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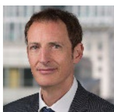
OUT OF THE ORDINARY

WEEKLY DIGEST | 07 March 2022

Rocks and hard places



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As we head into the third week of the Ukraine conflict, pressure on financial assets is increasing. As we have written in the past, wars tend not to fall into the realms of normal risk analysis because they are fraught with uncertainty. This is turning out to be the case not only with Russia's actions in Ukraine, but also with the rest of the world's response to them. Investors are naturally demanding a higher risk premium to account for this uncertainty. We believe this is a temporary phenomenon, but that doesn't mean we can know how long it will endure.

Hindsight bias

It's worth going back in time to the moment just before President Putin ordered the invasion to begin. Then there was still an expectation that a diplomatic solution could be found. If there was not, the received wisdom was that there might be just a limited land grab. Even if it went further, there was widespread belief, especially in the Russian camp, that the Ukrainian government would roll over quickly. While this encouraged a degree of caution, it was not seen as grounds to make the central investment case a prolonged conflict leading to punitive sanctions and enormous disruption to key commodity supplies. Yes, they were tail risks, but by no means a certainty.

All factors and prices must be continually recalibrated to reflect the current circumstances and the best view one can formulate about the future. This can be very frustrating to someone who is observing from the outside because everything can look very obvious in retrospect.

The challenge for Central Banks

One group that is struggling to justify the consistency of its actions at the moment is central bankers. When inflation was in the early stages of rising last year, they generally dismissed it as being 'transitory'. The US Federal Reserve (Fed) even went so far as to institute a policy of Flexible Average Inflation Targeting (FAIT) with the aim of letting inflation run hot for a while to make up for previous shortfalls. In retrospect, that was too relaxed a stance.

Latterly, the Fed and other central banks had been warming investors up to the probability of a more aggressive policy tightening cycle. The release in early January of the minutes from the Fed's December meeting revealed a much more hawkish stance than had been apparent in the original statement, triggering a sharp upward repricing of interest rate expectations and pushing bond yields higher. The Bank of England had already dropped its own hints about policy tightening in October, sending the market's forecast for the base rate in December 2022 from 0.5% to 1.5% in just a few weeks. With inflation pressures remaining firm at the beginning of 2022, the path looked well set for a tightening cycle to unfold, with this being a combination of interest rate rises, the end of asset purchases and the beginning of balance sheet reductions.

However, central bankers suddenly find themselves in an extremely uncomfortable situation. Inflation is set to increase further owing to the consequences of Russia's invasion of Ukraine, but at the same time the effect of higher prices and further potential disruptions to the supply of certain commodities (notably oil, gas, grains and fertiliser) is going to be to reduce economic growth, with the 'r' word (recession) being liberally bandied about now. Do central banks have the appetite to induce a recession to fulfil their inflation-controlling mandates?

The market's initial response to that question is 'probably not' and we have already seen interest rate expectations being pulled back in futures markets. That has provided some respite for risk assets, although the increase in the risk premium combined with a deteriorating earnings outlook means that equities have not been able to resist gravity and that credit spreads have widened.

One key factor last week was the fall in the real US ten-year yield from -0.57% to -0.93%, which was a function of rising inflation expectations meeting falling nominal bond yields. That move has also taken some heat out of the rotation from longer duration/growth stocks into shorter duration/value stocks, which had been the biggest driver of relative returns until the outbreak of hostilities. But one wonders how much further this measure can fall. It has not gone below -1.17% so far, which it did twice last year. The main credible route to it going lower would be if inflation expectations rose further while central banks depressed yields through market purchases. This would effectively be the 'financial repression' that we have talked about in the past. It might sound like an attractive exit route if it depresses the discount rate and supports equity valuations, but, as we have seen with Quantitative Easing, nobody can be quite sure what unintended consequences might result.

What might the market do next?

This remains a very fast-moving situation and we remain reluctant to make big moves in the face of such uncertainty, at least until we receive more compelling valuation signals from the market. At the time of writing (Monday), we note that the FTSE100 Index, having opened almost 3% lower, was trading in positive territory by mid-afternoon, buoyed by news of a conciliatory offer from the Kremlin. It would be wonderful if everyone laid down their weapons by the end of the week, but it would be just as risky from an investment perspective to make that one's central view now as it would have been to bet on outright war a couple of weeks ago.

Economic Commentary

FTSE 100 weekly winners

BAE Systems plc	9.3%
Pearson PLC	8.3%
Anglo American plc	5.9%
Rightmove plc	4.8%
Glencore plc	4.1%
Fresnillo PLC	4.1%
SSE plc	3.9%

FTSE 100 weekly losers

Polymetal International Plc	-31.7%
Evraz PLC	-27.7%
Coca-Cola HBC AG	-11.9%
Hargreaves Lansdown plc	-11.4%
Abrdn plc	-10.5%
Rolls-Royce Holdings plc	-9.4%
JD Sports Fashion Plc	-9.3%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

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