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OUT OF THE ORDINARY

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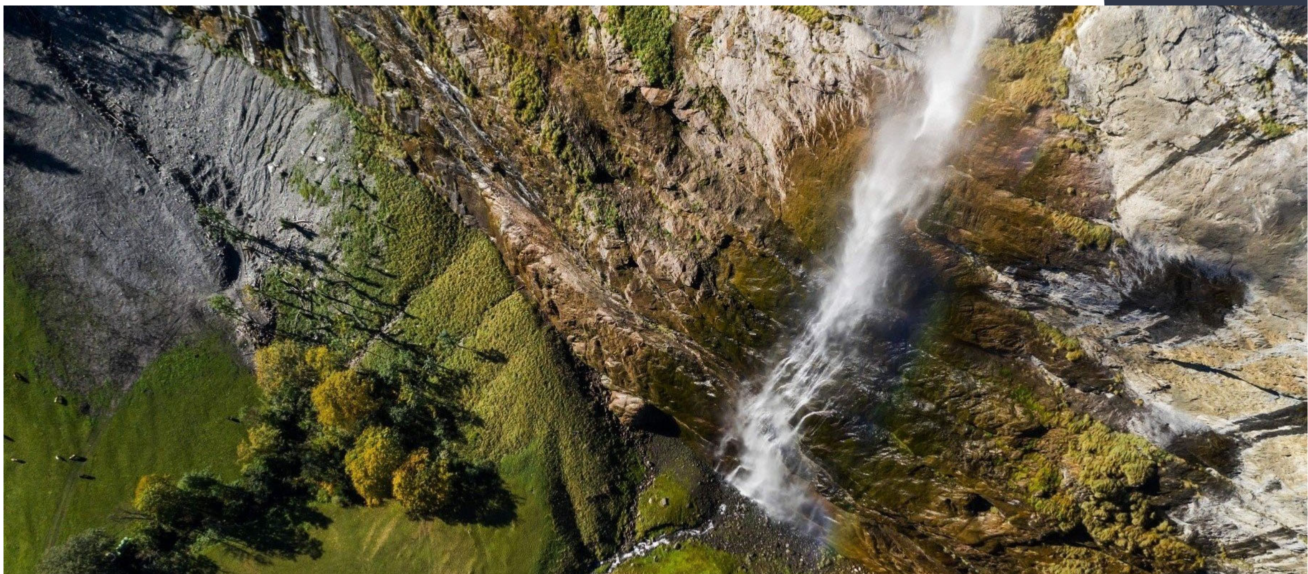
Market commentary



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Overview

The first half of May offered no respite to investors, with the "stagflation" narrative continuing to dominate. To remind you: stagflation is the worst economic background for being invested in a traditional portfolio that is populated largely with bonds and equities. Inflation fears tend to send bond yields higher (and capital values lower) and higher bond yields weigh on the valuations of risk assets such as equities. Furthermore, the "stag" element of stagflation, referring to stagnant economic activity, reduces earnings potential for companies, meaning that both elements of the Price/Earnings ratio (the traditional valuation yardstick for equities) are under simultaneous pressure. Playing defence in such circumstances is largely about limiting losses and living to fight another day.

For those still standing, the second half of May did finally offer a glimmer of hope, although it might more accurately be described as a peaking of pessimism rather than an outbreak of unalloyed optimism. Many market-derived and survey-based indicators suggested that participants with shorter investment horizons had thrown in the towel, unable to take any more punches from Mr Market. At the same time the collective brain of the market formed the opinion that central banks would not be able to raise interest rates as far as was then being discounted because of the negative effect it would have on the economy. Rate expectations and bond yields reversed, helping, in turn, to alleviate the pressure on equities.

Even so, we are still loath to call the "all clear". We note a comment by Ruchir Sharma (once a strategist at Morgan Stanley Investment Management, now Chair of Rockefeller International) in the Financial Times. He observed that the majority of S&P 500 bear markets going back to 1926 have seen selling pause in the -15 to -20% range for a median period of four months before resuming. In the five cases when the market held the -20% line and failed to enter a bear market it was on account of the Fed intervening to loosen monetary policy, with the most recent examples coming in 1990, 1998, 2011 and 2018.

Not for the first time in recent years, then, we are again largely dependent upon the opinions of the 12 voting members of the US Federal Reserve (Fed) Open Market Committee. They set the interest rate for the world's largest and most influential economy, but also, perhaps even more importantly, influence the discount rate that defines the valuation of many global assets (with the yield on ten-year US Treasuries being the key rate). They are currently engaged in trying to slow the pace at which prices are rising and also, perhaps even more crucially, keeping longer-term inflation expectations under control. To do this they are attempting to dampen demand through raising short term interest rates, but they are also attempting to tighten financial conditions by taking some of the air out of financial assets.

It's worth emphasising that point. The Fed has been deliberately trying to send stock markets lower as part of its strategy to keep inflation under control, which is not something it has ever done in the past, to the best of our knowledge. The inference from this is that unless inflation begins to subside quickly any meaningful rally in equity markets will be met with tighter policy. Another policy lever is balance sheet management. Central banks around the world flooded markets with liquidity in response to the Covid crisis, one of the factors that helped to buoy more speculative assets once the recovery got under way. One by one, they are turning off the liquidity taps and even removing the plug. The Bank of England, for example, began in March to allow gilts to mature without reinvesting the proceeds. The Fed's starting date for balance sheet reduction was 1 June. The European Central Bank (ECB) still has various asset purchase measures in place but is on course to follow suit.

Only the Bank of Japan amongst major developed world central banks continues to purchase government debt with no constraint, and this policy is reflected in the fact that the yen is trading at 20-year lows against the dollar. It is notable that currency volatility has increased markedly in the last few months as central banks have moved at different speeds to normalise policy settings (or at least to make them less generous). While this has created conditions ripe to be exploited by more aggressive trading funds, we also

note that large currency movements have in the past created the risk of unintended financial consequences as assets and liabilities are thrown out of equilibrium and trade flows are disrupted. The strength of the dollar is a particular problem for many emerging economies that have liabilities priced in dollars, but which have to be met from local currency.

Markets – US

At the risk of pushing a point too far, we return for the third month to the subject of the housing market. Although the US national average mortgage rate has come off its peak (now 5.45% vs a peak of 5.57%), it is still up sharply this year, and we maintained that it would take a little time for the "sticker shock" to start showing up in activity data. It has, finally. We have seen a visible rolling over of various housing related statistics, including new home starts, new home sales, existing home sales and mortgage applications. However, this has not yet manifested itself in house prices, although there is some anecdotal evidence that extremely high asking prices are being reduced to more reasonable levels. We uncovered a remarkable statistic about the US housing market recently, courtesy of Zillow, the US real estate marketing company. The median US home rose in value by $58,000 in the year to March 2022, surpassing the national median annual income of $50,295. Zillow cannot identify a period in history when this has ever happened before, including the boom that led up to the financial crisis. The peak then was in 2005/06, when a median house price gain of $22,000 played median income of $47,000. (And, yes, the fact that US median incomes have only increased by seven percent in sixteen years is worthy of commentary in its own right.) The fact that many will have made more wealth from home price appreciation rather than from working might help to support consumer psychology for a bit longer, although very few will now be tempted to "cash in" by refinancing their properties at the much higher rates currently prevailing. At an equity market level, investors have already rung the death knell for the housebuilding cycle, with a broad index of US housebuilders having fallen almost 30% from its peak last December. Another source of sticker shock is the price of gasoline, which has risen 47% this year alone to stand at an all-time high (in nominal terms) of $4.84 per US gallon. Readers in the UK or Europe will have little sympathy with US drivers when they translate that into pence per litre: barely more than a pound! Some Americans might be driving less now that fewer are commuting to work every day, but data compiled by the St Louis Federal Reserve suggests that total miles driven in the country annually is within a whisker of surpassing the all-time high of 3.28 trillion miles made in February 2020. Another seven years of that and you'd reach the star in closest proximity to Earth.

UK

We recently published a Weekly Digest entitled "Alternative Perceptions of Reality". The piece explored how groups with different biases or prejudices can interpret the same facts in quite different ways. Such a phenomenon is apparent in the reaction to the recent increases in new consumer credit in the UK. Monthly consumer credit growth (£1.3bn in March followed by £1.4bn in April, both ahead of consensus economists' forecasts) is now higher than the pre-pandemic average of £1.1bn. Economic optimists would have one believe that this is a sign of healthy animal spirits, with newly emboldened consumers throwing off the shackles of Covid-related restrictions and enjoying the pleasures foregone over the last couple of years. Pessimists, on the other

hand, suggest that increased borrowing is being forced upon consumers as they need to make ends meet when inflation is at multi-decade highs. Another source of fuel for demand is supposed to be the excess savings built up when spending was curtailed during the pandemic. Investec Bank calculates this sum to be a hefty £158bn relative to pre-pandemic trends, which would, indeed, provide a huge boost to consumption (around 10% of total annual consumption) if unleashed. As is often the case with savings, though, much of it rests in the hands of households with a lower propensity to spend it. And with much uncertainty prevailing about immediate prospects for the economy, we expect much of this powder to remain dry for a while yet.

Europe

The latest inflation data for Europe makes grim reading. Euro area inflation jumped to a new record high of 8.1% in May. Admittedly records for the euro area only stretch back to its inception in 1999, but these are still heady levels. It's not that long since economists were predicting that Europe would remain in a permanent state of low inflation or even deflation such as that endured by Japan for the last couple of decades. Only last year interest rate futures suggested that the ECB would not raise interest rates before the end of the decade. The ECB has yet to bite the bullet in terms of beginning to raise rates – they are still negative! – but the groundwork has been done and the market expects "take-off" to happen in July, finally. Ironically, it is quite possible that the rate of price increases might have begun to decline by then. The bulk of the inflationary pressure, as elsewhere, comes from volatile items, such as Food and Energy. "Core" inflation is much lower at 3.8%, but that also constitutes a record high in the euro era. If there turn out to be more structural drivers of higher prices, then we are going to have to get used to a very different policy structure than has been the case for much of the last two decades.

Emerging Markets

Emerging Market sentiment (or at least broad EM indices) remains largely driven by the fate of China. China's citizens have been subjected to some of the most draconian social restrictions witnessed anywhere as a result of the Covid pandemic, with an under-vaccinated population deemed by the government to be at high risk from the Omicron variant that has been brushed off by most of the rest of the world. It's not clear whether China will report a quarter of negative GDP growth in July, but it is clear that economic activity has been severely curtailed, a point made in a rare admission by Premier Li Keqiang in a recent speech. The government appears to be standing by its aspiration of achieving 5.5% growth this year, which is exciting hopes that it will unleash aggressive stimulus to meet that goal. However, it is not clear how this might sit with the new ethos of "common prosperity" or with President Xi's desire to quell the excesses associated with speculative investment in stocks and houses. And should the government open the liquidity and fiscal taps, how might that sit with the rest of the world? A sudden surge in Chinese demand would only serve to exacerbate existing inflationary pressures, further complicating the task that lies ahead for central banks. China's equity market certainly looks cheap in a historical context, but it has done for some time without being able to shake off its troubles. We also detect a growing distrust of China's leadership amongst global investors, even if US retail investors appear to be less reticent, having recently developed a taste again for triple-leveraged index-tracking ETFs. The sticky question of China's intentions for Taiwan hangs heavy over any asset allocation decision given the global reaction to Russia's invasion of Ukraine.

Fixed Income

The global fixed income market, as measured by the Barclays Global Aggregate Index, suffered its worst ever start to a year since the inception of the index in 1990, delivering a total return of -12.4% at the low point. Given very low starting yields, there was limited income to sugar the pill of capital losses as yields rose to the highest levels in the current cycle, finally breaking a downtrend that stretched back four decades. This is the effect that rising fears of inflation can have on bonds.

Yields did peak as concerns about growth started to dominate the narrative, although investors remain reliant on capital returns rather than income for real returns given the still high levels of inflation. Corporate credit markets began to send their traditional warning message to equity investors as spreads over sovereign debt widened in anticipation of economic weakness and potential defaults. Notably, US High Yield spreads expanded beyond the last pre-pandemic peak seen at the end of 2018. However, wider spreads potentially make for more attractive investment opportunities, and we now find the yields available on UK Investment Grade (IG) credit sufficiently alluring relative to those on Gilts to recommend increasing holdings again. Even if the economy does weaken, IG has a very low historic default rate.

UK Gilts have delivered a total return of -7.71% over the last three months and -10.88% over the last year. Index-Linked Gilts returned -16.01% and -12.25% over the same respective periods. Emerging Market sovereign bonds produced a total return of -1.04% in sterling over the three months to end May (-4.29% over 12m). Global High Yield bonds delivered +0.62% (+1.1% over 12m).

Conclusion and Outlook

We note that this commentary errs towards the side of caution combined with a heavy dose of realism. It is as well, we feel, to restrain expectations of returns in the short term given the current uncertainties, which range from domestic inflation and monetary policy to much broader geopolitical events. At the same time, though, we would also emphasise that it is in the nature of markets to endure difficult periods. They have done so regularly in the past, but now it feels as though even the smallest setback is amplified through the megaphone of (social) media. We would also observe that increases in debt relative to the size of the economy have made financial markets and the economy more interdependent than ever and this can have the effect of increasing short-term volatility.

We receive enquiries from concerned clients wondering if they should liquidate their entire portfolios and the answer we give is always “no”. A judicious mix of financial assets including bonds, equities, alternative assets and, yes, some cash remains the optimal way for most investors to realise their long-term financial planning goals. We regularly test our portfolios for their long-term (seven-year) growth potential and remain satisfied that the outcomes will justify remaining invested. Indeed, the good news for those still in the happy position of contributing to investment portfolios is that longer-term returns have become more attractive than they were at the start of the year. This is, in fact, a time to consider running towards markets, not away from them.

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