The 4 R's - May 2022

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The 4 R's – Rates, Recession, Russia & Recovery

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May has proven once again to be a difficult month for investors (see Figure 1). We have seen significant movements in equities as further commodity price movements, some company earnings weaknesses, the ongoing war in Ukraine, and further clarity on changes to central bank policy continued to drive markets lower during much of the month. The last week of May however saw markets stage somewhat of a 'risk-on' recovery as there was some better news with China beginning to ease its Covid-19 restrictions. In the final full week of the month, we saw global equity markets surge by 5.1%[1], a rare occurrence by historical standards.

Judged from a longer term perspective, there are 4 'R's' that investors must contend with:

1. **Rates**
Firstly, with inflation persisting, the debate rages in markets as to how far and how effective interest rate rises will be to contain the inflation problem.

2. **Recession**
Secondly, with the global economy slowing, recession risks are rising in many parts of the world.

3. **Russia**
Thirdly, the more protracted and geo-political nature of the Russian-Ukraine conflict is exacerbating the challenging backdrop.

4. **Recovery**
There will be recovery from this period of loss, the question will be when will we have reached the low. Markets are always forward-looking and will seek to price in recovery once the evidence begins to shift that way. But for now, however, volatility looks likely to prevail for some time to come.

Figure 1: Asset class performances Year to Date May 2022

Source: Bloomberg 02.06.22

Asset class performances	May	YTD
Global equities	-1.4%	-7.5%
European government bonds	-1.8%	-10.6%
Global commodities	-0.3%	40.5%

[1] Source: Bloomberg, 31.05.22

Warning: Past performance is not a reliable guide to future performance.

The 4 R's – Rates, Recession, Russia & Recovery (Cont'd.)

1 Rates

Inflation data in most of the developed world is persisting, at its fastest in 40 years, and more broadly-based than originally anticipated.

- Euroarea inflation now stands at a record 8.1% for May (and this is again ahead of the consensus forecast which had been 7.8%)[2].
- In Europe, a great deal of this arises because of supply problems that can be traced to the Russian-Ukraine war – energy prices in particular were a source of the inflation to begin with. Hardly surprising that has increased the expectation in markets that the European Central Bank (ECB) might have to increase rates that bit faster. In the US it had hit a high of 8.5% in March and has fallen back marginally to 8.3% in April[2].
- In the US, while the war is also a factor, it is also partly explained by the higher government spending supports provided during the Covid-19 period. These have led the US inflation rate higher than in other large developed economies[3]. More recently inflation has become more broadly based with US data for April showing price increases coming through mostly in shelter, food, airline fares and new vehicles, while energy prices actually fell back for that month[4].

What does this mean? The main tool that central banks use to tackle inflation is interest rates. The US Federal Reserve (Fed) has already raised its rates to 1% and a further two 0.5% rate rises are probably on the way in the next two quarters. By mid-2023, the US may have raised rates to a level of 3.5% judging by what stock markets and investors currently think.

In Europe, the challenge is different as so much of what's happening is due to supply, which interest rates have little or no effect upon. Nonetheless, the ECB has given a very clear signal that it will begin raising rates by July. However the pace of increase is likely to be more modest than the Fed's given the lower effect that is likely to have in Europe. That said, yet another higher than expected inflation number in May could result in higher rate rises to follow.

2 Recession

Investors began 2022 on an optimistic note that economic growth would be strengthening as consumers began to spend the stack of savings built up during the Covid-19 period. The war in Ukraine and resulting inflation pressures have changed that and delivered the biggest commodity shock since the 1970's. Now the concern has turned to the risk of stagflation – lower growth and higher inflation - a phenomenon last seen in the 1970's and one which is far more challenging to resolve. At present, the consensus global growth expectation has dropped to 3.2% from its January starting point of 4.1%. Meanwhile inflation expectations for the year have risen to 6.2%, 2.25% higher than expected in January[5]. In late May 2022, World Bank president Malpass suggested that when the slowdown in China is fully factored in this may be enough to trigger a global recession[6].

In the past month, some examples which illustrate the slowdown that is already occurring are:

- We have seen a slowdown in China largely due to the zero-Covid-19 lockdowns,
- We have seen UK consumer confidence fall to levels not seen since the 1970's[7] and
- We have seen US new home sales drop to levels last seen at the start of the Covid-19 pandemic[8].

What does this mean? Given this backdrop, there has been an increase in the probability of a mild recessionary downturn in much of the global economy at some stage in the coming year.

For investors, markets have already begun the process of embedding a slower growth environment into prices - as can be seen from the drop in equity prices so far this year[9]. Indeed were it not for the strength of the US dollar which has accompanied falls, the losses would have been much deeper for euro-based investors. The US dollar has once again proven to be the safe haven of choice in times such as these. The stronger dollar has provided protection for euro-based investors, reducing the impact of other falls. For the bond market, the prospect of a recession may help contain interest rates rising too far. It may even act to reverse some of the central bank rate rises further out into 2023.

Sources: [2]Bloomberg 31.05.22 [3]Federal Reserve Bank of San Francisco 28.03.22 "Why is US inflation higher than in other countries?" [4]www.bls.gov Consumer price index summary 11.05.22 [5]Financial Times 26.05.22 "The global stagflation shock of 2022: How bad can it get?" [6]Reuters 25.05.22 [7]GFK US consumer confidence Barometer May 2022 [8]Bloomberg 26.05.22 [9]Bloomberg: 30.05.22

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3 Russia

As the Russian-Ukraine war stretches into its fourth month, most commentators seem resigned to the belief that the conflict will be long-lasting.

What is of relevance to investors is the increasing probability that Europe will deepen its sanctions. Despite challenges to reach agreement, in particular with Hungary, a partial EU oil embargo has been agreed. Even if there are certain exemptions made for landlocked central European countries, and Russia finds alternate markets to offload oil upon, further damage will be done to the Russian economy and financing the conflict will become more challenging. Whether this extends to an embargo on gas is more challenging. The EU is on a path already to replacement of Russian oil and gas with the imports of US Liquid Natural Gas (LNG), in particular, beginning to act as a replacement.

Also, at time of writing, Russia faces into a technical default on its government debt as the US has closed remaining loopholes in its banking system that would enable payment. Russia is endeavouring to create new ways to make the payments but the countdown has once again begun for the first default by Russia since the Bolshevik revolution.

What does this mean? Russia has already stopped natural gas exports to some countries (Bulgaria and Poland) but it is increasingly showing a flexibility to ensure gas and related payments continue to flow. Even so, gas prices jumped very considerably during May and could continue to rise if Russia cuts off more supplies. Germany and Italy have heavy reliance on Russian gas and will struggle to replace it in the short-term (in total Russia supplies roughly 30% of EU gas). The EU has said it will nonetheless phase out purchases of Russian gas and new sources, such as the US, are already gearing up to replace this[10]. The impact is that it may cause inflation to be more longer lived; while it is likely that the rate of inflation will fall this year, it also seems probable that it will remain elevated and above the EU target of 2% for perhaps some years yet.

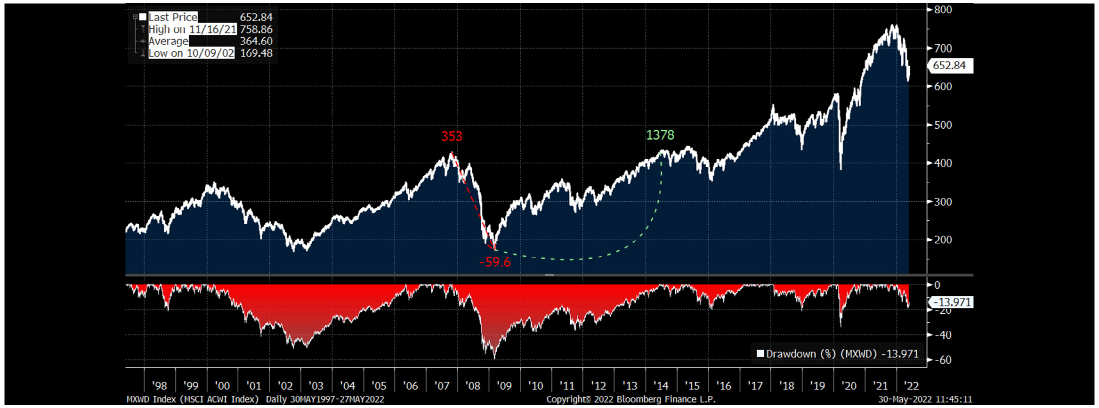
4 Recovery

Markets are always forward-looking and have already embedded most available information into the prices of assets.

After a period of loss such as we have seen in H1 2022, investors begin to ask whether all the bad news is now reflected in prices and if we can look forward to a recovery. By historic standards the losses incurred this year are quite modest as can be seen in Figure 2 which compares the 'drawdown' (the period when prices are falling[11]) over time. Markets are however pricing in a recession and a drop in company earnings as a consequence. This is seen in valuations of equities, which have cheapened considerably in recent months and now stand at below average levels compared to the past two decades[12].

What does this mean? Investors who are looking for signals that we have reached a bottom often look to factors such as price actions, market sentiment and breadth and look for signs of capitulation in these measures. We have not seen that kind of capitulation and may not. Furthermore, timing the bottom is exceptionally difficult and this time it may hinge on whether or not a recession arrives and of what scale. Markets are expecting a downturn and if it turns out to be a shallow or short-lived one then, for the long-term investor, there may be the beginnings of buying opportunities. But the coming months look likely to see ongoing volatility as this question remains highly uncertain.

Figure 2: Global equities in the past 25 years & scale of 'drawdowns[11]'



Source: Bloomberg 30.05.22

Sources: [10] Wall Street Journal, 25.05.22 [11] A 'drawdown' refer to how much an investment is down from a high before it recovers back to that high [12] Forward Price/earnings ratio of MSCI World All-Country in euros as of 30.05.22 compared to historical average since 2001

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Summary

May has once again proven to be a difficult month for investors as equity markets caught up with the losses already seen in the bond market.

With growth slowing and the possibility of recessionary conditions in the coming year, however mild, asset prices have been adjusting to this new reality. We can expect to see continued volatility for some time yet as central banks begin the process of reducing the size of their balance sheets as the pandemic support programmes are unwound and as markets grapple with the scale of recession that may emerge. That said May ended on a positive note as China began to ease its Covid-19 restrictions leading to some relief in equity markets.

Recovery – what is needed?

To see recovery from the losses that have been incurred this year, markets will need:

- to see a greater stability in the interest rate outlook, which in turn needs greater stabilisation in inflation pressures.
- to either avoid or get past a (hopefully mild) recession in the year ahead.

As markets are forward-looking this journey has already begun, with rate rises already accounted for in market expectations and a significant adjustment in valuation levels in the equity market (to below 20 year averages).

Central banks influence

As financial conditions have tightened and growth is slowing, central banks may begin to soften their tone in the months ahead.

- We saw a hint of this from Atlanta Federal Reserve President Bostic who suggested that the Fed should pause in September to assess the impact of interest rate tightening[13].
- Contrastingly, on foot of the latest Euroarea inflation data, there was a hint from the ECB that there will be five "benchmark-sized" increases in the coming four ECB meetings. This suggests one may be of the order of 0.5%[14].

As a result, we have a mixed bag of messages. For interest rates to top out and begin to turn down, inflation is going to have to come down faster than is currently anticipated.

Company earnings

To add to the challenges, we are coming off a period of exceptional company earnings growth - keeping up at the pace we saw in Q1 (approximately 10% growth) looks very challenging for 2022 in the face of tighter credit conditions, rising wage pressures and for some businesses, weaker demand.

Conclusion

In summary, it's hard to see this volatility dissipating for some time yet and calling a bottom in markets is unwise. However, buying opportunities will begin to emerge and for the value-for-money minded long-term investor, things are beginning to get more interesting. As always please be sure to talk to your Advisor before making investment decisions.

Sources: [13] Reuters "Fed policymakers back two more rate hikes but then what?" Schneider & Saphir 24.05.22 [14]Source: Bloomberg "Markets starting to price more aggressive ECB trajectory" V. Ram 31.05.22

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Equities

May saw heavy losses in equities for most of the month, only to see a strong risk-on rally in the final week of the month. Global equities dropped by 5.2%, in response to a mixed company earnings season and a steep sell off in Growth sectors such as technology, but rallied by over 5% in the final week. In terms of style, Value investing has been outperforming Growth for most of 2022 and has built up a sizeable outperformance.

Market	May	YTD
Global	-1.4%	-7.5%
US	-1.5%	-7.4%
Europe	-0.6%	-7.0%
Emerging markets	-1.2%	-6.3%
Global value	+0.4%	+2.6%
Global growth	-3.9%	-17.4%

Source: Bloomberg 01.06.22. Returns to 31.05.22 in euros.

Bonds

In Europe, May saw a higher level of certainty emerge from the ECB. President Lagarde gave a clear timeline that Covid-19 pandemic supports would be closed off in June and would be followed in a matter of weeks by the first interest rate rise. It was followed up with comment by Chief economist Phillip Lane that two rate hikes of 0.25% by September were the 'benchmark pace'. In the US a similar level of certainty was given by Fed Chairman Powell who indicated that two 0.5% rate rises are planned for the coming two quarters. However, European bonds finished the month in a slump as EU inflation came in higher than expected at 8.1%.

Market	May	YTD
Global	-0.3%	-9.2%
US government bonds	+0.2%	-8.3%
European government bonds	-1.8%	-10.6%
Emerging market debt	-1.7%	-10.3%

Source: Bloomberg 01.06.22. Returns to 31.05.22 in US index in $.

Commodities

Commodities racked up a fresh record high towards the end of May.

- Energy prices were once again to the fore, with oil and coal making substantial gains through the month (+12.7% for oil and +40% for coal for May alone).
- Oil prices reached over $120 per barrel late in the month.
- The broadening out of inflation pressures remained a theme during May with, for example, wheat rising 22% at one stage in May alone, before falling back towards the end of the month.

That said, downside risks to prices will begin to emerge; at these levels, demand will start to weaken for many commodities, the impact of Ukraine is largely priced in and as the interest rate hiking cycle gets fully underway it may begin to weaken inflation.

Commodity	May	YTD
Oil	+12.7%	+67.6%
Coal	+40.2%	+198.5%
Gas	+10.5%	+131.7%
Wheat	+2.4%	+49.7%

Source: Bloomberg 01.06.22. Returns to 31.05.22 in euros. Price change only.

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Performance table

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Table 1: 5 year historic performances

	2017	2018	2019	2020	2021
Global equities	7.5%	-4.9%	28.9%	6.6%	27.5%
US equities	6.9%	-0.5%	33.9%	8.6%	39.3%
European equities	11.4%	-12.0%	29.8%	-2.3%	23.8%
Emerging markets equities	21.2%	-10.0%	21.8%	8.7%	4.2%
Global bonds	1.0%	-1.1%	5.3%	4.9%	-2.63%
US government bonds	-10.6%	5.9%	8.8%	-2.2%	5.4%
European government bonds	0.1%	0.9%	6.8%	5.0%	-3.5%
Emerging market debt	-3.7%	0.6%	17.1%	-3.2%	4.3%
Broad Commodities	-12.4%	-6.8%	9.8%	-11.0%	36.5%
Oil	3.2%	-15.5%	25.1%	-27.9%	61.2%
Gas	-30.4%	4.5%	-24.1%	6.5%	57.7%
Wheat	-8.2%	23.7%	13.2%	5.3%	29.2%
Global hedge funds	-3.7%	0.9%	12.6%	2.7%	18.3%
Liquid absolute return	+4.0%	-8.2%	5.1%	0.4%	4.3%

Source: Bloomberg 06.04.22

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Warning: The value of your investment may go down as well as up.
Warning: If you invest in these funds you may lose some or all of your investment.
Warning: These funds may be affected by changes in currency exchange rates.

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