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OUT OF THE ORDINARY

WEEKLY DIGEST | 05 April 2022

# Horribilis Quartam

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And so we head into the second quarter of 2022. The first quarter is very much one that most people will be happy to see the back of. Should The Queen be checking in with her advisors, she might describe it as a Horrribilis Quartam (with apologies to any Latin scholars, but that's what Google Translate offers, and it's a long time since I achieved a B in my Latin O-Level).

The year started off with a sharp shift in rate expectations, this being driven by the release of the minutes of the US Federal Reserve's December meeting. They revealed a much more hawkish stance than had been apparent from the post-meeting statement and press conference. Cue a sell-off in both bond and equity markets. Investors are now on full alert for the latest set of minutes which will be released on Wednesday 6 April. These might contain details of the planned size and speed of the Fed's balance sheet reduction. Although this is something that is widely expected, past episodes of Quantitative Tightening (either real or threatened) have not been friendly to riskier assets.

### Which events impacted the market?

The most impactful event of the first quarter was Russia's invasion of Ukraine. I think it's fair to say that having recovered from the initial shock, investors are still working through the geopolitical and economic consequences. It is our belief that we will get more clarity about the effects on the corporate sector during the forthcoming results season when companies should reveal what is happening to both demand and supply. But even then, matters will be complicated by conflicting forces beyond the effects of the war in Ukraine. For example, while much of the developed world is experiencing a boost to activity from the receding Omicron tide and the arrival of Spring in the northern hemisphere, China's biggest city and major logistics hub, Shanghai, is undergoing lockdowns as local Covid-19 cases rise to the highest levels experienced during the pandemic.

### What were the effects?

The first quarter delivered what might be described as the 'nightmare scenario' for balanced portfolio investors, especially for those who had not diversified from holding just equities and bonds (the classic 60/40 portfolio). The MSCI All-Countries Equity Index returned -5.26% (including dividends), while the Barclays Global Aggregate Bond Index was also in negative territory to the tune of -6.16% (both in US dollars).

This is the scenario that we have often alluded to as a risk in the past, in which bond and equity returns are positively correlated in a rising yield environment. As a reminder, since the early 1980s we have been in two distinct investment regimes. For the first two decades, bond and equity returns were positively correlated in a falling yield environment. The underlying trend meant that both bonds and equities delivered positive returns at the same time. The high yield available from bonds combined with the rerating of equities driven by falling yields constructed as perfect an environment for investors as one could realistically hope for.

I worked out a few years ago that a 'typical' private client portfolio that started with capital of £100,000 in 1980 would have grown to just over £1.25 million by the end of 1999, while also delivering a 5% index-linked income for the whole period (based on a £5,000 initial income). Even allowing for inflation (which averaged 5.1%), the residual capital was worth £463,000 in real terms at the end of the period. Weep into the beverage of your choice now and curse the luck of a certain generation, but there is no way on earth this is going to happen again soon. Unless, perhaps, we reach a new starting point after bond yields rise into double digits and equity price-earnings ratios fall into single digits, which is not what any current investor would wish for, nor what we envisage happening.

The second two-decade period witnessed negatively correlated bond and equity performance – bond prices tended to rise when equity prices fell and vice versa. This meant that although the total returns were not as generous, portfolio volatility was much lower, leading to higher 'risk-adjusted' returns. There is a lively debate about whether or not higher risk-adjusted returns are more meaningful than actual returns over a longer investment horizon, but this is the measurement path that our industry has chosen.

### What might the future hold?

Are we entering a new positive correlation era? Is one quarter enough to call the turn? Much will depend upon the success of central banks in containing inflation and inflation expectations and what that means for interest rates and bond yields. And while the central banks can manage demand with the blunt instrument of interest rates, there is not a lot they can do about supply bottlenecks. We believe that talk of a return to conditions similar to the 1970s is misplaced, but we do acknowledge that persistently higher inflation would potentially lead to a meaningful risk of a longer difficult period for portfolios which rely purely on equities and bonds.

This debate will not be settled quickly, but, in the meantime, a more conservative investor might choose to have a more diversified portfolio. For us, this means a higher weighting in uncorrelated absolute return funds, real assets (including real estate and infrastructure) and either gold or US inflation-protected Treasuries (which tend to correlate). And a bit more cash to take advantage of future drawdowns. This approach by no means guarantees positive returns but should take some of the sting out of further bouts of volatility.

Sometimes it's also worth zooming out and taking a longer-term perspective. If I cast my mind back to early 2020, when I was doing the rounds of investment seminars on the annual "Vision" tour of the country, we suggested that a standard balanced private client portfolio should be capable of delivering returns in the 5-7% range without assuming too much risk. That was not a forecast, but what dropped out of our long-term scenario planning.

If I take the FTSE Private Investor Balanced Index as a proxy, the nine quarters from the end of 2019 have delivered an annualised total return of 5.33% (12.4% Total Return). Given what we knew at the time, we would have accepted that at on an ex ante basis, even if it is a slightly underwhelming figure. A 'full-fat' global equity portfolio has gained 33% over the same period, but the difference between, say, the US (S&P 500 +46.7%) and the UK (FTSE 100 +7.9%) is staggering. Who says there is not a role for active managers and asset allocators? All figures are total return in sterling – surprisingly, perhaps, the sterling trade-weighted index is barely changed over the period.

Of course, what these return figures do not reflect are the extraordinary ups and downs during the period, nor the effect of inflation on real returns. The ups and downs come with the territory, which is one reason why we counsel clients not to liquidate their portfolios at the first hint of trouble. The real return element is a lot more challenging, especially in the short term with consumer price growth at such high levels. But, in the long term, we continue to believe that equities, being real assets with a claim on nominal growth, are well placed to provide the real returns that investors require, and they will continue to form the core of portfolios.

# Economic Commentary

### FTSE 100 weekly winners

| | |
|---|---|
| Polymetal International Plc | 78.8% |
| Reckitt Benckiser Group plc | 10.3% |
| Ocado Group PLC | 9.6% |
| Just Eat Takeaway.com N.V. | 8.3% |
| Intermediate Capital Group plc | 7.1% |
| Croda International Plc | 5.7% |
| United Utilities Group PLC | 5.3% |

### FTSE 100 weekly losers

| | |
|---|---|
| Barclays PLC | -12.1% |
| Rolls-Royce Holdings plc | -9.8% |
| Royal Mail plc | -8.8% |
| Ashtead Group plc | -7.1% |
| Pearson PLC | -5.8% |
| BAE Systems plc | -5.5% |
| Hargreaves Lansdown plc | -4.9% |

### FTSE 100 index, past 12 months

### EuroStoxx 600 index, past 12 months

### S&P 500 index, past 12 months

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