Asset Class Commentary
April 2022

The conflict in Ukraine has added to inflationary pressures and has led to a challenging start to the year for investors.

UK consumers are facing the biggest cost of living squeeze in decades with the energy price cap rising by 54%, creating further pressure on already shrinking disposable incomes. At the same time, Brexit uncertainties are causing issues for small businesses and UK export trade. Stagflation is an increasing risk; the Bank of England recognises this and has adopted a more cautious approach to monetary policy than had previously been expected.

While markets have now priced in the war in Ukraine in financial terms and largely ceased reacting to news of the conflict's developments, the humanitarian cost of the war is hard to come to grips with and leaves all thinking about the Ukrainian citizens' struggle.

Major economies are already imposing strict sanctions on Russia for the atrocities, but the Ukrainian President is calling for further and tougher actions.

All eyes are now on the US Federal Reserve and its strategy to bring down inflation. It will be challenging to do so in a way which leaves economic growth unscathed and which avoids a recession.

The ECB's accommodating stance on monetary policy is coming under further pressure as inflation hits record highs. Something has got to give, and the ECB could risk falling too far behind inflation. The resulting actions may be quick and aggressive policy responses, which like the US will increase the likelihood of a recession.

Areas of Focus

- Inflation-linked securities continue to be in demand, while US government securities are experiencing their worst quarters on record.
- European equity funds are becoming increasingly unattractive due to the events in Ukraine. This comes only a few months after their place in portfolios had a brighter appeal and inflows were on the rise.
- The price of gold has increased as investors look for safety in a high inflation environment.
- Japanese equities may represent good value but a lot depends on the interaction between the Bank of Japan's (BoJ) monetary policy actions and a depreciating currency.
- Analysts recommend avoiding Chinese tech stocks in the short-term, while the long-term outlook is still uncertain.
- The cyclical nature of UK stocks have made them an attractive investment.
- Energy stocks continue to soar as commodity prices follow the same upward trajectory.

How far will Central Banks raise interest rates?

Inflation is persistently rising and Central Banks are rushing to respond to this by raising interest rates and sending signals to the market that further rate increases are on their way.

There are questions as to whether Central Banks are behind the inflation curve, and the answer is almost certainly yes. With the benefit of hindsight, the Federal Reserve's rhetoric last year that inflation was transitory could not have been more wrong and consumers are now paying the price for this misjudgement. The Fed is following in inflations path and needs to get to grips with the situation. It is likely that consumers will be living with high inflation rates for a while.

Predating the war in Ukraine, inflation in the US was already at a decades-high level. Current events have only made this worse and the latest reading in the US for February puts inflation at 7.9%. This is expected to reach 8.6% in March. Inflation in the UK reached 6.2% in February, the highest rate since 1992 and up from 5.5% in January. The BoE estimate this could reach 8% in June and could hit double digits by the year's end.

Inflation is often caused by overheating demand when economies reach the top of the business cycle. Central banks respond by tightening monetary policy, reducing their balance sheets and raising interest rates to reign in consumer demand and inject some much-needed disinflation (the slowing of the rate of inflation) to cool the economy.

In this case, the underlying cause of inflation is not overheating demand but supply issues and rising commodity prices. Globalisation, which has allowed many economies to grow, is now causing issues as the reliance countries place on each other for goods and services links one economy to another.

Central banks have indeed been tightening monetary policy by raising interest rates. The US Fed announced from their meeting in mid-March that their target interest rate is increasing by 0.25% and they intend to reduce the size of their balance sheet via quantitative tightening. They have halted purchasing any more debt and plan to reduce bond holdings in the coming months.

A further rate hike of 0.50% is on the table for May 3rd-4th and the market expects interest rates to finish the year around 2.25% - 2.5%. The overall tone from the Fed is becoming increasingly aggressive as senior officials take more hawkish tones, stating that rates need to increase (and quickly) to reduce demand and bring inflation under control.

There is a fine line between moving interest rates into neutral territory – to try and cool inflation while leaving growth untouched – and moving too quickly and too far, pushing the economy into a recession.

In the UK there have been 3 interest rate rises since December, with the interest rate currently sitting at 0.75%, in line with its pre-pandemic level.

The difference between the monetary response in the US and UK is that the BoE is adopting a much more cautious tone. They have recognised that while business confidence and the job market has remained strong, consumer confidence and the level of disposable income are dropping which will damage the growth outlook. A more careful path for rates rises needs to be taken. It should be noted that the UK has a bigger reliance on imported energy and events in Ukraine have affected the economy to a larger extent.

Central banks are in a tricky spot. Inflation is rising unchecked and needs to be controlled. Markets expected that rates will rise as the Central Banks are removing Covid-era stimulus that is no longer needed. Too much tightening will hit economic growth, leading to possible recessions or stagflation.

Inflation is being heavily pushed up by supply-side constraints and commodity prices, two factors for which there is no easy solution. The meeting of OPEC members on Thursday was received with disappointment as the members, led by Saudi Arabia, ignored calls to increase oil output. President Biden has announced the US will release over 180 million barrels of oil it holds in reserve to help control the rising oil price. This equates to an increase of 1 million barrels per day.

Increasing interest rates too far will damage employment and growth. Central Banks are signalling to markets that they can raise interest rates, put a lid on inflation and avoid this. The danger is the banks believe their own rhetoric and fail to appreciate the effects that policy decisions will have if rates are increased too far or too quickly. The Fed does not want to simply live with higher inflation and is using its policy tools to show it is doing something, having previously done nothing.

If the market no longer believes that central banks can control inflation with their policy responses then yield curves will rise further, as the risk premium demanded for holding fixed interest increases. Currently in the US (as at 28th March), the 5-year bond yield has risen above the 30-year bond yield, i.e. yield curve inversion, which signals an economy may be heading towards a recession.

The lack of increases in longer-term yield bonds suggest investors think is that policy tightening will be shorter-lived at the present time.

In terms of asset classes, government bonds are out of favour. Even as yields are rising, the real inflation adjusted yield will still be low/negative. In historic periods of supply-driven inflation, developed market government bonds have not been good portfolio diversifiers relative to other assets.

UK

Rising inflation, decreasing consumer confidence and smaller disposable incomes in the UK are weighing down on economic growth. Stagflation could be on the horizon. The Office for Budget Responsibility has forecasted that UK growth will drop from a projected 6% down to 3.2%.

The latest policy announcements from the Chancellor Rishi Sunak look to help with the rising cost of living, reducing fuel duty by 5p and increasing the threshold at which people start to pay NI contributions, while keeping the extra NI rate rise. Many critics argue that this is not nearly enough.

Recent data has shown that UK GDP grew by 1.3% in the final quarter of 2021, above the estimated reading of 1%. The UK is now 0.1% below its pre-pandemic GDP level in the final quarter of 2019.

Households' real income and savings dropped and there was lower spending growth. This all happened before the war in Ukraine.

Further data in the household savings ratio, which shows how much disposable income is saved, fell from 7.5% to 6.8%. This further cements the fact that households were starting to struggle before the Ukraine war and the energy price cap increase in April. Analysts expect that the BoE will not increase interest rates to 2% until next year.

While the UK consumer and economy face tough times, as of this year the FTSE indexes have still performed the best out of the major markets. This can mostly be attributed to energy and cyclical companies benefiting from the current market environment.

The investment outlook for the UK is still positive, although smaller cap stocks have struggled more than their large cap counterparts. Industries such as leisure and restaurants have had profits dampened by rising input costs.

China

Once again the investment case for China is up for debate and the answer as to whether it is a good investment opportunity depends on who you ask.

The Chinese government's decision to relax its regulatory tightening and ease monetary policy has slightly brightened the appeal of investing in Chinese assets – albeit only slightly.

New geopolitical risks have emerged which dampen the attractiveness and has caused investors to err on the side of caution. Chinese ties to Russia have caused concern, and their decision to not openly condemn Russia's invasion of Ukraine has disgruntled the US.

The Chinese property sector is also under immense strain as property companies face pressures to refinance. Corporate bond offerings from China have been very minimal this year as investors price these deals as high risk. US markets are requesting Chinese companies' hand over audited reports of their accounts or they risk being removed from US markets.

Given the Chinese property sector has been a big driver of growth, the current issues it faces and investors' decreased demand for the sector threatens growth going forward.

Covid levels in certain Chinese regions are increasing and the decision of the Chinese government to pursue a "zero-Covid" strategy by locking these regions down completely is a headwind for an already slowing economy. Easing monetary policy will attempt to bolster demand and growth, but the concern is that while China is easing monetary policy and other major economies such as the US are tightening monetary policy, China will experience capital outflows which will reduce the current yield advantage they enjoy.

Manufacturing and services data for March shows both sectors contracted under the Covid lockdown strains, putting further pressure on the economy.

In summary the outlook for China is far from certain. Over the long-term stock prices are ultimately driven by fundamentals and at the moment investors are focusing on the macro factors. Room for fundamental growth in Chinese companies is there, but whether investors are willing to take on the risks of investing in China and whether the Chinese government will re-introduce their strict regulatory policies will have a big impact on stock performance.

US

Over the last month the S&P 500 and the NASDAQ regained some of the ground they had lost so far this year. US treasuries have experienced their worst quarter on record. As shown by the Bloomberg Index of Treasuries, treasuries total return fell by 5.6% in the 3 months to March.

This is due to rising yields and falling prices as the demand for US treasuries declines over concerns surrounding inflation, rising US interest rates and the situation in Ukraine.

The outlook for the US economy is in the balance and until the Federal Reserve's policy decisions have been fully implemented we will not know with certainty what way the economy will go.

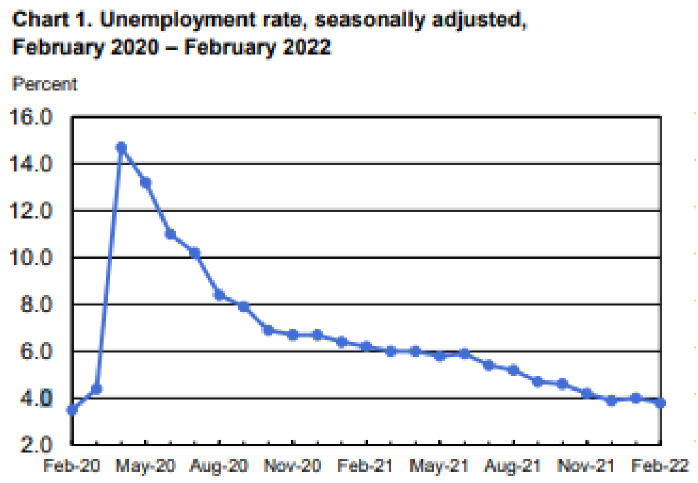
While some analysts believe the Fed can control inflation and achieve a "soft landing", avoiding a recession, others are more pessimistic.

Present issues relate to the Feds monetary policy framework of achieving an annual inflation figure of 2% and allowing for overshoots when this target has previously been missed.

The Fed's target was to not tighten monetary policy until inflation reached 2%, higher inflation was persistent and the employment rate had reached its maximum level to be consistent with 2% inflation. Under this framework the Fed has allowed inflation to overshoot and now it faces the task of bringing inflation back down while not damaging economic growth, which could lead to the US entering a recession.

This is problematic as inflation has risen to a decades high level (expected to be 8.6% in March). The Fed is behind the inflation curve and they will have to act more aggressively with bigger rate hikes to attempt to get inflation under control. We are already seeing this aggressive tone from senior officials.

The unemployment rate is currently at 3.8%, and the Fed will need to push this back up to be at a level consistent with inflation. This is because when unemployment is low, companies need to pay higher wages to attract workers as the supply of labour is smaller. Higher wages cause higher inflation as companies pass on these wages increases onto consumers, and the inflationary spiral continues.



Source – US Department of Labour

The increase in the unemployment rate will most likely need to be around 0.5%. History shows us that every time over the past 75 years when the unemployment rate has risen by this much along with monetary tightening there has been a recession.

All of the conditions are now present for tight monetary policy: high persistent inflation and a tight labour market.

While the Fed Chairman Jerome Powell has blamed unforeseen supply chain issues, which not many people predicted, the ultimate responsibility lies with the Fed. The dovish tone a year ago was that inflation would be transitory. As inflation is mainly supply driven, it was short sighted to see it as transitory – supply issues are structural in nature and are not quickly or cheaply resolved. We touched on the issue of supply in last month's asset commentary.

Even without the crisis in Ukraine, inflation would still be at unsustainably high levels.

Powell recently cited historic tightening events to try and reassure markets that the Fed is on track. In 1964, 1984 and 1993 the Fed tightened monetary policy and avoided a recession. The difference here is that in these cases the Fed did not tighten monetary policy enough to force up the unemployment rate and currently the unemployment rate is low and likely needs to increase.

The reactive nature of central banks framework means that when monetary policy action is taken, the reaction is a case of slamming on the breaks. This action is conducive to increased recession risk.

Minutes of the Feds March meeting have shown the Fed plans to reduce its overinflated balance sheet by selling up to $60 billion of US Treasuries and $35 billion of agency mortgage backed securities over a 3-month period. This is expected to equate to a 0.25% increase in interest rates.

The health of the US economy is globally important as it is the largest economy in the world. Any economic events in the US have global consequences big knock-on effects globally.

President Bidens announcement to release US oil reserves and fine any oil company that is intentionally not drilling or is hoarding oil will help to cool oil prices in the short-term. Other major economies also need to do the same and this would help to cool inflation without resorting to monetary policy and reducing the risk of recessions.

Japan

As investors look to readjust their portfolios due to tighter US monetary policy and slowing European growth, the question as to whether investment in Japan a good idea is reappearing.

While other major developed economies are tightening monetary policy, Japan is doing the opposite. The BoJ plans to increase its quantitative easing by buying 10-year government debt at a faster pace than before.

While other countries such as the US allow bond yields to move freely, the BoJ uses yield curve control to keep debt yields in a fixed range for given maturities. While the BoJ believes a depreciating currency will provide net benefits for the economy, the Japanese Ministry of finance is uncomfortable with the Yen's current level. It is expected that traders will test the BoJ policy decision to keep yields fixed in the coming months.

If monetary policy is tightened to support the Yen, we will see the Yen appreciate and equity values fall.

The interest rate in Japan is still at the -0.1% level and there are no plans to raise this until consumer demand-driven inflation kicks in.

As Japan is keeping a loose monetary policy and the US is tightening monetary policy, this has resulted in a depreciating Japanese Yen relative to the US Dollar which has seen the Yen fall by over 5% in March. This is creating both headwinds and tailwinds for Japanese businesses. A depreciating Yen means the import cost for businesses is rising, denting corporate profits, while at the same time export prices are increasing.

While prices are rising globally inflation in Japan is still meagre and the BoJ is trying to boost this along with economic growth. The main issue with Japan is that the country is set in a deflationary mindset which it is struggling to get out of – if prices are going to be cheaper tomorrow, consumers put off purchasing today to wait for a lower price. This spirals into a lack of consumer demand.

Analysts expect inflation to reach the central bank's 2% target in the next month or so. This would however come from rising commodity prices and would not be due to the sustainable consumer demand that the country needs.

In our view, whether Japan represents good long-term value rests on the following questions:

- Can sustainable consumer demand finally pick up enough for the BoJ to meet their 2% inflation target?

- Can the BoJ navigate its desired monetary policy while keeping the Yen at a level government and businesses are happy with?
- Will corporate culture in Japan enable businesses to reach their full growth potential?
- Will the barriers to foreign investment diminish sufficiently to make investment easy and attractive in the country?

Europe

Europe is the region that has been hardest hit by the Russian invasion of Ukraine, as they are heavily reliant on Russia for their energy imports. While Germany looks for alternative sources of natural gas and other commodities, there is a risk that countries will have to go down the route of rationing. Growth in the bloc will be hit hard, especially with inflation already at record levels.

Many expect Europe to react to the Russian atrocities reported in Ukraine with further sanctions and this is likely to dampen economic growth further.

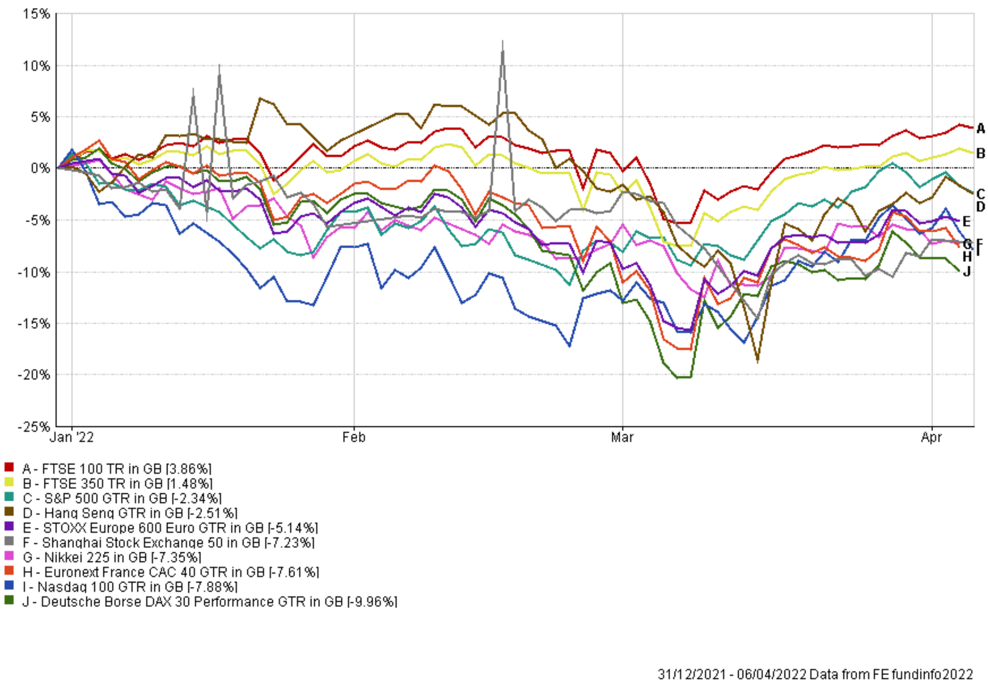
The ECB has a looser monetary policy stance than the UK and the US but inflation can only rise so far before European consumers will need to see a response.

Inflation readings in March showed EU inflation at 7.5%. Currently the EU base rate is -0.5% and analysts are expecting the ECB will have to bring forward rate rises this year. Current pricing puts rate rises at 0.63%, which will bring the rates back into positive territory for the first time since 2014.

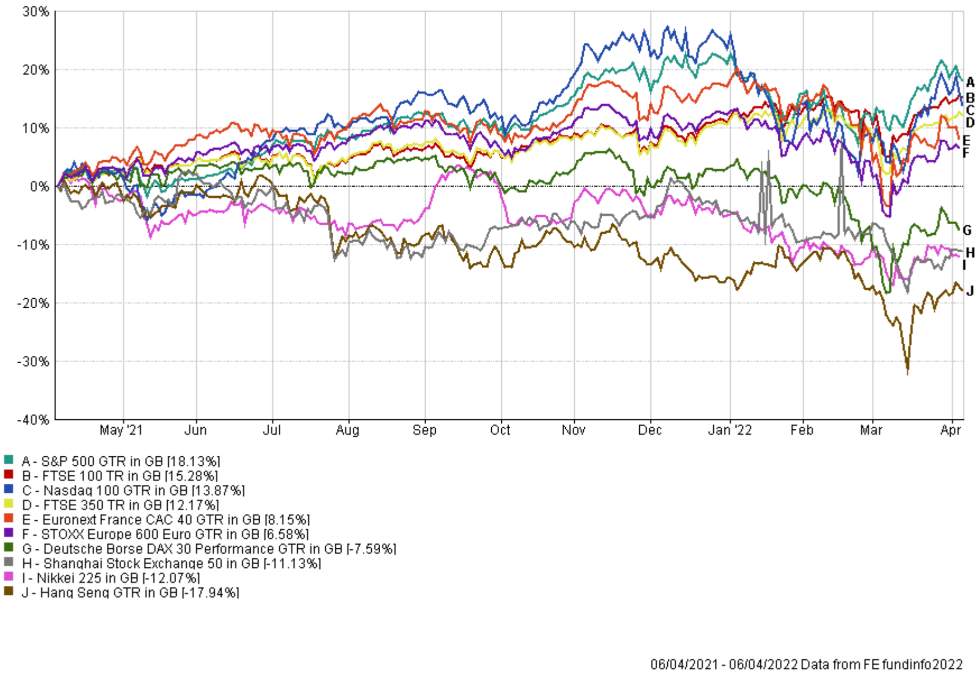
The only definitive plan the ECB has announced is that they will stop net bond purchases by September this year.

There is a now a significant concern that the EU will fall into recession, as the war in Ukraine weighs down on slowing growth.

This is reflected in the record outflows from European equity ETFs (of $5.5 billion), almost entirely due to the fallout from the war in Ukraine.



YTD performance of major stock market indices



1 Year performance of major stock market indices

Fixed Income

Government securities have been battered by outflows as the risk premium for holding the securities rise.

Not surprisingly investors have flocked to inflation-linked securities in the last year as the interest they pay and the principal at redemption rise and fall with inflation. Equities are still favoured over government bonds but as the risk of a recession rises, government bonds remain an essential component in portfolios to ensure a diversified asset allocation.

Commodities

As mentioned, OPEC members have so far ignored calls to increase oil supply output while President Biden has ordered the release of oil barrels from the US oil reserves in a bid to bring down oil prices.

While on the face of it this may seem like a good idea, there could be several problems. The first is that Biden has called on other countries to do the same and these calls may be ignored, reducing the impact of such a plan.

Furthermore, this is only a short-term solution and how far it will actually cool oil prices is unknown. Since the announcement prices of brent crude oil dropped to just below $105 a barrel.

Some analysts think this action of releasing reserves could cause further panic when investors and consumers are already risk adverse. It also presents the problem of how reserves will be topped back up in future when supply is already tight.

With lots of uncertainty in the markets, investors have once again moved to the safe haven of gold. Inflows into gold ETFs reached a record high of $11.3 billion in March, which helped to push the price of the precious metal to a near all-time high.

Robert Dougherty, April 2022.

This article is not a recommendation to invest and should not be construed as advice. The value of an investment can go down as well as up, and you may get less back than you invested.