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OUT OF THE ORDINARY

04 March 2022

# Market commentary

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## Overview

The events in Ukraine are tragic – and our thoughts are with all those affected in any way by them.

It remains incumbent upon us as stewards of our clients' wealth to continue to plot a course through what are becoming increasingly tricky markets. The Head of Trading at one of the major investment banks explained very honestly and succinctly in a recent end-of-day commentary: "The old mantra of 'hope is not an investment strategy' really hit home today as several client conversations have involved using the word 'hope' in the same sentence as words like 'escalation' and 'nuclear'... not exactly the kind of stuff you'll find in any textbook about stock investing and symptomatic as to how detached current market dynamics are from tangible anchors."

## What history might tell us

The first instinct of investors in such circumstances is to look for historical precedents. There have been a lot of notes and charts doing the rounds, which, at first glance, offer encouragement. There has been analysis of what sort of returns to expect from markets following the first interest rate rise in the cycle, a ten percent equity market correction and major geopolitical events, including wars. And the odds are very much on investors' side, with more gains than losses, as well a decent average percentage gain.

For example, in the last category, Goldman Sachs (among others) point out that the S&P 500 Index has risen, on average, 8.6% over the twelve months from when an event began, with a 75% positive hit rate. Their list of twelve crises starts with Pearl Harbor in 1941 and ends with the Iraq War in 2003. That might sound like a ringing endorsement of a "buy on the bullets" strategy but fails to take account of the background conditions. The biggest "win" was the 33.1% gain following the outbreak of the first Gulf War in 1991.

What the bare market data fails to relate is that the Federal Reserve (Fed) had already started to cut interest rates in October 1990, having engineered a recession, and would continue to do so throughout 1991. Today, the Fed is on the cusp of tightening policy to combat inflation. Similarly, the 28.4% gain that followed the invasion of Iraq in 2003 followed one of the worst bear markets in history, from which we had only reached the foothills of recovery. Today, most equity markets are still within touching distance of all-time highs attained in just the last few weeks, following one of the most powerful bull runs in history.

While we would not necessarily want to predict that the outcome now will be similar to those that followed the Arab Oil Embargo (1973; -36.2%) or 9/11 (2001; -18.4%), the inflationary backdrop in the former case and the unwinding of excess valuations and market leverage in the latter are much more analogous to the present.

## What to look out for

In addition to the escalation of the situation in Ukraine, the most important factors in the months ahead will be inflation, central banks' reaction to it and the effect on the economy. By mid-February, markets had largely made up their mind that central banks were about to administer higher interest rates (already started by the Bank of England) and shrinking balance sheets (known as Quantitative Tightening or QT). This was in response to persistently high inflation, with year-on-year consumer price index gains reaching levels not seen for three or four decades. Interest rate expectations shot up, administering a 'rates shock' to financial assets, which undermined valuations, especially those of unprofitable 'long-duration' companies. The situation was exacerbated by a rapid unwinding of speculative and leveraged positions.

By mid-February, investors were already beginning to anticipate a policy-induced slowdown. Various indicators started to signal the need for a more dovish attitude from the Fed before it had even started to tighten policy. The rates shock was in danger of developing into a 'growth shock'. Another factor in those average equity market returns referenced earlier is that the worst outcomes are accompanied by (or are the result of) a recession. Even the distant whiff of a potential one was unsettling.

And then came Russia's invasion of Ukraine. This is not the forum in which to discuss the motives behind the move. We accept that it has happened and must deal with the facts as we know them. And with that in mind, it is also probable that new facts will have evolved between the writing and reading of this commentary. At the time of going to press, our central view is that the theatre of war will not expand beyond Ukraine's borders, and certainly not into NATO-member countries. Perhaps that does fall into the 'hope' category, but it is the highest probability outcome given what we know and the expert opinions that we have been exposed to. But it is also clear that Ukraine has not proved to be the pushover that Putin may have expected and that the conflict could drag on with the threat of much greater disruption to supplies of commodities including oil, natural gas and grains.

There is a wide range of possible outcomes, although it is almost impossible to assign exact probabilities to them. The most benign would be that Putin realises the error of his ways, packs his bags and goes home. The worst, and worryingly more believable than the best, would be an escalation beyond Ukraine and/or the use of tactical nuclear weapons.

### A Central Bank response?

Who would be a central banker in such a situation, caught between the Scylla of politically toxic inflationary threats on one side and the Charybdis of slower growth on the other? And all the while trying to read the mind of a devious and capricious invader. Somehow, they will have to steer a perfect course, tightening policy sufficiently to dispel the fear that they might lose control of inflation, but without sending economies into recession. Investors were already fearful that central bankers don't really know at what level the equilibrium, or neutral, interest rate lies (R* in central bank shorthand). That is the level at which supply and demand for capital and labour are evenly matched. They will have to tighten policy until something breaks to find out.

Another potential source of support for financial markets would be the exercising of the 'central bank put'. This stems from the belief (and precedent) that central banks will not allow equity markets to fall too far owing to the risk of financial contagion into the broader economy. Excepting the special circumstances of the outbreak of the Covid-19 pandemic, the put was last exercised at the end of 2018 following a 20% market fall. But that was during a period of much lower inflation and when the Fed had a decent amount of ammunition to cut interest rates. They are still at zero. Maybe it will come in the form renewed Quantitative Easing.

Re-reading the commentary so far, we acknowledge that it must sound as though it errs towards gloom and doom. That is not the case, although we do retain a cautious stance within our tactical allocation. But it definitely feels like a period in which we should focus more on limiting the risks than maximising the rewards, at least until the fog of war lifts.

## Global markets

### US

During February the NASDAQ Composite Index fell into 'bear market' territory when it traded 20% below its all-time high, which was reached as recently as 19 November 2021. The broader S&P 500 Index entered a 'correction' by falling more than ten percent from its peak, a level that it reached on 3 January this year. The teams 'bear market' and 'correction' are emotive, perhaps only gaining currency because of humanity's obsession with round numbers divisible by ten. Is a market that falls 19.9% really that different to one that falls 20.1%?

It gets worse. Bank of America pointed out that on the day of Russia's invasion of Ukraine, 73% of the constituents of the NASDAQ were in a bear market. That must at least have meant that 27% were not, which gives succour to those, such as us, who continue to believe that active fund management has merit. No doubt some companies had been trading at excessive valuations, riding a tide of liquidity and speculation. They have fallen back to earth. But it has been notable in our conversations with external fund managers that we continue to hear about businesses they are invested in which are generating high returns and have strong growth prospects. The market is going through a painful period of sorting out the sheep from the goats. We are of the opinion that we will be left owning an attractive flock.

### UK

The UK market continued to perform well throughout February, closing the month in positive territory for the year so far. This is quite a turnaround from its pariah status for much of the last decade, especially since the Brexit referendum. There is no doubt that it was under-owned by global investors and last year several well-known companies were the subject of bids from either other corporations or private equity companies who sensed a valuation opportunity. One high-profile UK fund manager we recently met continues to bemoan the fact that the UK-listed companies he owns look unfairly cheap relative to peers in other markets, especially the US. We tend to agree with him and share his enthusiasm for some of the names that he has in his portfolio. But the real reason that UK indices have prospered relative to others is composition and so sector preference will have been much more important than country selection. The UK's large energy and mining sectors have benefitted from rising commodity prices, and (at least until the last two weeks of February) banks were also helped by the prospect of higher interest rates.

### Europe

Europe's proximity to the crisis in Ukraine has put it firmly in the line of fire. According to Capital Economics, no individual European country has more than two percent of its economy directly linked to trade with Russia and the whole European banking system's exposure is less than 0.2% of assets, with Austria and Cyprus being the most exposed. There is nothing here to suggest an economic meltdown or a systemic financial crisis. But, Europe's Achilles heel, at least in the current context, is its dependence upon natural gas from Russia. Some 40% of the continent's needs are met by pipeline flows from the country upon which it has just imposed economic sanctions. Natural gas retains a large share of primary energy consumption in many countries. Italy is the biggest user, with gas fulfilling about 40% of its needs. At the time of writing, there had been no actual disruption to supplies, although prices spiked higher in anticipation of disruption at a time when inventories are limited. Indeed, even though Spring is in the air, consumers, investors and traders are speculating on shortages developing, and there is a risk that those shortages lead to temporary closures in certain industries, in turn lowering overall economic growth.

## Emerging Markets

We rarely mention the European constituents of Emerging Market (EM) indices. And anyone who has visited Poland, which is defined as an EM, might struggle to differentiate its charms from those of parts of Germany or Austria, both Developed Markets in the eyes of index compilers. The Czech Republic, Hungary, Turkey and Greece are the other European EM constituent countries. Remarkably, given economic mismanagement and a plummeting currency, Turkey is the best performer of the group, falling 4.9% so far this year. No doubt a devalued lira is helpful to its exporters. The laggard is Hungary, a country with closer ties to Russia. Its main index has fallen 28% this year. But nothing comes close to Russia itself, with most of its financial institutions cut off from the Western world. The full extent of the damage was unknown at the time of publication because Moscow's main MOEX Index has not reopened since 25 February. It closed down 36% for the year to date on that day, but the London Depository Receipts of Sberbank, Russia's largest bank, are down 99%. But, to turn an idiom on its head, one man's poison can be another man's meat. The indices of resource-rich EMs including Brazil, Chile, Peru and South Africa can point to positive dollar returns so far this year.

## Fixed Income

Bond market volatility has risen enormously since the start of the year, with both real and nominal yields moving in wide ranges. The year began with a 'rates shock', following the release of minutes from the Fed's December meeting which revealed a much more hawkish tone that expected. This was backed up by statements from January's meeting. The US two-year Treasury yield shot up from 0.73% to 1.6% as the market priced in at least six quarter-point interest rate rises this year. Ten-year yields rose from 1.51% to 2.04%. As this was seen as an affirmation that the Fed was on top of inflation, breakeven rates (the market's view of future levels of inflation) remained fairly subdued.

This had the effect of pushing real interest rates (the difference between nominal rates and inflation) up sharply, with the US real ten-year yield rising from -1.1% to -0.42%. Real rates are a key component of discounted cash flow-based equity valuation methodologies, and the rise in the real discount rate explains much of the subsequent sell-off in equity markets. The peak of tighter conditions came around 10 February, but the anticipation and then reality of the outbreak of hostilities in Ukraine turned the bond market on its head, with yields falling rapidly as investors sought out safe havens. And with inflation expectations rising on account of commodity supply concerns, real rates also fell sharply, heading back towards -1%. This phenomenon has helped to put a floor under riskier assets such as equities.

UK Gilts have delivered a total return of -7.68% over the last three months and -3.02% over the last year. Index-Linked Gilts returned -8.37% and 9.4% over the same respective periods. Emerging Market sovereign bonds produced a total return of -8.15% in sterling over the three months to end February (-2.78% over 12m). Global High Yield bonds delivered -4.13% (0.88% over 12m).

## Conclusion and Outlook

Having entered the year with a slightly cautious stance, we feel as though we were on the right side of events. However, in hindsight, we could obviously have been more cautious. John Authers, the financial journalist, publishes an annual “Hindsight Portfolio”, which he populates with trades that one might have reasonably made but were not obvious at the time. As you might imagine, its performance is stellar. There is always a tendency to beat oneself up for having missed retrospectively ‘obvious’ events. And there is no shortage of commentators now coming out of the woodwork to claim that they ‘predicted’ the war in Ukraine. But it was just one of several possible outcomes, and as investors our job is to balance risks and probabilities.

It is noteworthy that only 7% of respondents to Deutsche Bank’s February client survey thought that Russia/Ukraine would, by April, be ‘a major story for financial markets and impacting many global assets’. Some 49% answered that it would be ‘fading into the background’, with a further 38% in the ‘still simmering at its current level’ camp. Six percent answered ‘Don’t know’. Hardly surprising, then, that a major recalibration of expectations was required once the invasion began.

The key task that we must now fulfil is to ensure that, even if things deteriorate, the investments in balanced portfolios are either strong enough to survive and prosper once the crisis ends (which it inevitably will) or to provide resilience and even positive returns in the short term.

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