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OUT OF THE ORDINARY

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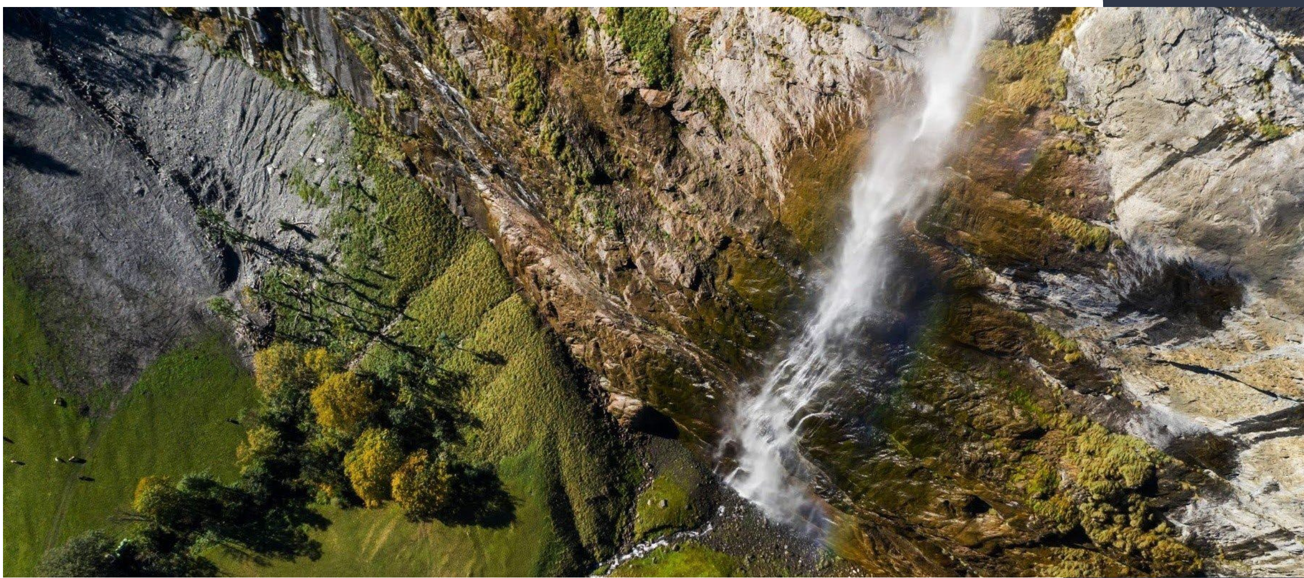
Market commentary



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Overview

Investors have experienced a difficult start to the year, with both equity and bond markets racking up losses in the first three months. What started as an adverse reaction to the threat of higher interest rates required to tame persistently high inflation, turned into a collapse in response to Russia's invasion of Ukraine. As we have commented in the past, events such as wars tend to be outside the usual risk parameters set by markets, extending more into the realm of uncertainty, which, by its nature, is harder to price.

Even so, there has been a respectable rally for equities since the lows were reached in early March as investors have had more time to assess the situation. There was also some evidence of indiscriminate selling at the bottom, driven by margin calls and deleveraging by funds whose gross investment positions are subject to the level of market volatility. The VIX Index (which infers from the options market the expected volatility of the S&P 500 Index) jumped to a peak in the high 30s in early March, a level associated with stressful markets, but one which tends not to be greatly exceeded other than in times of extreme dislocation. If one adds in the additional selling by momentum-driven funds as well as the hedging that was required to cover option liabilities, markets were close to 'offer-only' for a short period.

As is often the case, this technical situation created a set-up for a rally, which duly arrived, cheered on by hopes of a relatively swift resolution to the war. Equities have also benefitted from a perceived lack of realistic alternatives to invest in. Based upon current market-implied projections, sovereign bonds still carry the guarantee of losses in real terms if held to maturity. Equities, which represent real assets, at least have some claim on nominal growth.

This month we are providing more detail in the regional and fixed income sections. There is a particular focus on the US and its housing market as well as a more detailed comment on China. As the two largest economies in the world, they will ultimately have the greatest influence on investment outcomes, if, as is our current central view, the war in Ukraine does not escalate.

Markets – US

Although the S&P 500 dipped briefly into 'correction' territory by falling more than 10% from its peak, it has rallied well from its trough in early March and closed the quarter less than 5% below where it entered the year. However, there was considerable divergence beneath the headline index performance. The S&P Growth index, populated by shares whose valuation is more sensitive to long-term interest rates, fell 8.8%, while the S&P Value Index, exposed to more cyclical sectors and, crucially, Resource companies, lost just 0.7%. The underlying strength of the US economy appears to be intact, helped by the fact that it is less directly exposed to the war in Ukraine than most European countries. Not only is it geographically more remote, but neither does it have such great dependency upon some of Russia and Ukraine's exports, especially oil and gas. The unemployment rate is back close to the pre-pandemic lows, even if that does reflect some reduction in the overall working population following the 'great resignation'. Wages are rising, although not quite as fast as inflation.

One ghost that rattles its chains from time to time is that of the housing crash that helped to trigger the financial crisis. Given that mortgage rates have increased along with bond yields, should we be concerned that a replay is imminent? The US mortgage market is quite different from ours in the UK. The most popular type of loan carries a 30-year fixed interest rate, with the rate driven by the Treasury bond yield of the same maturity. The current national average 30-year mortgage rate is 4.85%, up from 3.27% at the start of the year and a cycle low of 2.96% in August last year. This implies annual payments on the average new mortgage of $453,000 being around $8,000 higher than last summer.

The better news is that those who have already locked in their rates are sitting pretty for up to 30 years (especially in a strong labour market), but it would not be at all surprising to see some reduction in the demand for new mortgages.

Another feature of the US mortgage market is the ability to refinance when rates head lower. Many Americans borrow against the value of their homes and the effect is amplified if their house is worth more and they re-leverage to account for their increased equity. The cash freed up can be reinvested in the property, put to work in markets or used for purchases. At the height of the most recent refinancing boom, the cash proceeds were equivalent to around 2% of all personal consumption. While that's some way short of the 4% reached in the build-up to the financial crisis, it's still a punchy sum, and will have played no small part in the consumption boom during the pandemic.

The fact that the actual mortgage rate is now well above the average rate on existing mortgages means that that the flow from this tap will turn to a trickle. Still, this portends a slowdown in consumption rather than necessarily a housing market bust. Lending standards have been much more stringent during the current cycle and neither has there been a proliferation of the issuance of 'adjustable-rate mortgages' (ARMs), which were a feature of the early 2000s, when they accounted for as much as 40% of new mortgages. New borrowers were then offered 'teaser' rates, which looked incredibly affordable even to those on low incomes, but when they reset to the market rat, the new payments were distinctly unaffordable. Today, ARMs barely exist. There remains undeniably strong demand for houses in many parts of the US, driven by post-pandemic lifestyle choices and the maturing of the 'echo-boomers' who want more space for growing families. And supply is also tight. Thus, a slowdown in price appreciation and transaction volumes would not come as a surprise, but a crash appears to be far less probable.

UK

We commented last month that one UK fund manager we 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. In March, his opinion was vindicated to some degree by a private equity bid approach for one of his holdings, which did help to spotlight potential value.

We note that the Royal Bank of Canada has made a bid for Brewin Dolphin, one of our direct peers in the wealth management industry and it has also been reported that NatWest Bank is contemplating a bid for Tilney Smith & Williamson. But the reality behind the fact that UK equities have outperformed this year, with the FTSE 100 being one of the few markets in positive territory, is the index composition. The index has itself gained 113 points this year (+1.52%). 93 of those points are attributable to just one stock – the pharmaceutical giant Astra Zeneca. Seven of the top twenty contributors are either Oil or Mining companies and most others are relatively defensive businesses sporting high dividend yields. BAE Systems has also benefitted from the new demand for Defence stocks.

Many listings have been reasonably unattractive for the past few years (not necessarily all for the same reasons. Therefore, whether the majority of them have suddenly become superb compounders of excess returns on capital is open for debate.

Europe

Europe finds itself uncomfortably close to the epicentre of geopolitical activity and its market performance has reflected that fact. Russia's invasion of Ukraine unfolded just as global investors were beginning to rediscover their appetite for companies listed on European exchanges, lured in by relatively attractive headline valuations and the promise of a post-Covid acceleration in economic activity. They beat a hasty retreat once hostilities began.

Europe is highly dependent upon exports of natural gas from Russia, with larger members such as Italy and Germany amongst the biggest importers. The importance of gas to economic activity is one key reason why it has yet to be added to the list of sanctions against Russia and also why European leaders have pledged to find new sources of supply. There has been talk of rationing gas supplies, such is the severity of the situation and several governments have reduced fuel taxes in an attempt to cushion the blow to consumers.

Even so, headline consumer prices are rising at an annual rate of 7.8% in the euro zone, a record since the inception of the euro. Given that manufacturing input costs are rising by more than 40% in some countries, the threat to margins and profits remains high. The inflation figure highlights that the European Central Bank faces opposing forces in its conduct of monetary policy: surging inflation on the one hand; deteriorating near-term growth on the other. European Central Bank President Christine Lagarde warned that “Europe is entering a difficult phase” and stated that “any adjustments to the key ECB interest rates... will be gradual.” The market is pricing in a total 0.5% rise in the deposit rate by the end of this year, which would take it back to exactly 0%.

Emerging Markets

While last month we took a detour into some rarely visited Emerging Markets, including those of Eastern Europe and South America, this month we return to China. By mid-March, the MSCI China Index had fallen 54% from its peak 13 months earlier. The NASDAQ China Golden Dragon Index, which is chock full of the stocks that have been most negatively affected, was down 75%.

These falls were driven initially by a combination of tighter monetary policy aimed at curbing speculation in both the property and stock markets, the activity-dampening effects of the country's “zero-Covid” policy, and the threat of default by the real estate giant Evergrande. The final straw was Russia's invasion of Ukraine.

On the economic front, China is a big importer of fossil fuels and was thus negatively affected by the surge in prices. On the geopolitical front, China's tacit support for Russia's actions raised the threat of sanctions being imposed upon China itself.

Moreover, speculation mounted that China would interpret any weakness on the part of Western governments in response to the invasion of Ukraine as a signal to launch its own assault on Taiwan, a territory over which it believes it has sovereignty. The word 'uninvestable' was liberally sprinkled over investment commentaries. We have long believed that there is a delicate balance between the legitimacy of the Chinese Communist Party in the eyes of the country's citizens and the ability of those citizens to continue to enjoy an increase in wealth and better lifestyles. Thus, when the economy begins to struggle, the authorities tend to step in with stimulative measures. While we had already seen some small moves to loosen monetary policy, this was followed up by some very clear comments from Vice Premier Liu He, in which he stated that the government would implement measures to "boost the economy in the first quarter" and introduce "policies that are favourable to the market". The MSCI China Index immediately rose 14.5% on the day following those words, while the Golden Dragon Index was up an extraordinary 33%. While there has been minimal follow-through from those initial gains, the comments do appear to have stabilised the market. Further encouragement has since been taken from reports that Beijing has revised its audit secrecy laws (which previously prevented overseas-listed entities from sharing sensitive financial information with foreign regulators) in an attempt to avert the delisting of shares in those companies from US exchanges. There are still a lot of uncertainties to resolve, but there are signs that sentiment is bottoming out.

Fixed Income

Bond markets continue to experience high levels of volatility. Barring the extremes of the early stage of the pandemic when market liquidity threatened to dry up, we must go back to 2013, when the Fed first raised the possibility of ending Quantitative Easing, to find a period of equal stress, and before that the financial crisis.

The big difference between all of those previous periods and the current one is that today's volatility is primarily being driven by high levels of inflation and by central banks' potential response. We have watched interest rate expectations rise sharply on both sides of the Atlantic in recent months as consumer price indices have continued to surprise to the upside and we have heard central bankers become increasingly hawkish in their policy rhetoric. But, the collective brain of the bond market has other ideas.

First, futures markets are discounting a lower peak in the interest rate cycle than central bank projections, and second the yield on longer-dated bonds is lower than that on short-dated ones – creating an inverted yield curve. In effect the market is saying that the central banks (and we are primarily focused on the US Federal Reserve Bank owing to its influence on global markets) are going to induce a recession and that they will be forced to back off. There is certainly plenty of empirical evidence that yield curve inversion portends recession within, on average, 18 months. But there are now also claims that "this time is different" owing to the manipulation of bond markets by central banks. For example, the Bank of Japan recently reaffirmed its policy of Yield Curve Control, by which it will continue to buy bonds as required to pin the ten-year Japanese Government Bond yield below 0.25%. At the margin, at least, this might serve to provide an anchor for global yields as traders take advantage of the yield differential. For reference, the yield on ten-year US Treasuries ended the quarter at 2.34%.

UK Gilts have delivered a total return of -4.92% over the last three months and -5.08% over the last year. Index-Linked Gilts returned -1.04% and 4.66% over the same respective periods. Emerging Market sovereign bonds produced a total return of -7.52% in sterling over the three months to end March (-1.98% over 12m). Global High Yield bonds delivered -4.1% (0.76% over 12m).

Conclusion and Outlook

The first quarter of 2022 has not been a pleasant one for investors, but we must spare our sympathy for those whose lives have been lost or disrupted following the Russian invasion of Ukraine. As investors, we have to accept financial risk in the pursuit of reward, more so than ever today in a world of low interest rates, especially when compared to current levels of inflation.

Although risk assets have rallied hard from their lows, we still have to negotiate the tightening of monetary policy that will be delivered by central banks over the course of the next year or two, if current projections are correct.

We have also yet to find out exactly what damage has been done to corporate margins by the sharp increase in input costs. Neither do we know how badly consumers will react to soaring energy and food prices.

We were firm in our belief that clients should not panic out of markets when the conflict began, but with global equity indices now higher than they were before the fighting started, it does feel as though there is insufficient caution. We expect markets to remain volatile within a trading range in the next few months and have recommended raising some liquidity to take advantage of future corrections. These will, in our opinion, be driven by a combination of the threat of a monetary policy-induced economic slowdown and downward pressure on company earnings.

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