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Square Mile's Market update

April 2022

Summary

Russia's invasion of Ukraine is exacerbating economic trends that were already established: rising inflation and slower growth. Although not our central hypothesis, the possibility of stagflation or even recession has clearly increased. The tightrope on which central banks are treading as they battle to contain soaring inflation without tipping economies into recession has narrowed and the risk of policy error remains elevated.

It was a painful quarter for investors in bond markets as spiralling inflation caused yields to rise significantly and prices to fall. Government bond yields are still very negative in real terms (i.e. after inflation) and could remain so for years to come. However, with economic growth set to slow markedly, the outlook for bond markets is more balanced. Our expectations of returns from investments in bond markets continue to be modest. As before and where our mandates allow, we favour flexible bond funds which can cherry-pick the best opportunities as they arise.

The first quarter of 2022 was characterised by one of the most violent swings in the fortunes of 'Growth' and 'Value' stocks ever seen, making it a much more difficult period for most investors than the relatively small declines in many stock markets would suggest. We believe that we hold a prudent level of equity risk in the portfolios we manage given the backdrop of slowing economic growth and rising interest rates. However, we are watching closely for any signals of impending recession and will not hesitate to reduce exposure to equities if the economic outlook deteriorates.

Macro Highlights

It would be wholly wrong to begin the main part of this report in any other way than making reference to the dreadful events unfolding in Ukraine following the Russian invasion on 24th February. We cannot, of course, predict how the war will end and can only hope that a diplomatic resolution will soon be reached that halts the appalling loss of life and destruction. The economic consequences of the conflict, however, will extend far beyond Russia and Ukraine and will be enduring. In the absence of complete regime change, it seems likely that Russia will be a pariah state, subject to heavy sanctions, for years to come. This not only has implications for the prices of a range of commodities and for economies for whom Russia is an important trading partner but is also certain to cause Western governments to reallocate more spending on defence and focus even more on supply chain dependencies.

Readings of both inflation and economic growth in the months ahead will certainly be worsened by the war. In truth, however, the trends of higher inflation and slower economic growth were already well established. Even before the conflict began, the prices of oil and gas had risen by more than 20% in the first eight weeks of 2022 and this followed increases of more than 50% in 2021. In early February, Ofgem announced that the energy price cap would rise by 54% on 1st April. The latest CPI inflation rate in the UK is 6.2% for the year to the end of February, up from just 0.4% twelve months ago, and this is before April's increase in the energy price cap. As measured by the 'old' Retail Prices Index, the UK inflation rate stands at a 30-year high of 8.2%.

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Fuelled by another probable hike in the energy price cap in August, the UK's fiscal watchdog, the Office of Budget Responsibility, now expects the CPI inflation rate to reach 8.7% in the final quarter of 2022. Unsurprisingly given its origins, soaring inflation is not just a UK phenomenon. The latest print of inflation in the US is 7.9% and even in Germany it stands at 5.1%. The rate of inflation is, of course, a year-on-year rolling measure and some of the factors which have contributed to the spike will necessarily wane over time. However, barely a day passes without another company announcing that it is increasing its prices to offset rising costs, creating a vicious circle. Similarly, and not least because unemployment rates have fallen close to pre-pandemic levels, workers are understandably demanding that their pay is increased at least in line with inflation. The risk of a wage price spiral developing cannot be dismissed. Rates of inflation should peak later in the year but it is wishful thinking that they will return to the 2% level targeted by most central banks anytime soon. We think a medium-term figure of 3-4% is more likely.

The outlook for economic growth is perhaps even harder to predict. 2021 was clearly a bumper year as the global economy reopened after COVID lockdowns. The UK economy grew by 7.5% and the US by 5.7%. The UK's superior economic performance in 2021 was largely because it suffered a much larger contraction in 2020 (-9.4% vs. –3.4%). 2022 was never going to match 2021 but it has been widely believed that continued consumer spending of excess savings accumulated during lockdowns and the momentum of 2021's recovery carrying over into 2022 would secure a healthy outcome. Forecasts of economic growth in 2022 are now, however, being revised downwards. Consumer confidence is being battered by soaring energy bills and inflation, rising interest rates and, in the UK, higher taxes. Companies are also being squeezed by rising raw material and labour costs and higher interest rates, with investment being put off by the deteriorating and uncertain economic backdrop. Finally, the scope for yet more fiscal support from governments is clearly limited, not least because of the rising cost of borrowing. The UK's national debt has increased from £350bn in 2000 to £2.3trn today and the cost of interest on that debt in the current financial year will exceed the budgets of all government departments except health and education. Although we still expect the global economy to grow in 2022, the risks of a period of stagflation (slow economic growth coupled with high inflation) or even recession are clearly increasing. It is also likely that there will be big regional variations, with Europe the most vulnerable to recession because of trading links with Russia and the US the most insulated and resilient.

We wrote three months ago that central banks are walking a tightrope as they battle to control inflation without tipping economies into recession. That tightrope has now become even narrower.

Bonds

Government bonds have traditionally been viewed as a refuge for investors in times of stress in equity markets. Prior to 2008's financial crisis, this generally held true but it certainly didn't in the first three months of 2022. The reasons are twofold. First, the suppression of bond yields through successive programmes of quantitative easing has been a central plank of central banks' policies to rescue and boost the global economy ever since the financial crisis. Although bond

yields rose in 2021, they still started 2022 at very low levels relative to history and therefore had only limited scope to fall and, in doing so, provide gains for investors. When the yield of a bond falls, its price rises. Second, and more importantly, rising inflation is the nemesis of bond markets (because it erodes the value of interest payments and the repayment of capital when a bond matures, both of which are fixed). As bond yields rose to take account of higher inflation, however, the valuations, and hence prices, of shares were also undermined. The root cause of the weakness in both bond and global stock markets was therefore the same.

As the rate of inflation rose and the Bank of England raised interest rates to a heady 0.75% (matching the highest level since the financial crisis), 10-year UK government 'gilt' yields climbed from just under 1.0% to 1.6% during the quarter. This resulted in a hefty loss of more than 7% for investors in the broad UK government bond market. In the US, 10-year US Treasury bond yields increased from 1.5% to 2.3%. Although the increase in 10-year yields in the US was more than in the UK, however, investors in the US bond market lost significantly less than their counterparts in the UK. This apparent anomaly is a function of the maturity profile of the UK gilt market, which is considerably longer dated than other sovereign bond markets. Whilst the UK government should probably be applauded for securing such long-term financing, investors should be mindful that prices within the gilt market as a whole are therefore much more sensitive to changes in bond yields than other government bond markets.

Looking ahead, bond yields, being higher, are clearly more attractive than they were. The burning question is whether or not they have risen to a point where they now represent good value as investments. Looking at inflation in isolation, the answer is clearly no. By buying gilts or US Treasury bonds yielding 1.6% or 2.3% respectively, an investor is locking in a return which is negative in real terms (i.e. after inflation) and likely to remain so for probably years to come. In addition, the US Federal Reserve has recently reaffirmed that as soon as in May it is likely to start selling the gargantuan holdings of bonds it has accumulated in almost fourteen years of quantitative easing. Other central banks will sooner or later follow suit. This supply, over and above the funding needs of governments, will need to be absorbed by investors. On the flipside, central banks will be acutely aware that substantially higher bond yields would not only expose the excessive leverage that characterises parts of the financial system but would also make it much more difficult for governments to deliver on their debt-funded infrastructure, green and levelling-up agendas. Finally, bond markets have historically performed best in periods of economic slowdown and recession, the former of which at least is clearly looming.

So, despite very negative yields in real terms, the outlook for bond markets is not at all easy to predict. On balance, our expectations of returns from the asset class continue to be modest. Overall, we maintain a bias to bonds of shorter maturities which are less sensitive to rising interest rates and yields. Where our investment management mandates allow, we continue to favour strategic and tactical bond funds whose own very flexible mandates allow their managers to cherry-pick the very best opportunities as they arise across the wide continuum of bond markets.

Equities

After 2021's bumper returns, global equity market indices posted their worst quarter of performance since the start of the COVID pandemic, albeit a decline of 4% can hardly be described as catastrophic. Indeed, given the surge in bond yields in response to soaring inflation and the economic impact of the war in Ukraine, the resilience of stock markets over the period was remarkable. In early March, in fact, investors in global equities were nursing year-to-date losses of just over 12%. However, the final three weeks of the month and quarter saw share prices rally by 8%. Astonishingly given the economic repercussions, from the day the Russian invasion began to the end of the quarter global stock market indices rose by about 5%. This demonstrates yet again that stock markets usually recover from and look through geopolitical events much more quickly than you might expect.

It was actually an even more difficult quarter for almost all stock-picking, active (opposed to index-tracking, passive) investment managers, ourselves included. Over the last five years at least, old economy 'Value' stocks have lagged far behind more glamorous, new economy 'Growth' stocks, such as in the technology sector. Managers of some value-focussed funds have battled even to stay in business as investors have jumped onto the growth bandwagon. This explains why the UK stock market, with its heavy weighting to energy, commodity and financial companies and dearth of technology companies, underperformed its US counterpart by more than 100% in the five years to the end of December 2021 in local currency terms. However, rising interest rates are beneficial for banks because it allows them to increase the margin between what they charge borrowers and what they pay to depositors. Rising oil and commodity prices are also obviously a boon to oil companies and miners. At the same time, rising bond yields undermine the valuations of growth companies because they reduce the present value of cash flows expected in the distant future.

The first quarter of 2022, therefore, saw one of the most vicious swings ever in investor sentiment between growth and value stocks, with most growth-oriented funds finishing the period with sizeable losses and many value-oriented funds delivering modest gains. It remains to be seen how durable this reversal in the fortunes of growth and value stocks will be. The prices of commodities are notoriously volatile and it is nonsensical to believe that 'Value' companies are immune from higher labour, energy and interest costs. Moreover, many are also vulnerable to an economic slowdown. In contrast, high quality 'Growth' companies with dominant market positions, pricing power and stronger balance sheets are better placed to weather such circumstances. The last three months and the years that preceded it have exposed not only the folly of having a big bias in portfolios to either Growth or Value but also the difficulty of trying to pivot between the two. In our actively managed portfolios we maintain a balance between Growth and Value but with a slight bias to the former. This is because we believe that high quality companies with strong balance sheets will be the best investments over the medium and long term.

The same abrupt swing in sentiment was also the main reason behind differences in regional stock market performance over the quarter. With a gain approaching 1%, the UK was the best

performing major stock market as a whole but there were significant variations within it. The index representing the performance of the UK's largest companies rose by almost 3% whilst indices for medium-sized and smaller companies were down by about 9%. It is no coincidence that most banks, oil companies and miners rank amongst the largest companies in the UK. In contrast, medium-sized and smaller companies, which tend to be more domestically focussed, suffered as forecasts of economic growth in the UK were revised sharply downwards. We share the view of many active fund managers in the UK that medium-sized and smaller companies can provide better returns over the long term but performance over shorter periods like the first three months of 2022 can sometimes be painful.

Elsewhere, the US market, with its much heavier weighting in technology companies, fell by nearly 5%. European stock markets were battered by their energy and trading links with Russia, with the German stock market tumbling by more than 9%. Bottom of the pile again, though, was the Chinese stock market which followed 2021's drop of just over 20% with another decline of 13%. At the time of writing, Shanghai, the country's commercial hub, is in full lockdown in efforts to contain a surge in coronavirus cases. Low levels of natural immunity, the inferior efficacy of Chinese vaccines and surprisingly low numbers of doctors and nurses in proportion to the population mean that the country's leaders have no real alternatives to their economically damaging zero-COVID policy.

Looking ahead, a backdrop of slower economic growth and rising interest rates does not seem a particularly conducive one for share prices. However, interest rates and bond yields are likely to remain very negative in real terms after inflation, diminishing the attractions of cash deposits and bonds as other stores of investor wealth. Moreover, companies are, for now at least, passing on their increases in costs and preserving their profit margins. All considered, we believe that we hold a prudent level of equity risk in the portfolios we manage. However, we are watching closely for any signals, especially in bond markets, of impending recession and we will not hesitate to reduce exposure to equities if the economic outlook deteriorates to this extent. Conversely, if stock markets tumbled to levels at which valuations became compellingly cheap we would be likely to add to equity risk.

Currencies

Over the quarter, the pound depreciated by almost 3% against the US dollar and was also fractionally lower against the euro. The strength of the dollar, which also appreciated by more than 5% against the Japanese yen, can be attributed to the US Federal Reserve's adoption of a much more aggressive strategy in its efforts to curb inflation. In March, the US central bank not only ended its purchases of bonds but also raised interest rates for the first time since 2018. Indeed, the latest so-called 'dot plot' of the expectations of the members of the Federal Reserve's monetary policy committee suggests that interest rates could be increased again at each of the committee's six remaining meetings this year (which will take interest rates close to 2%), with further hikes expected in 2023. Furthermore, recent messaging from Jerome Powell, who chairs the Federal Reserve, has pointedly failed to rule out the possibility of a 0.5% increase (in contrast to the 0.25% changes that investors have become accustomed to) if circumstances dictate. With their economies looking more vulnerable it is hard to see the Bank of England, the European

Central Bank or the Bank of Japan increasing their respective interest rates so rapidly and by as much.

Exposure to foreign currencies in the portfolios we manage is provided by investments in international equity markets and, opportunistically, in strategic and tactical bond funds.

Alternative Investments

Gold enjoys a reputation as a safe haven for investors in times of rising inflation and geopolitical conflict and both factors were present in the first quarter of 2022. Accordingly, the price of gold rose by close to 6% in US dollar terms and by almost 9% in sterling terms. In early March, the price of gold in dollar terms was up by more than 12% year-to-date (and close to its all-time high) and it is no coincidence that this matched exactly with the trough in stock markets when investors were most fearful. As investors' risk appetite subsequently recovered, gold gave back some of its gains. Notwithstanding the course of the conflict in Ukraine, the price of gold in the months ahead seems most likely to be determined by 'real' interest rates, which is the difference between interest rates and inflation rates. Thus, if rates of inflation continue to rise faster than interest rates we would expect the price of gold to rise further.

By its own extraordinary standards, the price of bitcoin was remarkably stable in the first three months of 2022, its price fluctuating by 'just' 25% during the period and ending the quarter virtually unchanged in dollar terms from where it began the year. Bitcoin and other cryptocurrencies are often touted as digital alternatives and rival to gold. We certainly see the parallels in that, unlike traditional money, both are in finite supply and neither can be printed and therefore debased by central banks. Unlike gold, however, the recent price swings in bitcoin have been highly correlated to trends in equity markets, suggesting that it is more of a speculative investment than a diversifying hedge. We continue to believe that bitcoin and other cryptocurrencies lack the credibility, foundation, transparency and track record to be considered for use in the portfolios we manage.

It continues to be Groundhog Day for retail funds which invest in physical property as the FCA delays its decision on the future of the sector ever longer. With workers returning to offices and town centres and many rent reviews linked to the rate of inflation, the outlook for the values of commercial properties is better than it has been for some time. For the portfolios we manage, however, it makes sense for us to remain on the side-lines given the uncertainty as to how the FCA will resolve the mismatch between the daily dealing currently offered to investors in property funds and the liquidity of their underlying investments.

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