OUT OF THE ORDINARY

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Market reflection

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Overview

The start of 2022 has been difficult for investors, with capital losses experienced in both bond and equity markets. The underlying cause of the malaise is persistently high inflation, with few signs of imminent respite.

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The proximate cause of the sharp falls in asset prices was the publication of the minutes of December's meeting of the US Federal Reserve's rate-setting committee, in which it revealed greater concern about rising prices (and the second-round effects of spiralling wage demands). It hinted broadly at tighter monetary policy settings than the market had been hoping for, leading to an immediate and brutal recalibration of expectations.

The greatest pain has been felt in the longest duration assets, namely those companies which, despite having business models that offer the potential for highly attractive long-term gains, currently fail to make profits or to generate cash. Retail investors are particularly exposed to these areas of the market and there has been evidence of a reversal of the headlong dive into equities undertaken by this cohort during the pandemic.

Much now depends upon the path of inflation indices over the next few months. While the lapping of the high prints in 2021 suggests that we could be close to the current peak of year-on-year consumer price increases, there remains no consensus about the speed at which they might fall back. However, it is broadly agreed that inflation will settle at higher levels than prior to the pandemic, especially as government policy in much of the developed world supports a larger role for the state. The transition to a greener future for energy is a key factor. Despite the current concerns, we do not believe that either a recession or a major equity market fall is at hand, although investors should brace themselves for greater volatility and lower overall returns than they have enjoyed in the last few years.

• Global economic growth momentum has waned but is expected to remain above trend. The consensus growth forecast for 2022 is 4.3%, followed by 3.6% in 2023.

• Corporate earnings are forecast to have grown by 50% in 2021, with 8% expected in 2022 and 5% in 2023. Much will depend upon the inflation outcome and whether higher input costs and pressure for higher wages impinges upon margins. A more positive outcome could materialise should companies increase capital expenditure in a productive manner to mitigate input cost increases.

• Futures markets suggest that the UK base rate will be 1.2% by the end of 2022 from a current 0.25%, while in the United States the market expects four quarter-point rises, taking the Fed Funds rate to 1.25%. All the Federal Reserve's meetings this year are now deemed to be "live". In both banks' cases this will leave the base rate below the expected prevailing inflation rate, leaving limited appetite for cash and low-yielding government bonds in portfolios.

• The main feature within equity markets, and one not entirely captured by headline indices, has been the factor rotation in favour of shorter duration Value stocks at the expense of longer duration Growth stocks. The MSCI World Growth Index has fallen by more than 10% so far this year, with the equivalent Value index showing a small gain.

• This factor rotation has been somewhat detrimental to performance, but we retain great faith in the constituents of our equity portfolios in the context of a long-term investment horizon.

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