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OUT OF THE ORDINARY

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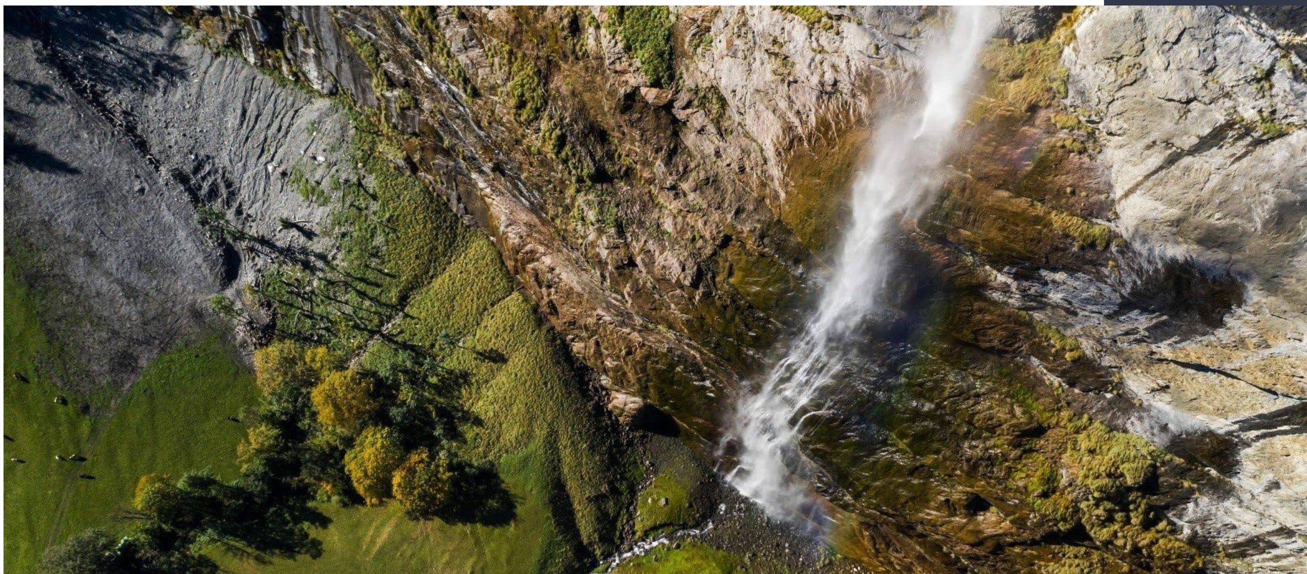
Market commentary



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Overview

The first quarter had been a difficult one for balanced portfolio investors, and unfortunately, the first month of the second quarter provided no respite, with losses experienced in both equity and bond markets once again.

According to data from the market historians at Deutsche Bank, April 2022 was only the fourth time that the S&P500 Index lost more than 5% and the aggregate US bond index fell by more than 2% since 1973. Cash was indeed king, although with inflation rates hitting highs not seen for several decades the challenge of preserving the real value of accumulated wealth remains the most pressing one for the wealth management industry.

One way to meet this challenge may be to not rely entirely on portfolios made up solely of equities and bonds, or the classic "60/40" portfolio that is often referred to in this context. We have been concerned for some time that a more persistent period of higher inflation might lead to a positive price correlation developing between equities and bonds, which would see both asset classes under pressure in a world of higher interest rates and bond yields. Thus, we have undertaken more diversification into Alternative assets, including infrastructure funds, certain types of hedge funds that promise uncorrelated returns and (where appropriate) gold. However, it is fair to say that, at the overall portfolio level, these moves have only served to mitigate losses rather than to provide outright gains.

What is it that markets are fretting about? In a word: inflation, which continues to hit new highs for this cycle in most countries, but at the highest levels we have seen for several decades. And then it's about central banks' response to that inflation, which is being delivered in two forms: higher interest rates initially, to be followed by a shrinking of balance sheets. The main actor in this is the US Federal Reserve Bank (Fed), which has become increasingly hawkish in its pronouncements. At the beginning of the year, the market was expecting US interest rates to be sitting at around 0.75% by the end of 2022. Now it is forecasting almost 3%. That is a massive shift in expectations, especially in such a short period. As for the UK, at the start of the year the market was expecting the base rate to be around 1.2% by December; now it is forecasting 2.25%.

It is quite possible that we have already seen the highest print for the headline US Consumer Price Index (8.5%), but it could be a while before it returns to the Fed's 2% target – the Bloomberg consensus forecast for 2023 is still 3%. The Fed's intent is to stop expectations of higher inflation becoming embedded and potentially leading to demands for higher and higher wages, which would perpetuate the cycle. If this leads to a sharp slowdown in economic activity and even a (shallow) recession, it seems to be saying that the price is worth paying. Many are describing the potential for a recession as a developing "policy error", but, with the benefit of hindsight, it is clear that the policy error was in keeping monetary conditions too loose for too long (compounded as it was by extremely generous fiscal policy). Perhaps they might have got away with it had Russia not invaded Ukraine or China not succumbed to the Omicron variant of Covid, both of which events have put further unwelcome pressure on supply chains. As for the UK, we are unlikely to see inflation peak until the next time the energy price cap is lifted in October.

Markets – US

In last month's commentary, we provided a deeper dive into the US Housing Market and what the surge in mortgage rates might mean. During April we received the February data for house prices, and the S&P/Case-Shiller 20-City Composite Home Price Index rose by 20.2% from a year earlier. The month-on-month increase of 2.4% was the highest in the history of this series (which dates back to 2000). It would not be an exaggeration to say that the US housing market was on fire at the start of the year, with strong demography-driven demand from maturing millennials and those taking advantage of more flexible working arrangements meeting a persistent shortage of new housing stock. However, since we last wrote, the 30-year mortgage rate has risen even further, from 4.90% to 5.42%. As we discussed previously, the structure of the market is far healthier now than in the build-up to the financial crisis, and we are not expecting a similar bust to develop. Even so, it is hard not to envisage at least some deceleration ahead, not only in the housing market itself, but also in the flow of refinancing funds which will have been used for both consumption and channelling into investment portfolios. We will be keeping a very close eye on the monthly data.

The US economy surprisingly shrank in the first quarter of 2022, by an annualised --1.4%, although underlying demand remained robust. The main culprits were a burgeoning trade deficit (partly driven by a rush to import goods that might be in short supply following Russia's invasion of Ukraine), a winding down of precautionary inventories that had been built up in the fourth quarter of 2021, and a reduction in government handouts – so all "technical factors" in the market's eyes. Consensus expectations are that the US economy will continue to grow this year, but the current forecast of 3.2% is well below what it was last summer, when it peaked at 4.3%.

There was much anticipation of the first quarter results from the large capitalisation technology companies that have led the market higher in recent years, but whose share prices have languished more recently as a higher discount rate weighed on valuations. The pick of the bunch was Microsoft, whose various lines of business all continued to grow. Meta (the parent of Facebook, as the company was formerly known) beat expectations by reporting decent subscriber growth. Although Tesla posted good sales numbers for its electric cars, more headlines were generated by founder Elan Musk's bid for Twitter, the social media platform. Both Apple and Amazon pointed towards increasing costs and ongoing supply chain disruptions when reining in expectations for the rest of the year. This was, then, a relatively mixed set of reports, although insufficiently poor to shift the perception that these companies remain long-term leaders in their respective industries. The biggest raspberry was reserved for Netflix, the video streaming pioneer, which, although never quite in the same league as the likes of Facebook, Apple, Amazon and Google (now Alphabet) when it came to profits or sheer size, was still a key member of the catchily-named FAANG group of market-leading technology stocks. It announced a disappointing decrease in subscriber numbers as well as a strategy shift that betrayed greater pressure on its business model than it had previously been willing to recognise or admit to. The share price (along with the those of household names such as Peloton and Zoom) is, perhaps, the most high-profile representative of the "round trip" journey taken over the course of the pandemic by those businesses which boomed as we all hunkered down at home. It has fallen 72% from its peak, shedding $233 billion in market capitalisation as a result (which is slightly more than that of Shell PLC, the largest company listed on the London Stock Exchange!).

UK

Much has been made in the press about the weakness of the pound, but we need to put this into some context. Headlines tend to focus on the pound's exchange rate versus the US dollar (often referred to as "cable" owing to the fact that currency trading information used to be transmitted between London and New York via deep undersea cables). At the start of the year a pound could buy $1.35; by the end of April only $1.25. Briefly, during the early pandemic panic, the rate dropped as low as $1.15. The low in the months following the Brexit referendum result was just over $1.20.

Through a different lens, matters are not so bad. Our main trading partner is still Europe, and the sterling/euro exchange rate has been remarkably stable this year, remaining largely in a range of €1.18 to €1.20. For those considering a more distant holiday option, perhaps, the pound now buys 163 yen, up from 155 at the start of 2022, but it has fared worse against the currencies of commodity-producing countries such as South Africa and Brazil. Overall, the pound's trade-weighted index is only 1.3% lower this year and pretty much exactly where it was a year ago. The real story here is the strength of the dollar, which has seen its value against a basket of currencies rise by 7.6% this year. This is thanks to expectations of rising interest rates that have been underlined by increasingly hawkish rhetoric from the Federal Reserve. Given the fact that many large UK companies earn the majority of their revenues in dollars, the strength of the US currency provides a tailwind to reported revenues and earnings. Several also declare their dividends in dollars, bolstering income expectations.

Europe

Investors breathed a sigh of relief when Emmanuel Macron prevailed in the second round of France's Presidential election. Although the bookmakers had Macron as the firm favourite, there was always the outside chance of an upset, which would have sent shockwaves through Europe's political and financial systems. Even so, Macron faces a tough task ahead to unite a population that is increasingly being drawn towards more extreme political parties, while at the same time needing to control the budget of a government that has the highest social welfare liabilities as a proportion of the economy of any large European country. The next election in 2027 seems like a long way off, but it will be here before we know it – and Marine Le Pen will undoubtedly be setting out her stall once again. Europe, owing to its physical proximity to Russia and Ukraine, as well as its dependency upon energy supplies from Russia, is at the sharp end of the effects of rising input costs. Germany's latest Consumer Price Index reading showed annual inflation to be running at 7.8%, a post-reunification high and matching the 1973 peak in the old West Germany during that decade's oil crisis. This must be difficult to bear for a country that has long been fervently anti-inflationist in its economic policies, an attitude born from the hyperinflationary experiences of the 1920s and 1930s. But monetary policy is now in the hands of the European Central Bank, which has been much more forgiving in its approach than the Bundesbank ever was, while the Social Democrat-led coalition government is also more generous with its fiscal policy. The relative weakness of the euro resulting from all of this stress provides a thin silver lining for European exporters, although they will need to see stronger demand from prospective customers to reap any rewards.

Emerging Markets

We came across an interesting statistic about China's stock market which emphasises the point that economic growth can be a poor predictor of investment performance. Chinese equities were added to the MSCI's suite of indices on the last day of 1992. Since then, China's economy, as measured by Gross Domestic Product, has grown by a factor of thirty-five times, which, we have to observe, is an extraordinary feat. It has brought hundreds of millions of people out of poverty and placed China at the forefront of the global financial, technological and geopolitical system. However, the cumulative total return of the MSCI China equity index over the whole period to the present is a mere +27%, with the price return being a negative -35% (the difference being made up by dividend income). This is testament to a combination of a heroic misallocation of capital and, latterly, heavy-handed state intervention in several industries including entrepreneurial technology. That does not mean that there have not been periods when Chinese equities have delivered exceptional returns. Often these have been achieved thanks to what one might describe as "state sponsorship", with domestic policy levers (monetary, fiscal and regulatory) being pulled to maximise wealth generation. All these levers have been in the "off" position for the last year or so, and the world waits with bated breath for China's leadership to restimulate the economy. The latest Politburo meeting account certainly suggests some desire to spend more on infrastructure projects and even promises to support the growth of the sort of "platform" companies that were recently chopped down to size. But there has so far been little in the way of firm action or policy change. Furthermore, another great engine of wealth creation, the housing market, continues to be reined in, with the government repeating the refrain that houses are for living in, not speculating with. Meanwhile, the country's zero-Covid policy is a restraining factor, while attitudes towards China's governance continue to harden in the face of its tacit support for Russia as well as the persistent threats to the independence of Taiwan.

Fixed Income

Global inflation data has continued to surprise on the upside, having already been much higher than the long-term norm at the start of 2022 as a result of the disruption to supply chains and the economic recovery from Covid. However, the war in Ukraine has exacerbated the situation, especially with respect to energy and commodity prices. These factors have left central banks behind the curve in tightening monetary policy from very loose levels, and the market is expecting some catch-up, which is reflected in interest rate futures and shorter-term bond yields. Indeed, two-year government bonds now represent a reasonable parking place for cash deposits in the UK and the US, with yields of 1.59% and 2.71% available. Long-term interest rates have risen to their highest levels in several years and have begun to attract more buying interest, especially as a portfolio hedge against possible recession. However, they still fail to offer the sort of real returns required to attract meaningful investment from those looking to match long-term liabilities. The latest values for 10-year government bond yields in the US, UK and Germany are 2.93%, 1.91% and 0.93% respectively as of 29 April 2022. As for index-linked bonds, long-term inflation expectations are now elevated, and this appears to be a less good time to add to existing positions. The ten-year average inflation rate discounted in bond markets is currently 2.94% in the US and 4.44% in the UK. Credit markets have also suffered this year from the rise of sovereign yields compounded by an expansion of credit spreads. Default rates have at least remained low.

UK Gilts have delivered a total return of -6.19% over the last three months and -8.26% over the last year. Index-Linked Gilts returned -9.09% and -2.9% over the same respective periods. Emerging Market sovereign bonds produced a total return of -6.27% in sterling over the three months to end April (-5.14% over 12m). Global High Yield bonds delivered -0.81% (-0.08% over 12m).

Conclusion and Outlook

Our last tactical asset allocation recommendation was to reduce the equity risk weighting in portfolios. In hindsight, when markets have fallen, it never feels as though one has done enough. However, we remind ourselves constantly that we are long-term investors and that trying to time markets too cutely in the short term tends to weigh on longer-term performance. Risk is the entry fee for making returns, especially in a world where the prospective returns on safer assets such as cash and government bonds has been repressed. In investment language, risk is defined as volatility and we are definitely seeing plenty of that at the moment, in equity, bond and currency markets.

Sometimes markets deal a set of cards that are virtually unplayable, and we are in one of those situations at the moment. But don't think that we have given up. The key behaviour at times like this is not to make big bets on highly uncertain outcomes. Sometimes it helps to reframe events that many see as a risk as an opportunity instead. It's not clear whether the current slowdown in economic activity will tip the world into a recession but should that happen (and we would expect a shallow recession at worst, not a rerun of the financial crisis or the early days of the pandemic) there will be opportunities to deploy some of our dry powder into those companies who will be able to take advantage of the weakness of others. As we recently read in a research note: "Recession is a corporate restructuring triggered by significant margin compression".

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