Investec

OUT OF THE ORDINARY

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Peering Through The Fog Of War

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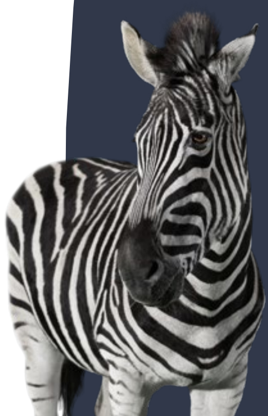
When I am hosting our internal morning meeting on a Monday, one of my starting points is to look at weekly moves for a range of asset classes and other indicators. Markets can be exceptionally volatile on a day-to-day basis, especially when they are being driven by technical factors, and zooming out a bit can be a useful antidote to the emotions created by shorter-term price movements.



One thing that became apparent when looking at this week's data was that investors are already "looking through" current events and trying to focus on how the world will look once the current crisis in Ukraine has faded from the headlines. However, it's harder to divine whether this will follow a peaceful resolution which reverts to the status quo ante or a new environment in which Russia controls large chunks of Ukraine. Still elevated commodity prices suggest a leaning towards the latter outcome.

If one looks at traditional gauges of investor fear, they generally peaked in the middle of last week. Gold is often viewed as the ultimate safe harbour during periods of geopolitical unrest. I'm not going to rerun the debate about its value in that respect now. I think that for the purposes of this exercise we can just take its role as given in the light of its performance. A brief glance at the chart of its price is illuminating. It rose almost immediately from $1,909 to $1,973 on the morning of the invasion (24th February), before giving up all its gains and more by the close as investors initially concluded (along with President Putin) that hostilities would be over by the weekend. Once it became clear that the conflict would endure, the price started to move higher again, before spiking to an intra-day peak of $2,069 last Tuesday as the fighting and threats escalated. It has since subsided to $1,960 as I write (noon on Monday), with overnight news suggesting the possibility of constructive talks between Russia and Ukraine helping to improve investor sentiment.

One can also spot a better mood in volatility indices. The chart of the VIX index (which measures the implied volatility of equities based on activity in options markets) looks strikingly similar to that of gold, spiking sharply on 24th February and then climbing more steadily until peaking last Tuesday. The MOVE Index which reflects volatility in fixed income markets has a similar profile.

What other indicators can we look at? Sovereign bonds are another indicator of sentiment and tend to be in high demand as safe haven assets during periods of dislocation. I will take the US 10-year bond yield as my example, it being the world's key benchmark. If we scroll back a few months, we can see the yield rising sharply from below 1.4% in December 2021 to a peak of 2.04% on 15th February. This was in response to expectations of rising interest rates in the face of already sticky inflationary pressures even before they were exacerbated by the war. The start of the conflict sent the yield down to 1.73%, but it is back over 2% now as the market shifts its focus to the fact that the Federal Reserve will almost certainly begin its cycle of raising interest rates on Wednesday this week. The shape of yield curves in other Western countries looks much the same. The UK 10-year Gilt yield has round-tripped from 1.6% to 1.12% and back again over the same period, with the Bank of England set to raise the base rate by another quarter-point to 0.75% on Thursday.

Is this a case of "out of the frying pan and into the fire"? Much as we would love not to have to worry about an enduring, and possibly expanding, conflict in Ukraine, the reality remains that central banks still have the unenviable task of keeping inflation expectations under control. They are just about managing at the moment, with longer-term inflation breakeven rates (market-implied expectations for future inflation) rising much less than short-term rates. But, to some degree at least, that is predicated upon the market's opinion that interest rates are going up – and fast. US interest rate futures have now priced back in all the expected increases that they took out in response to the invasion – in fact more. The same is true for the UK, and almost the case for Europe. Make no mistake, we are in a monetary tightening cycle.

What the market is still trying to evaluate is whether the combination of input cost squeezes and monetary tightening will result in an "official" economic contraction. As I mentioned last week, the word "recession" is no longer quietly whispered, but widely discussed. We continue to see downgrades to both growth forecasts and equity index targets, although few mainstream economists have been willing to stick their necks out. And if there are signs of greater weakness, will the central banks back off, and at what level of rates?

Much will depend on how quickly inflation can fall from its peaks, and the depressing news is that we have not yet reached them. Last week I saw the first call for a headline US Consumer Price Index year-on-year increase of 10% to be registered later his year against the already vertiginous 7.9% that was reported last week. Maybe it was from a high-profile bond investor who loves to generate headlines, but it's not beyond the scope of our imagination. It's not rare to see numbers starting with eight or nine in the UK, either, with the peak likely to coincide with the second semi-annual increase in the energy price cap next October.

Another factor weighing on bond prices and pushing yields up is the threat of more supply. This could emanate from central banks shrinking their balance sheets as proposed, or from more issuance by governments. Fiscal revenue will be under pressure if growth slows; increased expenditure on defence is suddenly back on the agenda; and there might be measures taken to mitigate how much of the commodity price increases flows through to essential consumer goods. This will all be costly, but there remains no political appetite to return to the days of austerity and the "lesson" from Covid is that more government debt is the less bad option. I'd say that's one of those beliefs that is fine... until it's not.

Another big imponderable in the inflation data is what happens to supply chains. Disruption in this area was widely expected to dissipate by the middle of last year but did not. The Delta and Omicron waves of Covid were unhelpful in this respect, and even now we are still seeing problems in China as it persists with its "zero-Covid" strategy. But the better news is that there are signs of bottlenecks such as those in the semiconductor industry beginning to ease, and even if freight container rates have not collapsed, they have at least started to drift off the top and we know that more ships are now being built. There are also signs that the Covid-driven demand for certain goods is waning, and inventories of goods are also in better (but not perfect) shape.

Countering that optimism is a report in the Financial Times concerning a new potential shortage of crew members on commercial vessels. Russia and Ukraine between them provide around fifteen percent of maritime workers, and many of the Ukrainians appear to be keen to get back home to enlist in the army. The report also mentions delays at ports as cargoes are checked for sanctioned goods. Nothing is ever simple.

Events in Ukraine have particularly affected commodity prices, with the effect on the oil price there for all of us to see on petrol station forecourts. It is going to take some time to ascertain the long-term effects. Some supplies, such as this year's corn harvest from Ukraine, will likely be lost forever, but there is a strong possibility that Russian oil production will find its way onto world markets via other outlets.

Certain commodity markets, notably nickel, have been horribly disrupted. The nickel price quadrupled from $25,000 per tonne to more than $100,000 briefly, although the market has been suspended now for several days. The reason for such a disruptive move is that one very large and influential Chinese producer and trader was short of nickel (and he was not alone) and demand for physical delivery had to be met from a very tight market that was holding very low inventory by historical standards. Cue a huge squeeze and margin calls. This is pretty much the inverse situation to that which prevailed in the oil market when it traded at a negative price in April 2020 as traders who were long of physical oil could not find a way to deliver it. Interestingly, the Chinese trader is in the process of negotiating massive loans to meet his margin requirements, one would suppose on the basis that he will either be able to deliver the nickel eventually from his own production resources or that he believes the price will subside to more realistic levels. Yet another book for Michael Lewis to write!

Taking all of this uncertainty into account, we have been topping and tailing portfolios rather than making big shifts. We entered the year marginally cautious and that's where we remain. But, in the light of the fall in equity markets relative to other asset classes, we did see an opportunity to rebalance equities back up to recommended levels. Somewhere in all this uncertainty there will be opportunities to increase our risk appetite, but we don't think we are there yet.

Economic Commentary

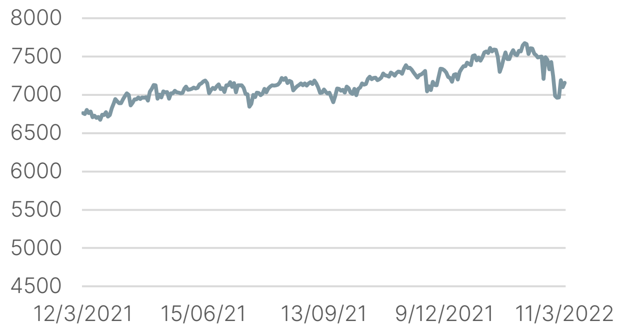
FTSE 100 weekly winners

Weir Group PLC	25.4%
M&G Plc	21.6%
Evraz PLC	18.3%
Just Eat Takeaway.com N.V.	13.3%
Flutter Entertainment Plc	11.9%
ITV PLC	11.3%
Glencore plc	11.0%

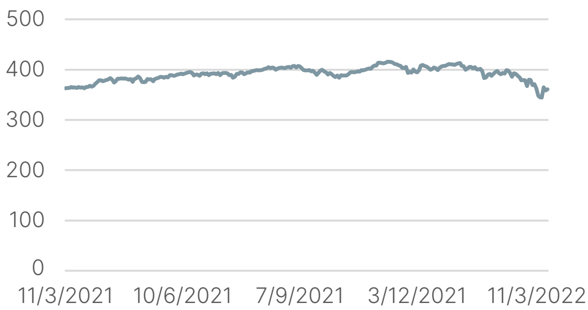
FTSE 100 weekly losers

B&M European Value Retail SA	-8.0%
Rio Tinto plc	-7.7%
RELX PLC	-6.5%
Persimmon Plc	-5.5%
Burberry Group plc	-4.3%
Diageo plc	-3.9%
Rightmove plc	-3.6%

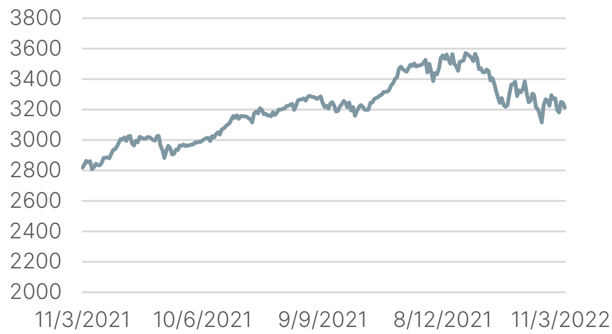
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



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