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Investment review – End Q1 2022

30 March 2022

It is now two years since the start of the global pandemic and despite having made significant progress we now have another, and altogether different, unfolding shock costing lives and creating potential for significant economic uncertainty and disruption.

Prior to the Russian invasion of Ukraine in late February, there was hope that several key global macroeconomic variables, including economic growth, inflation and employment might return to some form of normality later this year. Although Omicron had delayed the recovery and supply chain bottlenecks were causing a spike in inflation, we seemed to be edging closer to the point where we could visualise supply and demand imbalances ironing themselves out during 2022 and global growth finally returning to pre-pandemic levels maybe in 2023. The outlook also suggested that the world's central banks were reaching the point where the emergency monetary and fiscal measures put in place during the pandemic could be gradually removed. In a matter of weeks, however, the course of the world economy and the lives and livelihoods of millions of people have, tragically, changed once again.

Elements of the pre-conflict narrative, particularly relating to those economies less directly exposed to the war itself, may not yet be taken too far off their originally expected course. So, some care is needed in terms of potentially making sweeping changes to any existing long term investment strategy, especially whilst so much uncertainty over data and eventual outcomes prevails. But the facts are that even with a swift resolution to this ugly conflict, which currently seems unlikely, the world's economy and people's living standards are already being impacted by the knock-on effects of higher energy and food prices. Although its inflationary effects are starting to diminish slightly, the coronavirus pandemic is also still very much with us and renewed restrictions in countries such as China and continued disruption to supply chains do still need to be factored into the inflation and growth outlook. Global economic activity this year is therefore unlikely to be as strong as originally anticipated. The Organisation for Economic Co-operation and Development ('OECD') suggests that if current higher commodity prices are sustained throughout the year, then this might clip one percentage point from global economic growth and potentially add 2.5 percentage points to global inflation.

Markets adjusting to inflation expectations

Despite recent, quarter-point interest rate hikes in the US and UK, plus further moves signalled for later this year, central banks are still talking about a gradual path to policy normalisation. That backdrop should remain supportive for risk assets such as stockmarkets. But the higher inflation goes, so the pressure to be more aggressive with monetary policy might also rise. Equally, though, policymakers and markets will be well aware that overdoing the policy response would also be a major risk to economic growth and employment, something they will also be keen to avoid. Some compromises will therefore need to be made which also allow natural market forces of rebalancing to occur, with perhaps some acceptance that inflation will need to run at a higher level, without intervention, for a little longer than would ideally, or normally, be the case. As things currently stand, 2022 is still expected to be the year of primary inflationary concern – after that, expectations, including those from the likes of the US Federal Reserve, are for price pressures to subside via the firmer stance taken on monetary policy, easing of pandemic bottlenecks and gradual stabilisation of conflict-induced commodity inflation.

Financial markets have already begun to adjust to the prospect of this additional upward pressure on inflation, an altered course for interest rates and weight on economic activity.

Bond markets have had a particularly difficult quarter, with the shorter maturity end of yield curves rising sharply in the US and UK in anticipation of central banks needing to take bolder and swifter steps to address inflation. Global stockmarkets have, so far, held up remarkably well in the circumstances although we have seen a topsy-turvy start to the year and some sharp market falls in late February, followed by a partial recovery since then. In January, we encountered a big sell-off in growth stocks, impacting the technology-heavy US market in particular, and saw increased appetite for areas more geared to a cyclically-orientated economic recovery, such as Europe; but this rotation was short-lived with the conflict between Russia and Ukraine exacerbating the uncertainty over inflation and boosting the appeal for markets laden with commodity stocks or more defensive growth companies with strong cash flow, low debt and pricing power. By the end of the quarter, worries over stagflation – stagnating growth and significantly higher inflation – have surfaced, particularly in Europe, whilst the more immune US economy has, once again, been showing its capacity to be more resilient, its stockmarket rallying once again into the quarter-end.

Increasing exposure to infrastructure

We have resisted the temptation to make big changes during the quarter and have maintained stockmarket positioning at the upper end of strategic ranges. That said, just as the unfolding global pandemic in 2020 prompted us to make changes to our stockmarket composition, so the rapidly changing inflationary scene and war in Ukraine has also caused us to rearrange some exposure. It seems clear that, until their reliance on Russian energy can be diluted, Europe's economies are most at risk amongst developed regions. We have therefore trimmed (or cut entirely in some cases) the exposure to dedicated continental European equity funds and increased the exposure to global infrastructure investments.

Infrastructure assets have historically performed very well in times of slower growth and elevated inflation, offering investors cash flows that are frequently underpinned by regulation or long-term contracts and where revenues are typically inflation-linked. Income yields are also generous, currently in excess of 4%. Such investments also tend to involve more defensive assets – companies building, maintaining and upgrading critical infrastructure frameworks including power networks, pipelines, railways, roads, bridges, airports and renewable energy infrastructure in both the developed and emerging world. The additional investment we have made to this area may still give some exposure to selected European companies, but these will include enterprises that can help reduce Europe's reliance upon Russian energy – which the war has so acutely highlighted – and help it obtain greater security through more stimulus and investment in renewable energy sources.

Finding alternative energy sources now a priority

Russia clearly now stands alone, ostracised through its own military actions, economic sanctions and a growing 'cancel culture' as Western businesses sever all ties. It will be a very long time, probably many decades, before those countries and organisations that previously had trading relationships with Russia consider re-building those economic pathways. Russia's contribution to global gross domestic product is small, estimated to be under 2%, so its economic isolation will not be missed internationally. But as we are all now acutely aware, its influence over commodity price inflation means that finding alternative energy supply solutions, quickly, has become the number one priority for many countries.

We noted in our February update that the diversion of liquified natural gas ('LNG') destined for other parts of the world might help, so it is already good to read that the US is freeing up 15bn cubic metres of LNG for Europe, equivalent to around 10% of the gas that Europe currently obtains from Russia. Germany, which currently receives more than half its gas needs from Russia, has also clinched a long-term LNG supply deal with Qatar. These are just a couple of examples which reflect what will be a lengthy period of negotiations that redesign the energy supply map. Ultimately, however, it is the advancement of new energy technologies that will be the game-changer for Europe – these will evolve over a much longer time period, but rather like what we saw with the pandemic in terms of changing mindsets towards remote working and technological solutions, a similar 'hurry-up' is now likely to evolve in relation to Europe's energy transition.

Many of the future investment opportunities surrounding this broad theme are already present across our existing commitments to global infrastructure, environmental and sustainable energy funds, as well as via the diverse range of active managers of regional equity funds held in clients' portfolios.

At the consumer end of the inflation equation, those in charge of the purse strings, including our own Chancellor, are busy getting creative, trying to do what they can within their budgets to shield low income consumers and small businesses faced with huge rises in their energy and food bills. All the piecemeal gas and oil supply deals, subsidies, reductions in fuel duties or other rebates and handouts from governments may seem small measures individually but they will add up. To coin a phrase used by a well-known supermarket, 'every little helps' at present. In a similar vein, we are doing what we can to insulate portfolios as best we can from the vagaries of inflation, but there are limitations in terms of what we can do.

Markets still investable – but back to basics

We are now likely to enter a period of lower, less inspiring, economic growth as this year unfolds, and that in turn may make it a more challenging backdrop in which to generate investment returns than we have seen for a while. But slower economic growth and rising inflation does not make stockmarkets uninvestable. It does create more uncertainty, which markets dislike, and does add more complexity to the investment selection process, including requiring even more care. But that is sometimes no bad thing, frequently allowing companies that had been keeping a low profile to have their time in the limelight. Because the rising tide of liquidity has floated most investment boats, it has been a while since equity markets have needed to really focus on investment fundamentals, such as quality of franchise and management, barriers to entry, cash flow, strength of balance sheet and debt levels. With the cost of debt and input costs rising, and the discount rate upon which shares are priced increasing too, the task of finding the survivor businesses or those well positioned to take advantage of current economic conditions and trends has become a more challenging one compared to the past few years.

But that does not mean opportunities cannot be found. As one of our active American managers put it to us recently, we should be focused on owning more "real stuff" – growth companies with pricing power that have established franchises and visible earnings, either in more defensive sectors or linked to long term structural tailwinds, that are trading on sensible multiples of future earnings – rather than some of the more glamorous, less-established, expensive "fluff", much of which has dominated investor appetite in the past couple of years. Outside some of the mainstream index heavyweights, stockmarkets such as the US are not as expensive as might meet the eye, especially after their recent sell-off: it is still possible to find companies with strong fundamentals, some also with progressive dividend policies, and it is these businesses we are hopeful our range of active managers can continue to uncover.

Successful businesses can use their profits to reinvest organically to grow their business or distribute to shareholders by way of dividends, or a combination of the two. Either way, they provide a means by which investors' wealth can put up a strong wall of resistance to fight the corrosive effects of inflation. The compounding effect of steady profits and growing dividends can help keep both the real value of capital and income levels moving forward in a way that few other asset classes can. But it does require a strong constitution during periods of market duress to gain the most in the longer run. Over the past 15 years, for example, missing just the best ten days in the broad UK stockmarket would have reduced one's total investment return, including reinvested dividends, from almost 5% per annum to virtually zero. Although it has been tempting to take cover at times during the first quarter of 2022 by reducing stockmarket exposure, we have held our nerve, guided by longer-term experience that reversals are often over quickly, particularly for investments supported by solid foundations. We are not complacent about the heightened risks that currently threaten market stability, but do feel that a lot of uncertainty is already priced in. We are equally aware that with so much conflicting macro-economic and geopolitical noise around us, the better action is probably to keep our heads down and play the long game so as to keep participating in the rewards that come from stockmarket investment.

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For those investors who do not have the stomach for large commitments to stockmarkets, the availability of asset classes that can genuinely combat inflation are quite limited. But we feel our commitments to asset classes such as inflation-linked bonds and market neutral alternative investment funds do have a chance of grinding out real headway and can also act as stabilisers in times of turmoil. Some might argue that cash is the ultimate defence tool, but when interest rates are still low and inflation is running hot, it is definitely not king – holding it for any length of time is likely to be particularly damaging to the real value of one's wealth.

Yes, if inflation stays high for too long and interest rate moves are so big that they bring on recessionary conditions, then stockmarkets are initially likely to see a de-rating. In that scenario there may be few places to hide. But what typically follows is a period when stimulus returns to bring the economy back into equilibrium once again, and for markets to stage a recovery. Finding that economic balance is never easy for central banks and governments, and for this reason stockmarkets do, by and large, tend to be constantly out of step with what one might intuitively think should be happening. That is because markets are always a mix of the immediate news, both good or bad, and a much longer-term perspective that recognises the rewards that come from participating in business profitability.

Having seen inflationary pressures build during 2021 we have been content to maintain index-linked bond exposures and have a lower duration stance generally within fixed interest markets to minimise the impact from rising interest rates. That stance is still appropriate today, with more nuanced positioning in fixed interest markets being left to the specialist strategic managers with the aim of trying to manage the threat of even higher inflation as best they can. Against a backdrop that is generally unkind to fixed interest investments, it will probably be a case of damage limitation rather than making real progress whilst this inflationary spike is brought under control. Alternative investment funds are one area that can still play an important role, capable of grinding out steady positive returns, but a combination of the availability of consistent performers, liquidity and tax-efficiency means the pool of acceptable vehicles is quite small. We are reluctant to stray into more exotic alternative investments, especially since finding genuinely diversified instruments that can act as stabilisers *and* provide inflation-busting returns tend generally to be mutually exclusive traits. Caveat emptor: if it sounds too good to be true, it probably is.

Maintaining a disciplined approach

As noted, we are resisting the temptation to tinker too much with strategies that we feel are already as well positioned as they can be in this uncertain period. We are continuing to give good exposure to those parts of the world, most notably the US and Asia, that should still be able to grow at an attractive rate and possess total return opportunities that can combat inflation. And on the other side of the coin, where relevant, we have exposure to more defensive assets that should, at least in part, make a reasonably firm fist to fight inflation. It is a tough environment for several conventional defensive assets, most notably fixed interest, but we hope our positioning can avoid some of the larger potholes.

Realistically, 2022 is likely to be a more modest return year than last, but remaining invested does at least give investors the chance of fighting inflation, in contrast to a much more defensive stance which almost certainly will not. Like most forecasters, including those advising on central bank policy, we do expect inflation risks to subside but perhaps now to a higher level than expected a few months ago. But whilst inflation is elevated we believe that maintaining a disciplined approach, with a greater focus on investment fundamentals, should allow clients' wealth to be carried over this inflationary and economic speed-bump without too many scrapes. When the road ahead is less embattled than it is at present, this approach should provide a platform for longer-term growth journeys to recommence.

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