Watson French
INDEPENDENT FINANCIAL PLANNING
& INVESTMENT MANAGEMENT

Asset Class Commentary May 2022

GDP, inflation and unemployment rates are being closely watched by investors as prices continue to rise and investors disagree on how central banks should proceed. While economic performance and financial market performance is not correlated, inflation is dominating investor sentiment and this is driving markets lower.

Markets are questioning the Federal Reserve as to why they have not explained their lack of policy action in the last year. The Federal Reserve has changed its stance on the current economic conditions on several occasions and now investors are questioning their understanding of the inflationary environment. This degrading confidence in the world's most powerful central bank is a big area of concern.

The ECBs stance on tightening monetary policy is beginning to change, although a rate rise is not likely until July and the risk is that by this time, inflation could be even further out of their control. This follows the narrative most developed central banks have followed in the past year.

The possibility of a recession in major economies is becoming more real, but investors have different views on the path economies will take.

China's zero-covid policy has caused further problems for both its own economy and for the global economy. Lockdowns have caused delays in manufacturing, shipping companies have reported extended delays for the unloading of their ships, and it has also been reported that lorries have been dumping their cargo on the side of the road as they face huge delays.

The EU's decision to impose a ban on using Russian energy will almost certainly damage domestic businesses. Oil prices have not moved much but this could be more down to the lockdown in China lowering demand for the time being.

Areas of focus

- Tech and discretionary stocks have struggled since the beginning of the year as consumer staples and energy businesses are in demand.
- US markets have seen poor returns this year and investors do not think they have reached the bottom yet.
- Chinese stocks are struggling and zero-covid policy measures in the country are further dampening their appeal.

- Returns in fixed income are difficult to come by, but this asset class could prove to be more important going forwards, as the possibility of recessions increases.
- Gold has proved its worth as a safe haven asset but with interest rates increasing, the cost of holding the precious metal is rising as well.

UK

In its meeting on Thursday, the Bank of England Monetary Policy Committee (MPC) raised interest rates by 0.25% to 1%. The BoE faces difficult decisions in how high to lift interest rates and it has decided to hold off on unwinding its balance sheet for the time being, instead looking to start sales of government bonds in August at the earliest.

Bleak economic forecasts followed this meeting with the BoE predicting a recession in the UK by the end of 2022. GDP now is forecast to contract by 1% in the fourth quarter of this year.

The rhetoric of the BoE and the Federal reserve is very different. While the Fed is trying to convince investors they can bring down interest rates and avoid a recession, the BoE has signalled to investors that they are not confident they can do this.

This less aggressive nature has been a factor in the depreciation of the GBP against the USD.

There are differing views on how inflation can be brought down and which way is the best is a now an important debate.

Some investors believe a weakening economy will help to bring inflation down on its own. Consumers will have smaller disposable incomes due to rising energy costs and food prices. This will have an effect of slowing the economy down naturally as demand decreases, which will result in slowing price increases. Lower incomes today means lower inflation tomorrow.

Other investors and officials alike believe higher interest rates are needed to bring inflation down and avoid inflation sticking at high levels. Three members of the BoE's monetary policy committee believe higher rate rises are needed to stop this from happening. This is to stop inflation expectations from becoming ingrained – essentially, if consumers believe their money will be worth less in a year's time, they could accelerate planned expenditure despite the rising costs of energy and food.

Regardless of the actions of the BoE, inflation is now expected to reach at least 10% this year and could push even higher.

Consumer confidence has unsurprisingly dropped to near record lows as the cost of living and lack of government support bites into consumer disposable income. This is reflected in retail sales data, which have dropped in the last month (both online and physical) by 1.4%.

Growth in GDP slowed from 0.8% in January to 0.1% in February, below analysts' expectations. Further data to support falling consumer demand comes as one in five businesses have reported lower revenue streams. The hospitality sector has particularly struggled with one in three businesses reporting lower revenues.

Pressure on the government to impose a windfall tax on energy companies' soaring profits is increasing. There are both positives and negatives to this idea but the likelihood of it being implemented is low at the present time.

While it would certainly provide increased tax revenue for the government to help assist consumers with the increasing cost of living, it will affect how much cash these companies have available for investment in cleaner energy in the UK. If it is implemented we will see energy companies profits fall and so will their share prices to reflect lower profits.

Financial stocks such as banks are expected to perform well again as any rate rises will boost their profitability. If we dig deeper into this sector, insurance companies also have the potential to lead the way. The asset side of insurance companies' balance sheets will see greater returns from higher savings rates, while the value of their liabilities will reduce as they are discounted at an increased rate. This amounts to a more valuable business.

Firms that are able to pass on rising costs onto consumers are still performing well. These include consumer staple firms and big, well-known businesses such as Unilever. FTSE 100 companies that receive their revenues in USD will also benefit from a depreciating currency.

YTD the FTSE 100 and FTSE 350 are still the best performing indexes out of the major economies. They are also the only indices that have posted positive returns YTD, driven by their overweight in financials and energy firms relative to other indices.

Data showing consumer confidence index in the US (blue), UK (red) and OECD (black) (Source – OECD)

China

With Covid cases rising in China the government has adopted strict restrictions to stop the spread of the virus. This combined with rising US debt yields and an already slowing economy has resulted in sharp losses from Chinese equities and bonds.

These restrictions have caused further supply issues and the global effect of this will be felt in the coming months and the extent of the damage will depend on how long the lockdown measures are in place for. It could help to push prices even higher and will certainly exacerbate supply chain issues further.

Throughout the pandemic investors have used Chinese fixed income as a source of higher returns due to their yield advantage over developed economies which had loose monetary policy. Now with US yields rising the yield advantage has disappeared and investors have sold over Rnb193 billion worth of renminbi-denominated debt.

This has resulted in a depreciation of the Chinese Yen relative to the US Dollar. While a weaker currency should help Chinese exports in theory and support economic growth, some analysts question whether this will be the case due to the way currency changes affects domestic income distribution in a country whose domestic saving levels are greater than the domestic investment levels.

The target growth rate that Beijing is aiming for is 5.5% this year. The issues in the property sector which have provided much growth in past years, strict covid lockdown measures and a depreciating currency are making this a difficult task to achieve. If looser monetary policy is required this will only make the situation worse for fixed income.

Short-term investment prospects in China are getting bleaker and the longer-term prospects are still unclear. The prospects for long-term growth are still present, that mainly being a growing middle class consumer base. The risks of over-interference of the government are always there and will deter investors for years to come.

US

US 10-year treasury yields rose above 3% on Thursday, double the level at the start of this year. Higher yields show a decreasing demand for these bonds as prices move inversely to yields. When prices fall due to increased selling, yields rise. This has the effect of raising borrowing costs for companies and discounting equity cashflows to lower values.

GDP growth in the US contracted for the first three months of 2022 by 1.4% on an annualised basis when compared with the previous year. This equates to a 0.4% fall in GDP compared to the previous quarter and is due to decreased exports, increased exports and weak inventory growth.

That came as an unexpected surprise, but domestic demand still looked reasonable as personal consumption grew by 2.7% in the first quarter and business investment also rose.

The risk of a recession in the US is increasing and more investors are assessing the risks and probability of an economic downturn.

The inversion of the yield curve with 2-year US government bonds yielding more than 10-year bonds in late March was a signal investors believe a recession could be on the horizon. There are however many doubts over the reliability of this indicator and the time between the inversion of the curve and the time of a recession varies widely.

The NASDAQ composite index (which is tech heavy) fell 7.8% in April, its worst month since 2008. The S&P 500 also fell 4.2%.

At the Federal Reserve meeting this week the Federal Funds rate was increased by 0.5%. Further interest rates rises are expected at the upcoming meetings. Initially investors found dovish tones in comments made by the Fed chairman Jay Powell. The possibility of a 0.75% rise was not as high as investors had expected. Markets initially reacted positively with the NASDAQ rising. The next day the NASDAQ reversed this gain and fell 5%.

Investors initially bought into the dip in the market and later decided that they did not think that this was the bottom. Tech stocks and consumer discretionary stocks still have further to fall. US government bonds are not yet at the bottom of their slump with yields expected to rise further still.

The market agrees interest rates in the US need to rise to a neutral level. This would be a level at which unnecessary stimulus is taken away while leaving economic growth undamaged. The Fed acknowledges this but in actual fact, the neutral level is unknown. When inflation is at 2% this neutral level is around 2-3%. With inflation at much higher levels the neutral level is potentially around the 5% mark.

The Fed has said it will not hesitate to go above the neutral level to control inflation and the risk of overshooting the neutral level is therefore high.

US 10-Year treasury Yield YTD (Source – Marketwatch)

Europe

Europe’s reliance on Russian energy is making the economic situation in the bloc very uncertain. While buying Russian gas is helping to finance the invasion of Ukraine, if Europe stops buying Russian gas the gap will not be easily filled. Investors warn that an EU ban on Russian natural gas would result in one of the deepest recessions in the eurozone.

This is because, among many other factors, consumers' energy would be rationed and business productivity and output would drop. Consumers would not be able to go to work as their transport would be restricted. This would also result in lower incomes as businesses refuse to pay for workers who cannot work.

In Germany, experts would expect output to be down by 2.2% and unemployment up by 400,000 in 2023. Although this would not be as high a drop in GDP as other periods, the cumulative impact is expected to be greater.

The chemical and steelworks industry in Germany would also lose its global competitiveness.

Last week the EU had agreed to ban thermal coal imports from Russia. This will hit Germany particularly as they are the biggest importer of coal in the EU. These restrictions will be imposed by the end of the year.

The momentum for the ECB to raise interest rates is increasing and there are expectations for an upshift in the negative borrowing costs that have been present in the bloc for eight years. Currently the borrowing rate is minus 0.5%.

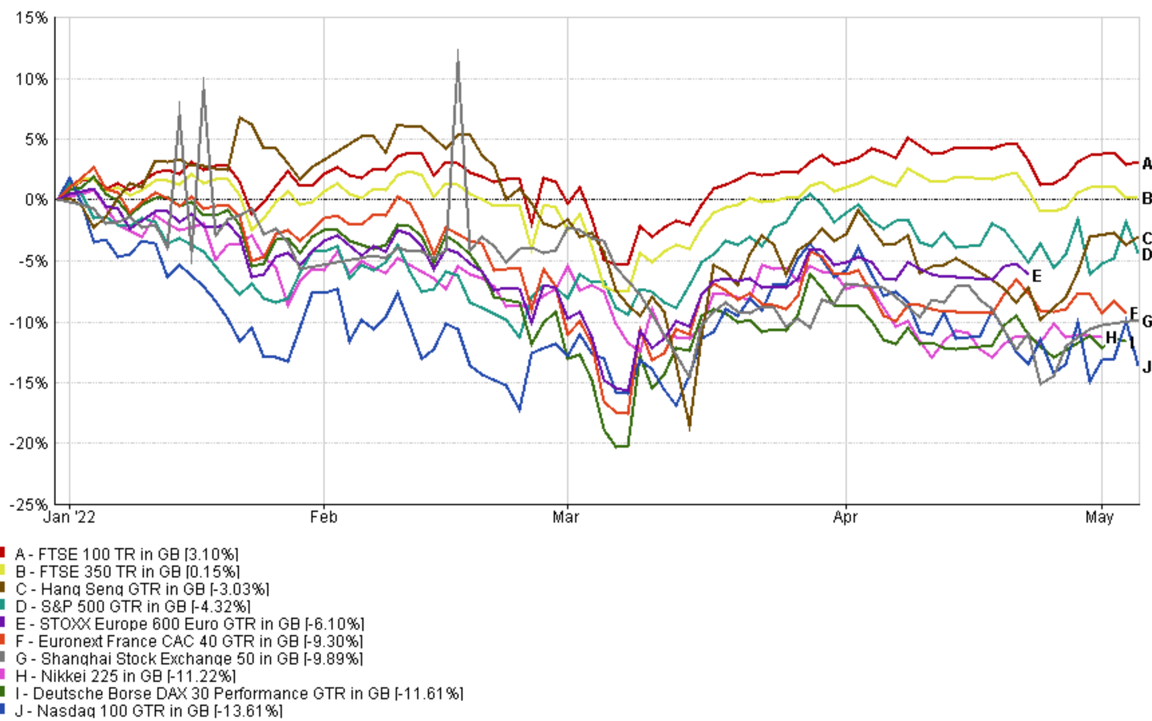
This comes as the ECB starts to worry about inflation – the readings for April show inflation at 7.5%. The decision to restrict oil imports as well as imports of thermal coal will only further push up the inflation readings for the coming months. The risk of a recession this year in the bloc is rising, although economists think it is more likely in 2023.

Countries in the Eurozone such as Italy have benefited from historically low interest rates as Italy's government debt is more than 150% of GDP. To put this relative to other countries, Germany has a government debt to GDP ratio of 59%. Rising interest rates will make servicing this existing debt more expensive and this weighs down on the economies of European countries which have long been able to finance growth through extremely low rates.

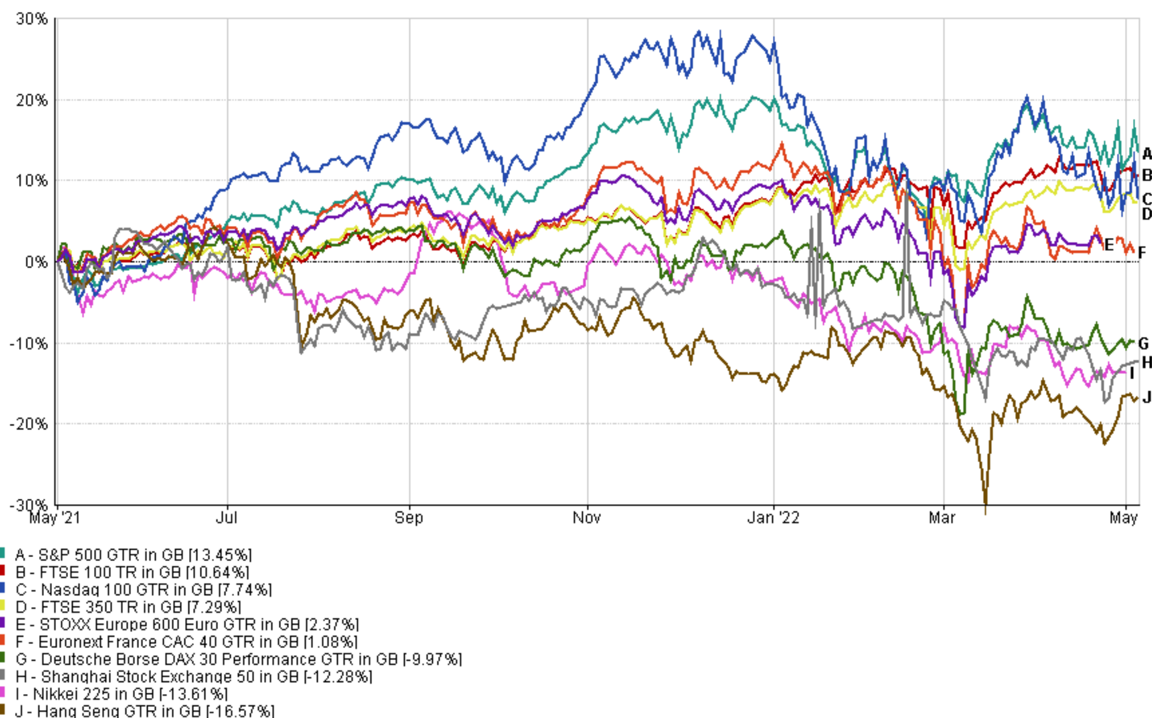
A further issue European countries face is that a lot of financing they receive comes from China. Countries such as Greece have used Chinese borrowing to finance projects on which no one else would lend. The debt covenants include terms such as the Chinese government can make political concessions if the debt is defaulted upon. Rising refinancing costs does increase this risk in the longer-term.

European stock markets have experienced negative performance YTD with the German DAX 30 down over 11% so far. Industrial companies are likely to continue to suffer going forward as the impact of higher costs and also restricted energy sources weighs on output.

The sustainable energy sector, of which Europe is a leader, has experienced negative returns as investors' preference for traditional energy companies has increased as higher energy costs are helping boost their profits.



YTD performance of major stock market indices



1 Year performance of major stock market indices

Fixed Income

Fixed income has continued its poor run of returns with yields again on the rise. There was some respite this week as investors sensed dovish undertones in the Feds policy meeting minutes and this initially sent yields slightly lower. These gains were then reversed as investors decided this was not the bottom of the market and sold off government bonds once again.

Yields are not expected to rise too much further and this could represent a good buying opportunity.

Although inflation-linked securities benefit from rising inflation, they are not immune to losses when interest rates rise and this is being seen across the sector. That said, these bonds are still providing protection against increasing inflation and are seen as a preferable asset at the present time.

Commodities

While most asset classes have fallen this year, the safe-haven asset of gold has been one of the few positive performing asset classes. The price did take a small hit in April, dropping by 1.6% in US dollar terms. This was mainly due to a rising US dollar and rising interest rates.

As interest rates rise the opportunity cost of holding gold increases, decreasing the relative value of gold.

Historically the US dollar and the price of gold have had a negative correlation. As the US dollar increases in value due to an increased hawkish stance on monetary policy, the price of gold theoretically decreases. If the goal of investors is to hold gold for the risk protection it offers then we should see a continued increase in the price regardless of the direction of the US dollar.

The relative value of holding gold for protection has been called into question in recent years and investors have looked to alternatives such as property and infrastructure. However, these sectors would both suffer in the event of an economic downturn.

US Dollar

The US dollar has strengthened against most currencies recently including GBP (the pound is at a two-year low relative to the dollar). The USD is currently as a 20-year high versus the USD index.

What this means for the US is that businesses that rely on exporting their products will find they will be exporting at a higher price which could make them less competitive. Importers will be able to bring in products at a cheaper price and this will help domestic businesses. It should also help to lower inflation as imported products can be bought at a cheaper price.

For some UK businesses a strengthening dollar is beneficial. Many companies in the FTSE 100 book their profits in dollars and then convert these back to pounds sterling. A strengthening

dollar means their dollars can buy more GBP. When the value of the pound falls relative to the US dollar the FTSE 100 tends to rise.

As the UK imports more than it exports, for the economy as a whole a weaker pound is not beneficial. Importing goods at higher prices will increase the prices of goods and push inflation up.

One of the biggest risks from a strong US dollar is in emerging markets. Less capital is likely to flow into these higher risk markets as safer and increasing returns can be achieved in US markets. When emerging economies need investment the most it is often taken away.

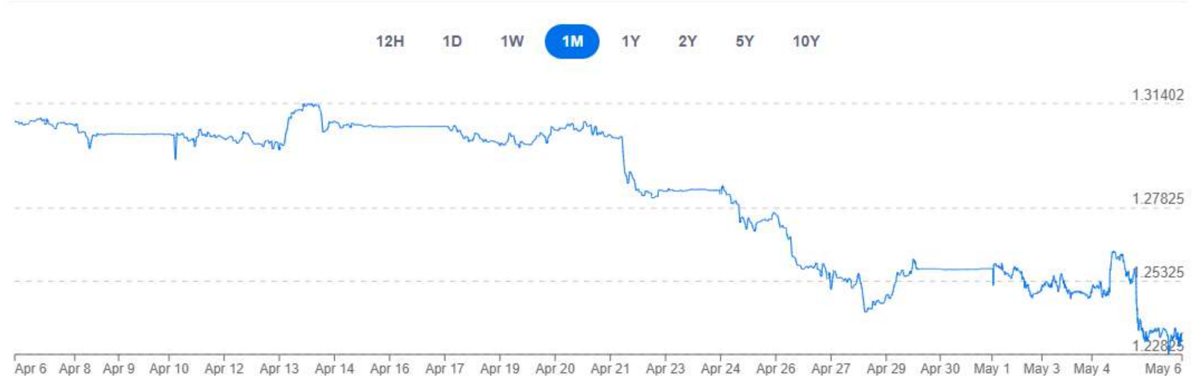
The second problem is many emerging markets obtain financing in USD-denominated debt. During the pandemic when interest rates were low and economic growth in emerging markets was down, emerging economies shored up their economies by taking out cheap USD-denominated debt. Now interest rates are rising and the US dollar is strengthening these countries will find it more expensive to service this debt, as their local currency will be depreciating relative to the USD. When they come to refinancing they will also find it more expensive as interest rates will be higher.

Emerging economies find the need to increase their domestic rates to help lift their currency. This creates more pressure as their own debt becomes more expensive and economic growth is restrained further.

Emerging countries which are most vulnerable to a stronger USD are Hungary, Peru, Turkey and Poland according to the US Fed.

The US dollar has strengthened mostly due to the more hawkish stance the Fed has taken over interest rates. As the interest rate is expected to be increased more aggressively, the demand for the US dollar increases as institutions and savers can earn more interest per unit of currency in a US savings account.

USD Index (DXY) YTD. The UDS index tracks the USD against a basket of 6 currencies. (Source – Marketwatch)



GBP to USD Currency exchange rate over 1 month (source XE.com)

Robert Dougherty, May 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.