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OUT OF THE ORDINARY

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One Year On...

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Friday 24 February marked the first anniversary of Russia's invasion of Ukraine, although it is not the sort of anniversary that calls for celebrations. One slightly dispiriting aspect of being an investment strategist is that one must leave one's emotions at the door, if possible, when assessing the prospects for markets in the light of such events. This is difficult for all investors when shocking news breaks, but we have noted in the past that humans become quickly inured to the sort of news that might initially cause upset.

How risk models work

Much of this might be down to the difference between risk and uncertainty. Major events such as the destruction of the twin towers in New York in 2001 or the initial outbreak of Covid in 2020 were so far outside almost everybody's imagination, let alone planning, that it was almost impossible to know what would happen next or how to react. But we can see that subsequent terrorist events and secondary Covid waves lost their capacity to shock. Investors had at least been able to recalibrate their risk assessment models (mental or in a spreadsheet) to account for the new information available.

Of course, risk models have a habit of being wrong too. Looking back at the Weekly Digest I wrote on 28 February 2022, I note that ahead of the invasion I had cited work claiming a 15% probability of it going ahead. Even those who thought they had built in some protection were having to shift their positions quickly. I also commented on the extreme volatility of markets during that period, with equities moving aggressively in both directions. It seemed that any market trade could be the source of regret very quickly, and we counselled remaining calm.

One widely circulated view was that history showed that it was, on average, right to buy riskier assets such as equities on the outbreak of a major geopolitical event. We countered that averages were very dangerous things and that it would be beneficial to pay more heed to existing economic and policy trends. Central banks were already threatening to tighten monetary policy in response to inflation pressures and it didn't appear that they were about to relent in the face of supply disruption to key commodities such as oil, gas and grains.

And that's how it turned out. The US Federal Reserve raised its key policy rate for the first time in the cycle by 0.25% just a couple of weeks later, before following up with 0.5% in May and then four consecutive 0.75% increases over the summer and autumn. And it is still going. A recent run of stronger economic data and sticky-looking inflation prints means that expectations for peak US rates continue to rise and now stand at 5.4%. The prevailing rate is 4.75% and the market was pricing in just 1.75% when the war broke out. I must admit that we didn't see rates going this high either, but at least we acknowledged the risk from inflation-busting monetary policy.

How have markets reacted?

What have markets done since then? If I take the end of the first day of the war as the base and end at last week's close of business, equities in aggregate have been reasonably resilient, with the MSCI All-Countries World Index down 7.9% in US dollar terms. At its worst in October, it was down 18%. Sterling-based investors have had a better ride (+3.05%), with the weakness of the pound providing a nice tailwind to the translation of overseas assets and earnings.

But, as we have pointed out before, the overall index fails to capture the drama beneath the surface. MSCI World Growth is down 12% over the period, while World Value is down just 2.3% (and in positive territory when dividends are accounted for). Taking the analysis a step deeper into industry sectors (and using data for the US S&P 500 Index), we see that Energy is +27% and Industrials (which includes major players in the Defence industry) is +4%, while sectors such as Communications Services (-25%), Consumer Discretionary (-18%) and Information Technology (-11%) have fared much worse.

A key factor here is bond yields. The 10-year US Treasury yield has risen from 1.96% to a current 3.95%. The real yield (accounting for inflation expectations) has risen from -0.6% (yes that is a minus) to +1.57%. The UK 10-year Gilt yield has gone from 1.44% to 3.79%, while Germany's 10-year Bund yield has risen from 0.16% to 2.55%. The amount of negative-yielding debt in the world has gone from around $5 trillion then to essentially zero (having been as high as $18.3 trillion in late 2020). This has knocked the stuffing out of the valuations of shares which are more dependent upon the promise of future growth and cash flows than what is achievable today. Indeed, we continue to believe that it is this repricing of longer duration investments that has been the primary driver of performance over the last year.

What economic developments are notable?

That is not to say that markets ignore economic developments. For example, we note two massive spikes in the price of natural gas as supplies from Russia declined and European buyers desperately tried to fill their reserves for the winter ahead. These raised the prospect of energy shortages and a deep recession. Amazingly, though, the one-month-ahead price has dropped from €116 per Megawatt/hour (MW/h) on invasion day to a current €49, having briefly spiked up to €311 in August. It would be foolhardy to say "crisis over", but this is at least testament to the ability of humanity to adapt in the face of an extreme situation (with a little help from the weather, to be fair).

One major repercussion of the war has been the increase in defence spending, with the promise of more to come. It was a bone of contention within NATO that some members were not pulling their weight when it came to their fiscal budget allocations, with the general rule being that it should be at least 2% of GDP. Although two-thirds of NATO members have yet to reach the target, there have been enough pledges to confirm the direction of travel (not to mention the increased risk of much more public criticism of those who lag).

It has been noted by economic historians that long periods of disinflation or deflation have regularly been ended either by the outbreak of war or by a pandemic. The former creates demand for spending on armaments (often funded by fiscal deficits) and the latter reduces labour supply (with the Black Death in Europe and the UK being an extreme example of pricing power being taken away from feudal overlords and put into the hands of labourers). We have experienced both in pretty short order.

As we look back on a year of turmoil, our thoughts and prayers remain with all those whose lives have been affected by the war. Our investment thesis remains consistent. Inflation is proving to be a tough nut to crack, and its evolution is affected by a lot of different factors. While short-term headline inflation has almost definitely peaked and it could conceivably fall quite quickly, we might find that the core measure needs a more patient approach. We have also experienced a material shift in interest rates and bond yields, and while that influence has played out in company valuations, we're still not convinced that the effects have been fully transmitted to actual economic activity. If that is correct, then we still need to see more downward pressure on company earnings (which, I will admit, we have been anticipating for a while) before wanting to build equity weightings with more confidence.

Economic Commentary

FTSE 100 weekly winners

Smith & Nephew plc	5.2%
M&G Plc	4.9%
BAE Systems plc	2.7%
HSBC Holdings Plc	2.4%
Standard Life Aberdeen	2.2%
Melrose Industries PLC	2.1%
British American Tobacco p.l.c.	1.7%

FTSE 100 weekly losers

Anglo American plc	-11.3%
Antofagasta plc	-11.1%
BHP Group Ltd	-9.2%
Polymetal International Plc	-8.7%
Just Eat Takeaway.com N.V.	-7.7%
International Consolidated Airlines Group SA	-7.5%
Rio Tinto plc	-7.1%

FTSE 100 index, past 12 months

EuroStoxx 600 index, past 12 months

S&P 500 index, past 12 months

All data shown in GBP.

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