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Investment review – End Q2 2022

30 June 2022

It has been another difficult quarter for financial markets and the investments exposed to them. Supply chain bottlenecks, labour shortages and continued coronavirus restrictions have been an upward inflationary force for some time, but the huge war-induced rise in energy and agricultural commodity prices is exacerbating the inflationary issues now being felt by consumers and businesses across the world.

The global economy has therefore begun to slow and deviate from its expected course, impacted by the larger-than-anticipated spikes in inflation and fears about its ultimate impact on consumption and economic ripple-down effects. The rhetoric and reactions from central banks have, so far, sent a more hawkish message to markets by prioritising the tackling of inflation and embarking upon an earlier and more aggressive strategy for interest rates. Having been beneficiaries of cheap and ample liquidity for some time, financial markets are understandably finding it difficult to wean themselves off the highly accommodative policy introduced following the outbreak of the global pandemic.

Few safe havens but some stability returning

This uncertain backdrop has proved challenging for most asset classes: there have been few safe havens of late, with both equities and bonds suffering losses in the first half of 2022. Even cash, whether deposited in the bank or stashed under the bed, will have lost significant value in real (i.e. inflation-adjusted) terms. So-called 'growth' companies, particularly in technology-related sectors, have seen some of the bigger downward adjustments in share prices this year, the value of their future earnings being eroded by the threat of a higher cost of capital. Income- and more 'value'-orientated investments, or markets biased towards energy- or commodity-related sectors, have fared better on a relative basis. This helps explain what appears to be an anomaly in the UK stockmarket where, rather surprisingly given the underlying poor economic backdrop, the larger capitalised UK-listed companies have barely lost any ground in aggregate this year. This is reflective of the overall bias towards international stocks in the energy, industrial metals and mining sectors in the mainstream market index. In contrast, an index of medium-sized UK company shares, which does not have such sectoral skews, has fallen by around 20% over the same period.

In the very last days of the quarter some semblance of order has been restored, with bonds and equities staging modest rallies from their mid-June lows. The bounce has been insufficient to offset the falls in asset prices during the quarter, but it is perhaps a hint that financial market participants are starting to come to terms with the complex interplay between inflation, interest rates and economic activity, and they are beginning to look through the near-term uncertainties to focus more on some of the longer-term opportunities that have been exposed by the recent market weakness. The darkest hour is always just before the dawn, and staying invested, as we have done, allows us to capture those (often paradoxical, yet powerful) market turnarounds when they do occur.

An alternative to bonds and equities

The declines in bond prices this year, as well as their volatilities, have at times been as great as those seen in equity markets. The sharp rise in inflation and upward shift in interest rates has not been kind to this asset class, although our earlier moves to reduce the sensitivity of clients' bond market exposure to higher interest rates and inflation has helped us avoid some of the worst falls. Looking ahead, with attention potentially turning to protecting growth rather than curbing inflation, an opportunity to take a little more risk within fixed interest markets may soon materialise.

We, along with our underlying strategic bond fund managers, have therefore recently reduced slightly some of the more defensive tilts in this asset class.

What the recent highly correlated movements in both equity and bond markets have illustrated is that a traditional 60:40 balanced portfolio made up of 60% equities and 40% bonds will not have fared well this year. Neither asset class has offered much defence from rising inflation, tighter monetary policy and a simultaneous slowdown in economic activity. The supposedly lower risk element, i.e. bonds, has not been a counterbalance to equity risk. Part of the solution, therefore, for those investors without the stomach for full-blown stockmarket risk, has been to divert part of their traditional fixed interest budget to 'alternative' investments, a coverall term for assets that offer the potential to provide a different source or structure of return when more traditional assets fall out of favour. Our general increase in exposure to 'alternative' investment funds over the past year has helped to cushion some of the declines witnessed in more conventional asset classes. Where relevant, we have recently continued to add to this important asset class, at the expense of fixed interest.

There is no standardised labelling or categorisation of 'alternative' investments, and some of those that rely on listed equities to fulfil their objectives or return profiles have experienced just as much volatility as conventional stockmarket investments in recent months. We have steered clear of all such 'quasi-equity' vehicles and concentrated instead on allocations to funds that can genuinely neutralise market risk. Their return expectations may not be overly ambitious, but we quite like that attribute – it typically means low levels of volatility (in many cases less than bond markets) and the potential to make a positive return irrespective of whether markets are generally moving up or down. Genuinely alternative investments, particularly 'market-neutral' funds, have come into their own in the past few months, and are likely to continue to act as portfolio stabilisers and sources of good risk diversification and return if more traditional assets continue to come under some pressure. We are quite choosy about what makes the cut as an 'alternative' investment fund within our range of preferred investment vehicles, with low volatility and accessibility being two key things we prioritise.

Central bank policy and looking ahead

Where economic growth will settle for different countries and regions over the coming months and into 2023 is still shrouded with a great deal of uncertainty. There are many variables that will influence the global economy's path from here, but probably the most important to focus on, and which is likely to have the propensity to cause the biggest margin for error in forecasts, is the seemingly impossible balancing act required of central banks to manage both inflation and growth.

Global policymakers clearly face some difficult decisions ahead, potentially needing to switch their attention to maintaining economic momentum rather that tackling inflation. The recent larger-than-expected 75 basis point hike in US interest rates suggests that inflation is still the US Federal Reserve's number one priority. But we could soon be at a crossroads on policy if recessionary noise becomes too loud, leading to central banks lifting their foot off the brake pedal. Contributing to the potential for central bankers' indecisiveness and difficulties in setting appropriate levels of monetary policy will undoubtedly be how the Ukraine crisis unfolds from here. This includes whether we see further chaos in energy markets or whether prices begin to ease as new supply routes and energy sources open up, or if oil price caps are introduced. How China's current zero-COVID policy continues to impact global supply chains and activity is also another critical piece of the global growth and inflation jigsaw. It seems that the fate of the world economy (and hence people's lives and livelihoods) and financial market stability does lie in the hands of just a few global influencers on the Board of the US Federal Reserve or those presiding over war or COVID tactics in Russia and China respectively.

On a slightly brighter note, core inflation, which excludes historically more volatile food and energy prices, has already begun to moderate, perhaps a sign that we are close to seeing peak inflation. Our expectation is that inflation will retreat to more manageable levels quite quickly, possibly within central banks' target ranges in under two years.

As noted already, much still hinges on residual COVID restrictions being relaxed and no material escalation of the conflict in Ukraine, including no further fallout in energy markets. We are mindful that an environment of high inflation and softening growth is not sustainable for that long. Interest rate rises are therefore expected to be contained within ranges that do not create instability in credit markets or long-term hardship. Global economic growth is expected to slow, but not grind to a halt. It is worth noting, for example, that leading global indicators for both manufacturing and service sectors are still pointing towards expansion rather than contraction, despite the data incorporating at least three months of the Russia/Ukraine conflict. Currently, these data, which are forward looking in nature, do not suggest global growth is on the edge of a precipice. We are alert to the fact that some areas may slip into technical recessions (defined as two consecutive quarters of negative GDP growth), but we do expect these to be relatively short-lived. Current forecasts suggest global growth could actually hold above 3% this year and into next, only slightly lower than the average seen in the five years prior to the global pandemic.

Economic uncertainty priced in for now

Much of the current economic uncertainty seems priced in to financial markets, with government bond yields having risen sharply and equity markets already reflecting a more muted outlook for corporate profitability. So far, corporate earnings and profit margins seem to be holding up quite well, with stockmarket valuations in many regions now significantly lower than their 25-year average. Even in the US, valuations have come back within a more acceptable range, particularly when the more expensive 'tech-orientated' index heavyweights are excluded. It is worth noting that in previous periods of significant economic and market uncertainty (e.g. the 2008 Global Financial Crisis, the early 1990s recession or during the outbreak of COVID-19), the downward move in equities was typically greater than the ultimate downward adjustment in corporate profits. There could of course be another leg down in markets if corporate earnings are worse than analysts are currently pencilling in. But there does appear to be a reasonable margin of safety after recent falls in share prices, with stockmarkets already pricing in a lot of the aforementioned gloomier news on the state of the world economy generally.

Corporate margins are another thing to watch closely whilst inflation is running hot. So far they have held up quite well as companies have generally passed on rising costs to consumers. It will be those companies that have strong balance sheets, a higher proportion of fixed rather than variable costs, and have dominant franchises or a competitive edge that are less likely to face demand pressure or price sensitivity. They should also be more resilient to profit margin pressures, finding it easier to trade through the expected downturn by maintaining pricing power. We are hopeful that active managers can continue to seek them out.

Geographical economic disparities remain

Asian economies are expected to continue to provide a strong underpin for the global economy in the medium to longer term, with some attractive economic growth rates expected and cheap valuations available to investors. This includes China which, in contrast to many western economies, is scheduled to pursue more expansive monetary and economic policy, aided by low levels of inflation, that should increasingly become an investment tailwind. Whilst China will be reluctant to lose face and materially alter its zero-COVID policy in a hurry, news of certain quarantine arrangements being cut from three weeks to ten days is a step in the right direction and should help the economy to get back on its feet. But if the country is serious about achieving an economic growth rate anywhere close to 5%, as it has recently re-affirmed, then it will certainly need to be more accommodative with its policies.

After a lengthy period of underperformance, partly brought about by the government's own actions, Chinese share valuations have become very appealing. There is also an improved belief that the authorities have now finished targeting certain sectors with restrictions and regulatory crackdowns, and that the risks of further, damaging, government intervention has now dissipated. Indeed, there is a possibility that President Xi Jinping, keen to position himself optimally for re-election at the National Congress in the autumn, might actually begin to announce some fresh pro-growth initiatives.

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A number of our underlying Asian managers have identified the opportunity in China and have recently begun to increase their exposures. We, too, are keen to take advantage of the longer-term opportunity in Asian markets, including China, by increasing exposure in those strategies that have the room for it.

The one main area that still gives us some cause for concern, and where we are further reducing exposure, is the eurozone. The economy still looks vulnerable to continued energy-related shocks, whilst efforts by the various governments to reduce their dependence on Russia and make energy sources more sustainable are not helping the inflationary picture. At the same time, wage pressures are rising rapidly. The European Central Bank therefore faces the prospect of tightening policy more aggressively than it would otherwise like to do, particularly for some of the bloc's economically-weaker periphery – tighter borrowing conditions, reflected for example in Italian bond yields trading at a significantly higher level than German bunds, raise the risk of eurozone fragmentation as wedges are driven between countries sharing the single currency.

Our positioning and outlook

The outlook for the second half of 2022 is not straightforward. However, as noted, recent falls in both bond and equity prices do look overdone based on the expected trajectory for interest rates and corporate earnings. It is also interesting to observe that consumer sentiment has already plummeted to levels lower than in the mid-1970s, the early 1990's recession and the Global Financial Crisis. Those previous troughs in consumer sentiment were followed by a strong rally in equity markets over the following 12 months.

Overall, we are maintaining our commitment to stockmarkets at the upper end of strategic ranges – we are taking a medium-term view that the current downturn will be relatively short-lived and that the risks of exiting and re-entering markets are greater than riding out this period of adjustment in asset prices. Our focus, tactically, is to continue to position stockmarket risk towards the areas of superior opportunity or growth, and away from those areas that are likely to remain under strain.

We continue to have good exposure to the US market. Whilst it, too, is facing more challenging conditions, including heightened recession risk from the US Federal Reserve's firm stance on controlling inflation with higher rates, the equity market has a rich seam of leading (and in some areas less-expensive) global businesses for active managers in particular to access. We remain comfortable with our commitments to both the market and US dollar – the currency should remain supported by expected policy moves and we see the US economy performing better than areas like the UK and eurozone, helping the relative strength of the currency versus the pound and euro respectively. The dollar also has the capacity to act as a safe-haven currency should even trickier conditions materialise. Meanwhile, the pound looks set to remain under pressure. The UK economy has its own, highly specific, issues to deal with including a fractious post-Brexit trade framework and political backdrop, neither of which seem encouraging for business domestically or from abroad.

Opportunities remain but expect a bumpy road

The investment path over the next few months could still be quite bumpy, but that does not mean there will be no opportunities to make progress. The backdrop does, though, perhaps require more agility than normal, both for us and the underlying active managers we deploy. In that process we must also keep a firm eye on some of the longer-term trends and growth drivers that were well under way before the global pandemic or war in Ukraine came into the frame, or have been permanently impaired or enhanced as a result of these unscheduled events. We are confident that the various alterations we have made to our investment positioning in recent months (and those we are embarking upon right now) – whether those changes have defensive attributes or are designed to make hay whilst the sun shines – can carry investors' portfolios through this cloudier period to deliver on longer-term objectives.

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