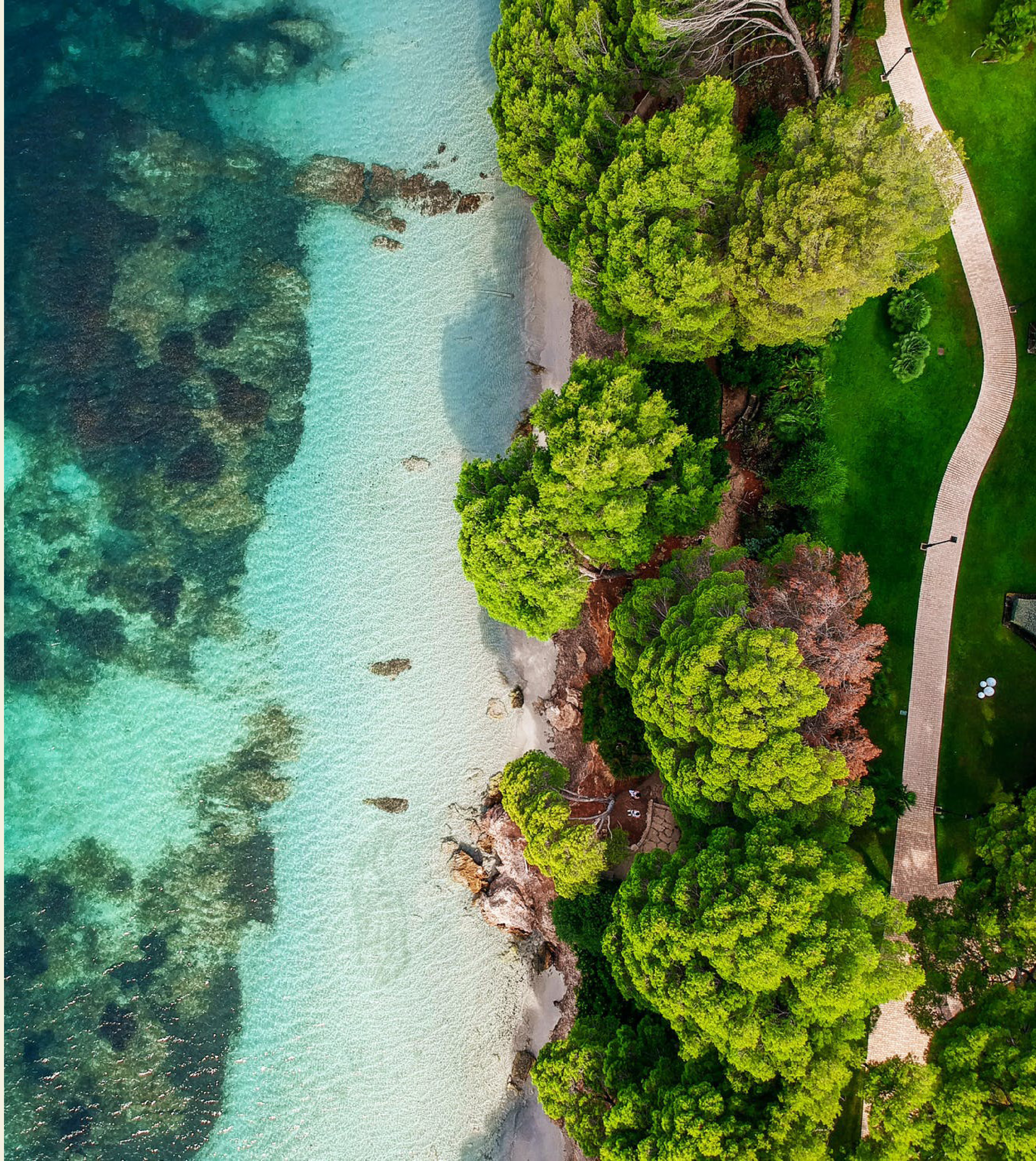
The amount the market fell over fears that the Federal Reserve would raise interest rates and the recent COVID-19 panic, before recovering.

This turned into a protracted bear market for approximately three years before equities finally bottomed out around 2003. However, since then the saying has been a more accurate reflection of market moves. Markets have generally grinded higher but have been subject to rapid drawdowns: the Global Financial Crisis in 20008/2009, the fourth quarter of 2018 sell-off due to concerns that the Federal Reserve would raise interest rates too far, too fast and more recently the COVID-19 panic, which saw the market fall around 25% in a matter of weeks before recovering rapidly. Between these sharp drawdowns, markets have seen small sell-offs of around 5-7%, which are a natural part of volatility inherent in investing. This dynamic has seen a 'buy the dip' mentality become ingrained in many investors; when markets have wobbled, there has been a sense of unease but before long, buyers stepped in and markets recovered.

Part of the reason for this has been that the policy environment has been very supportive and low interest rates have been an important pillar of this policy support, so a turn in the monetary cycle is an important development. Equity multiples are high by historic standards and multiples usually fall when interest rates rise, so earnings growth becomes of paramount importance. The earnings outlook typically hinges on the economic growth outlook but inflation pressuring profit margins is an added complication. The reopening of the global economy as the pandemic recedes should support growth this year but the outlook for consumers has darkened as inflation erodes real incomes and interest rates are now on the rise. We remain optimistic that growth will remain resilient. Given all the headwinds however, we have recently become more defensive in corporate credit exposure and cyclical consumer exposure within equities.

Know what you own, and know why you own it

Fixed income markets continued their roller coaster ride in January. Concerns over Omicron gave way to a much more aggressive central bank outlook across the world and policy makers were eager to send a signal to markets that inflation will be brought back to target and inflation expectations contained. The pivot from the Federal Reserve since the middle of September has been dramatic and can be best shown by the rise in two year US Treasuries, which have risen from 0.21% to 1.18% in the short space of four months, reflecting the prospect of 3-4 base rate hikes in 2022. With risk assets digesting this news relatively well, policy makers pressed on and floated a reduction in the balance sheet starting around the middle of the year.



This led to a much broader rise in volatility and risk assets have since struggled as bond yields rose even higher. With global growth slowing, energy prices spiking, geopolitical risks rising and leverage now higher than during the previous tightening cycle, the odds of a policy mistake are high. With Powell and Putin effectively controlling risk asset sentiment, we lack conviction in the outlook and therefore we have reduced corporate exposure to hedge tail risk, the first time in 10 years, adding to US Treasuries with the proceeds.

$88

The price of West Texas crude per barrel (a 17% increase)

Economic and market data has been extremely volatile this month with the massive move in global bond yields triggering not just a broad sell-off in equities but also a 20% rise in credit spreads. We also witnessed energy prices once again rise to levels that normally trigger economic slowdowns - West Texas crude at $88 per barrel (a +17% increase) and natural gas at $4.87 (+31%) - as Russia/Ukraine risks escalated and supplies remained tight. Economic data in China, Emerging Markets and Europe weakened over the course of the month but Japan and the US performed slightly better than expected - US Q4 GDP came in at +6.9% annualised.

Although inflation data remains very high - European CPI is +5%, UK +5.4% and the US +7% - we are seeing more evidence that supply chains are normalising at the same time as consumer demand is starting to falter. Combined with the fastest pace of global monetary tightening since 2004-2006, this should lead to a peak in inflation globally in Q1 2022. This has important implications for the path of US base rates as policy makers are now solely reacting to elevated price pressures, with the employment market no longer in any need of support.

$4.87

The price of natural gas (a 31% increase)

Portfolio positioning remains neutral duration in US dollar accounts as bonds now represent good value given the risks we face and we have been buyers of bonds during the last week of January in our US bond funds. Even though the Federal Reserve hasn't raised the base rate yet, and is even still actively purchasing bonds, the market has already priced in five 25bps base rate increases for 2022 with a 100% probability that this will start in March, and another two thereafter (reaching a terminal rate of 1.85%). A lot of hawkishness has already been discounted and we remain comfortable adding exposure to 2-5 year US Treasuries at these levels.

There continues to be much uncertainty as to the path of longer term interest rates

...with the New York Federal Reserve estimating fair value of the 10 year US Treasury at 2.16% vs current market pricing of 1.78%. Given the current economic growth and geopolitical risks, even long bonds have a sense of value surrounding them. "Know what you own, and why you own it" - the famous quote from Peter Lynch seems very appropriate for these times.

Given our January decision to reduce investment grade corporate credit exposure to neutral, we started reducing credit risk within portfolios but our already largely defensive positioning meant that we do not have much portfolio reallocating to undertake. Looking forward we expect default rates to return to historical averages and for credit spreads to widen as the market prices out the prospect of a blanket Federal Reserve 'put'. At this point, we would need to see a much firmer economic growth outlook, easier monetary policy and cheaper valuations before we lean back into risk assets. Emerging Market debt continues to be held as a hedge against a weaker US dollar and for its much cheaper valuations, which have already partially reflected tighter US monetary policy.

Pricing Power in Focus

Equity markets had a rough start to 2022 as increasing concerns about inflation fueled a surge in interest rates, triggering revaluations in many previously high-flying growth stocks. After generating a 22% return in 2021, the MSCI World Index declined near -10% in January, before partly recovering near the end of the month to finish down -5%. The downturn in the equity markets started early in January, coinciding with the release of the December Fed meeting minutes which highlighted an increasing probability that imminent monetary tightening could be paired with multiple interest rate hikes.

-5.7%

The percentage the US equity market fell in January 2022.

Above-target inflation, above-trend growth and a rapidly improving labour market suggest market turbulence is unlikely to dissuade the Fed from starting to hike rates. As long as tightening financial conditions are not expected to impede above-trend US economic growth, the Fed will tend to focus on fighting high inflation, not on supporting asset prices.

The bounce in the equity markets late in the month was aided by strong quarterly reports from market heavyweights Apple and Microsoft, both of which delivered continued strong profitability and positive outlooks. Apple's earnings shone despite global chip shortages and supply chain disruptions, while Microsoft provided investors with reassurance by maintaining solid projections for its high margin cloud-computing business. The bounce back in these mega-cap stocks masked much heavier price declines in many smaller and less profitable market constituents (some of which declined -40-50% from their peaks) as the technology heavy NASDAQ index finished the month down -9%.

15.6%

The energy sector was one of only two sectors to rise last month.

The US equity market fell -5.7%, lagging the rest of the developed world which declined -4.4%. The sectors which sold off most were Consumer Discretionary and Information Technology (despite Apple holding up better than the market at -1.6%), with Tesla and Amazon finishing the month down >-10%. Emerging Market exposures provided diversification, finishing -1.9% with China -2.5%. The only two sectors which generated positive returns in the month were Energy and Financials. The Energy sector soared +15.6%, with some stocks including Exxon Mobil and ConocoPhillips >+20% on higher energy prices. Banks gained +2.8%, with Wells Fargo and HSBC up >+10% on the expectation that rising interest rates will boost income.

A key question at this point is which companies and sectors will be able to weather the inflationary pressures. This means that pricing power has become an important question posed by analysts when companies have reported their fourth quarter earnings results. The extent to which companies can pass on higher input costs (raw materials, transportation, labour) is a function of pricing power - if prices rise what happens to the volume sold? Chipotle Mexican Grill, for example, hasn't shied away from increasing the price of its burritos and tacos whereas The Clorox Company has struggled to pass on higher costs to customers.

These diverging circumstances have been reflected in the relative share prices, with Chipotle up almost 10% after reporting results and flagging further price increases, while Clorox fell around 14% after highlighting the challenge of passing on higher costs. With the overall market challenged by higher interest rates, company specific factors are now very important as company fortunes diverge. This presents opportunities for active managers.

-9%

The NASDAQ index finished down on the previous month.

The only two sectors which generated positive returns in the month were Energy and Financials.

Disclaimer

This document and the information contained herein has been prepared and issued by Butterfield Asset Management Limited, Butterfield Bank (Cayman) Limited and Butterfield Bank (Guernsey) Limited and is for illustrative purposes only. It neither constitutes investment advice nor is it an offer or an invitation to acquire or dispose of any securities and should not be relied upon as such. Prior to making any investment decision a financial adviser should be consulted. Products and services are available in the respective home jurisdictions and only in those other jurisdictions where they may be legally offered or obtained.

The data source for this document is Bloomberg unless explicitly stated otherwise and is believed to be accurate as at the date of publication and may be subject to change without notice. Whilst every care has been taken in producing this commentary, neither the author nor Butterfield Asset Management Limited, Butterfield Bank (Cayman) Limited, nor Butterfield Bank (Guernsey) Limited shall be liable for any errors, misprints or misinterpretation of any of the matters set out in it. Past performance is not necessarily a guide to future performance. The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. In the case of some investments, you should be aware that there is no recognised market for them and that it may therefore be difficult for you to deal in them or to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain investments carry a higher degree of risk than others and are, therefore, unsuitable for some investors. Before contemplating any transaction, you should consider whether you require financial advice.

Butterfield Asset Management Limited is licensed to conduct investment business by the Bermuda Monetary Authority.
Registered Office Address: 65 Front Street, Hamilton HM12, Bermuda.

Tel +(441) 299 3817
www.butterfieldgroup.com/Investments

Butterfield Bank (Cayman) Limited is licensed to conduct securities investment business by the Cayman Islands Monetary Authority.
Registered Office Address: Butterfield Place, 12 Albert Panton Street, George Town, Grand Cayman KY1-1107, Cayman Islands.

Tel +(345) 949 7055
www.butterfieldgroup.com

Butterfield Bank (Guernsey) Limited is licensed and regulated by the Guernsey Financial Services Commission under the Banking Supervision (Bailiwick of Guernsey) Law, 2020, The Protection of Investors (Bailiwick of Guernsey) Law, 2020 and the Regulation of Fiduciaries, Administration Businesses and Company Directors, etc. (Bailiwick of Guernsey) Law, 2000, each as amended from time to time. Registered Office Address: P.O. Box 25, Regency Court, Glategny Esplanade, St Peter Port, Guernsey, GY1 3AP. Company registered in Guernsey No. 21061.

Tel +44 (0)1481 711521 Fax +44 (0)1481 714533
www.butterfieldgroup.com

Telephone calls are recorded for training, regulatory and security purposes.

BUTTERFIELD