Investment Views

May 2022

Are we nearly there yet?

Since the US Federal reserve dialed up its hawkish rhetoric in mid-November, the S&P500 has shed over 20%; the traditional definition of a bear market. In the tech arena, the repricing has been even more acute; the Nasdaq is nearly 30% lower with high profile names like Tesla and Netflix slumping 49% and 75%, respectively. Global equity indices followed suit.

Bond markets were similarly troubled as investors moved to price in rising interest rates. The US Treasury market has seen an 11% peak-to-trough decline, whilst UK Gilts have lost 16%; the spectre of stagflation (rising prices, but weak growth) is particularly stark in Boris' Britain. Dollar credit fared even worse as the yield on high quality corporate bonds has doubled from its September low, touching 4.5% by mid-May. For American investors a resurgent greenback served to amplify the pain as the trade-weighted dollar (the DXY) added 7% for the year to date. One of the few assets to buck the trend was gold. Bullion was broadly flat in dollar terms, but 5-to-10% higher when priced in sterling, euro and Aussie dollars; a safe haven despite rising yields.

With US inflation touching 8.5% in March, the Fed has started to withdraw its post-covid largesse. The Fed funds rate has risen from 0.25% to 1%, with markets expecting 1.75% of additional hikes by the summer next year. It also plans to shrink its $9trn balance sheet, letting up to $95bn of Treasuries and mortgage backed securities mature every month.

This reduction in liquidity has kicked the chair from under assets markets, washing out over-valuation born of excess stimulus. So far, this has mostly been a valuation correction; earnings forecasts have held up as markets have fallen. For the year to date, the 2022 price/earnings multiple on the S&P500 has contracted from 22x to 17x (source: Yardeni).

The question is, what next? At the time of writing the 5-year Treasury yields 2.7%, akin to market based inflation expectation of a similar duration. Rates and inflation are now broadly in line. Has the Fed done enough to tame prices and, if so, is all the bad news now reflected in equity indices?

With manufacturing and service activity surveys confirming a US economic slowdown, it is reasonable to assume that inflation will moderate as we head into the autumn. If that proves to be the case, the Fed will be able to row back from its more aggressive tightening rhetoric. Indeed, the President of the Atlanta Fed has already suggested that the rate rise cycle may pause at 2% in September. With similar dynamics evident in the UK, EU and China, this could put a floor under equities, as it would reduce recession risks and concomitant profit downgrades.

The key threat to this narrative is the ongoing supply disruption born of the Ukraine war and China's draconian covid policies. As regards the former, Putin has weaponised the supply of hydrocarbons, fertilizers and foodstuffs to test the resolve of his western adversaries; domestic inflation and food poverty are hard to stomach. On a more positive note, whilst we do not doubt President Xi's desire to maintain his zero covid policy, the economic cost of extended city lockdowns is having a dramatic effect on mainland GDP and employment. As Premier Li noted in a call to thousands of Chinese government representatives, the economy is in some respects faring worse than in 2020. We thus expect policy to strike a more even balance between disease containment and domestic stimulus as we head into the summer, allowing Chinese growth to stabilise.

As such, even if Putin persists, we are possibly at or near peak supply disruption, reinforcing the argument that inflationary winds will soon abate. This would take the pressure off rates, yields and equities. Of course, if Putin's adventurism continues to drive commodity prices higher and/or China continues to sacrifice growth at the altar of covid containment, inflation could be quite sticky, complicating the Fed's decision. A rapid snap back in Chinese demand could also aggravate the supply deficit in oils and metals. The risk then is that they keep raising rates to cool the fastest inflation in four decades, thereby triggering a deep recession. This, in turn, would catalyse the next down-leg in equities, as corporate earnings slump.

Our best guess falls somewhere between the two extremes. On the plus side, we see a more pro-growth China as we head towards Xi's re-election at the 20th Party congress in October. We also believe that Fed policy will tolerate higher inflation if the alternative is a deep recession; this is doubly so given the US mid-term elections in November. Set against that, we suspect that US (and global) growth is actually weaker than current headlines suggest, meaning a mild recession is all but inevitable.

Turning to markets, we would be unsurprised to see further equity downside, although a precipitous sell-off is not our core scenario; we do not expect politicised Central Banks or populist Governments to stand idly by. For client portfolios, we continue to book profits on the likes of gold, "value" equities and specialist volatility funds, recycling the proceeds into favoured growth sectors as sentiment drags them lower.

We have also started to add back to US Treasuries, given the sharp rise in yields. As recession fears come to the fore, high quality bonds are set to re-establish themselves as an effective offset for equity risk. After several years where floods of QE cash pushed yields to artificially low levels, value is now emerging in the bond universe. Indeed, having shunned corporate bonds, mounting recession fears could well push yield spreads wider, offering us an attractive opportunity to buy company debt for the first time in nearly a decade.

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 US Treasuries	Gold, Volatility Strategies
–		European US	UK European Japanese	

Market Performance

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

	30th April 22	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.2574	-4.3%	-6.5%	-9.0%
CHF	1.0272	-5.2%	-4.8%	-6.2%
AUD	0.7061	-5.6%	-0.1%	-8.5%
JPY	129.7000	-6.2%	-11.3%	-15.8%
EUR	1.0545	-4.7%	-6.1%	-12.3%
BOND YIELDS (10 yr)				
UK	1.90	0.30	0.60	1.06
US	2.94	0.60	1.16	1.31
Germany	0.94	0.39	0.93	1.14
Australia	3.13	0.29	1.23	1.38
Japan	0.22	0.01	0.05	0.13
EQUITIES				
US. S&P 500 (USD)	4,131.93	-8.8%	-8.5%	-1.2%
UK. FTSE 100 (GBP)	7,544.55	0.4%	1.1%	8.2%
MSCI Eur ex UK (Local)	1,561.41	-1.8%	-6.0%	-0.4%
Japan. Topix (JPY)	1,899.62	-2.4%	0.2%	0.1%
China. Shangai Comp (RMB)	3,047.06	-6.3%	-9.4%	-11.6%
HK. Hang Seng (HKD)	21,089.39	-4.1%	-11.4%	-26.6%
Australia. All Ords (AUD)	7,724.76	-0.8%	6.3%	6.0%
MSCI Pac ex Jap (USD)	1,400.74	-6.0%	2.1%	-9.8%
MSCI World (USD)	2,795.62	-8.4%	-8.6%	-4.9%
MSCI World (GBP)	2,222.62	-4.3%	-2.4%	4.6%
COMMODITIES				
Oil (WTI)	102.94	6.3%	24.5%	76.9%
Gold	1896.93	-2.1%	5.6%	7.2%

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