Investment Views

March 2022

The Times They Are a-Changin'

Heading into 2022 our core belief was that the withdrawal of global monetary and fiscal stimulus would tighten financial conditions sufficiently to break the economy, markets or the financial plumbing. As we head towards the end of a troubled first quarter, all three are under pressure, triggering the largest correction in risk assets since the pandemic-induced panic of Q1 2020.

By mid-March, most stock indices have fallen 10-20% from their peak, with bond markets following suit. Spooked by rising inflation and hawkish Central Banks, major sovereign bonds have sold off with the additional yield (or spread) offered by corporate issues rising from historic lows. Having started the year at 1.5%, the yield on a 10-year US treasury is now 2.4%, whilst the UK Government bond index has shed over 8% for the year-to-date. Losses on investment grade bonds have been broadly similar.

Conversely, commodity markets have fared far better as Russian and Ukrainian exports were taken off-line by sanctions and supply disruption. The onset of war sparked a near 40% surge in the price of Brent crude in just one week, temporarily taking it to a multi-year high of U$140/barrel. Russia was previously supplying around 10% of the world's oil and was the largest global exporter of natural gas (source: US IEA). Around 45% of EU gas imports come from its eastern neighbor, making sanctions a costly weapon for the Eurozone nations.

Whilst oil and gas prices will ebb and flow with the unfolding crisis, any outcome that leaves Putin in the Kremlin will sustain sanctions and the current energy bid. A similar dynamic is at play in agricultural markets as the loss of Russian and Ukrainian exports bite. With the two countries accounting for 30% of global wheat exports, benchmark prices are now 40% higher than pre-war levels. Other grains and oilseed markets have seen similar moves with certain key industrial metals, most notably nickel, experiencing dramatic price volatility on rampant speculation.

Trying to divine a way forward is hampered by the sheer number of conflating factors. The impact of the pandemic on aggregate demand and global supply chains remains unresolved whilst global growth is slowing as inflation touches multi-decade highs. The inter-play of these factors is amplified by the most consequential military engagement on European soil since WW2, making the risk of policy error much higher. Central Banks are raising rates to head off inflation even though the conflict uncertainty, swollen global debts and softer economic data argue for a dovish tilt.

In such a febrile atmosphere, where political and policy paths have an outsized impact, it is nigh on impossible to forecast short-term macro and market moves. That said a few notable trends are starting to emerge.

With commodity prices charging higher, the global economy is experiencing an inflationary supply shock that could persist for some time. Compounding the Ukrainian fallout is an outbreak of omicron in China, forcing a major lockdown of the key manufacturing hubs, including Shenzen. Ironically this comes just as many pandemic supply bottlenecks were starting to ease.

On the flipside, aggregate demand is already softening in response to rising resource costs. This is not unusual as every major oil price spike since the early 1970s has been swiftly followed by a US recession. Higher prices act like a tax on consumption, forcing households to spend more on necessities like food and energy, leaving less disposable income to fund non-essential purchases.

Indeed, US retail sales have been cooling since last summer and came in surprisingly weak in February; headline consumption actually contracted if you remove gasoline purchases (source: Census Bureau). Consumer activity will remain pressured over the coming months, intensifying recession risks in the US and beyond; the "cost of living crisis" is a global phenomenon. However, any signs that growth and price increases are moderating would likely give the Central Banks an excuse to row back from their tightening plans, offering beleaguered economies (and risk assets) a reprieve. We note that consumer inflation has fallen sharply in all eight US recessions since 1965.

Interestingly, whilst the US Federal Reserve adopts an increasingly hawkish posture, we note the more nuanced approach of its peers. China is set to ease both monetary and fiscal policy to prop up the economy and asset markets whilst, closer to home, the Bank of England accompanied its recent 0.25% rate rise with more dovish guidance; across the Channel, the ECB is forecast to delay its first rate rise until the end of this year. Whilst market volatility will likely remain elevated through the summer months, there are early signs that Central Banks are losing their Volker-verve.

Looking further out, and setting aside the sad human cost of this terrible war, we feel that the emergency sanctions will have a fundamental bearing on the established world order.

Sparked by the effective US/EU confiscation of nearly half of Russian Central Bank reserves and the Russo-excommunication from the global banking system (via exclusion from SWIFT), we are likely seeing the early stages of a new global monetary regime. There is no modern day precedent for sovereign reserve confiscation and the ramifications will be profound.

Central Banks will now revisit how (and where) they hold their country's investments. With around 60% of the U$12trn global FX reserves held in dollar assets, many will look to diversify. In time, other fiat currencies will benefit, with a growing role for sovereign digital currencies. Gold may also gain, as it has long been a core allocation for national savings. Whilst Western European states and the US hold 26% and 66% of their FX reserves as bullion, the equivalent for China and India is only

3% and 7% (source: World Gold Council). If the latter nations reallocate towards bullion, its price could accelerate sharply; the total gold market is currently valued around U$12trn (source: 13D).

That said, calls for a rapid dollar demise seem misplaced, particularly given its entrenched role in international trade and the paucity of viable alternatives. Indeed, a precipitous rejection would severely impair the value of existing reserves, hurting the countries that have substantial exposure; China alone owns U$1.1trn of US treasury securities. Whilst the change will be slow, we could well look back on early 2022 as the end for the post-Bretton Wood era, when the suspension of the dollar's convertibility into gold left the greenback as the de facto global reserve currency.

Another major development has been the rapid exodus of the investment and corporate communities from Russia. After years of realpolitik, consumers and electorates have forced companies (and countries) to consider the moral aspects of their Russian operations; even the Swiss have given up their long held neutrality to freeze oligarch wealth.

The immediate effect of this should be limited given Russia's relatively small economy, but any future misdemeanor by a nation state could now be viewed through the prism of ideological beliefs and moral outrage. Could the human rights record of Saudi Arabia or China finally become an impediment to global economic engagement? It is hard to tell at this time, but the risk premium on related investments has surely risen.

Finally, the aggressive use of sanctions and the 'weaponisation' of the dollar clearing system will accelerate the bifurcation of global trade and the localization of supply chains. Both the US and China have explicit goals to re-shore key forms of production, reducing their reliance on (and vulnerability to) other nation states. These dominant countries look set to exact increased economic fealty as a price of trading with their huge domestic markets. Over time, the world will split into a US and a Chinese sphere of influence with Europe floating somewhere in between.

These structural shifts will take years to play out, but the international response to Russia's invasion of Ukraine has acted as an accelerant of seismic change and the catalyst for a new monetary world order. This could ultimately undermine the US dollar as a reserve asset, expedite the rollout of Central Bank Digital Currencies and strengthen the case for private crypto-currencies. We will share more on these long-term trends as our thoughts develop.

Policy Matrix Summary

The matrix below is a summary of our current 12-24 month outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high level guide on where we stand at this time.

12-24 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives	Gold Miners China A Shares UK Small Companies Japan ESG & Impact funds FinTech & Blockchain	Inflation-linked	Gold, Volatility Strategies
–	Bonds	European US	UK European Japanese High Yield	

Market Performance

All performance numbers show % changes except for bond yields which show yield changes.

	28 Feb 22	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.3420	-0.2%	0.9%	-3.7%
CHF	1.0906	1.1%	0.2%	-0.9%
AUD	0.7263	2.8%	1.9%	-5.7%
JPY	115.0000	0.1%	-1.6%	-7.3%
EUR	1.1219	-0.1%	-1.0%	-7.1%
BOND YIELDS (10 yr)				
UK	1.41	0.11	0.60	0.59
US	1.83	0.05	0.38	0.42
Germany	0.13	0.12	0.48	0.39
Australia	2.14	0.24	0.45	0.22
Japan	0.19	0.01	0.13	0.03
EQUITIES				
US. S&P 500 (USD)	4,373.94	-3.1%	-4.2%	14.8%
UK. FTSE 100 (GBP)	7,458.25	-0.1%	5.6%	15.0%
FTSE Europe Ex UK (local)	1,588.82	-4.3%	-3.9%	9.4%
Japan. Topix (JPY)	1,886.93	-0.5%	-2.1%	1.2%
China. Shanghai Comp (RMB)	3,462.31	3.0%	-2.9%	-1.3%
HK. Hang Seng (HKD)	22,713.02	-4.6%	-3.2%	-21.6%
Australia. All Ords (AUD)	7,323.24	0.8%	-3.5%	5.5%
FTSE Asia Pac ex Japan	1,399.52	2.0%	-0.6%	-5.7%
FTSE World (USD)	2,977.95	-2.7%	-4.0%	9.2%
FTSE World (GBP)	2,223.85	-2.3%	-4.9%	13.7%
COMMODITIES				
Oil (WTI)	95.72	10.7%	46.9%	72.3%
Gold	1908.99	6.2%	7.6%	10.1%

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