Watson French
INDEPENDENT FINANCIAL PLANNING
& INVESTMENT MANAGEMENT

Asset Class Commentary
March 2022

With the world's attention focused on the tragic situation unfolding in Ukraine, it is difficult at times to put aside personal, political and humanitarian views and to concentrate on the financial implications of global events.

Nonetheless, as professional investment managers this is what we are obliged to do. From an investment perspective, investors are concerned with how the conflict will affect global inflation and ultimately Central Bank's monetary policy decisions. The uncertainty this situation presents is causing increased volatility in the markets and a shift away from riskier assets.

Despite this potentially short-term geopolitical risk, equities are still favoured over bonds in delivering a higher return over the year and beyond.

The Covid pandemic is now passing into investor's rear-view mirror but risks still linger and long-term effects are still being felt. The UK has relaxed most covid rules including the legal requirement to self-isolate after a positive covid test. Developing countries are still struggling due to stubbornly low vaccination rates in some areas and this is dragging down their economic recoveries.

Supply disruptions are still ongoing but for most industries these are expected to subside by the end of the year. Despite this, long-term structural challenges will remain which will hold back supply.

In the UK interest rates have risen to 0.5% with more rates to come in the year ahead. Inflation has hit 5.5% and Bank of England members expect it to reach over 7% by April.

In the US interest rates have not yet been increased, but the market has priced in six rate hikes in 2022. Although the quantity of rate hikes has increased, it is the sum total which is important for equity valuations, and the markets expectations of this have not yet materially changed.

Investors will be watching closely in March for the Fed meeting minutes which will give more details surrounding rate hikes and the unwinding of the asset purchase program. This should help to reduce some of the volatility markets are currently experiencing.

Areas of focus

- Government bond yields have been falling as investors become more defensive in their portfolios.
- Inflation protected securities are still favoured as inflation is expected to settle at a higher rate.
- Growth sectors are increasingly falling out of favour while cyclical industries are outperforming.
- The healthcare sector has struggled so far this year after two years of growth.

- Since 1st January, UK equity has performed the best out of the major indices (as measured by the FTSE 100).
- Ethical investment funds have struggled recently but long-term the outlook remains positive, in our view.
- Energy stocks have delivered higher returns due to rising energy costs.
- Emerging market equities face tough economic conditions, but hard currency bonds could provide high yields in the next few years.

Ukraine

Although the situation in Ukraine is causing increased volatility and many risk assets have dropped in value, falling markets do present long-term opportunities for investors. It is these long-term opportunities that ultimately dictate market returns, and short-term volatility provides bumps in the road and where appropriate, opportunities to rebalance portfolios.

The situation in Ukraine is constantly evolving. Beyond what is said in the markets, no one knows how the situation will unfold. Currently, President Putin has ordered troops into Ukraine and Russia has attacked Ukraine military targets and cities. In all likelihood the West will not send troops to fight on Ukraine's behalf, but they have already started to impose sanctions, and these are likely to continue as and when the situation deteriorates. The sanctions include cutting off Russian banks from using the global SWIFT banking system, sanctioning Russian individuals, and restricting the purchase of Russian commodities. Russia has responded in turn by restricting their exports of certain products.

The US, UK and Europe have cut off energy supplies (or began to phase out the purchase) from Russia and this has pushed energy prices even higher.

Many oil traders are struggling to sell Russian oil as the risks are too high, and this has pushed oil prices even higher.

How the situation in Ukraine will affect global markets revolves around geopolitical risk. In reality the impact on global demand will most likely be small and possibly shorter-lived as Russia does not make up a large proportion of the global economy (it is the 11th largest economy). The real issue will surround energy prices, but the effect this will cause will be varied.

Russia supplies around 10% of the world's energy and the restriction of energy supplies has pushed prices higher, which will cause already high inflation to move even higher. The risk here is that central banks tighten monetary policy further to combat this (which would really have little effect).

Europe will feel the worst effects of any reduction in energy supplies as the region imports 50% of its total energy from Russia. Globally it is expected that any reduction in energy supplied from Russia will add 2% onto inflation figures in the worst case scenario. Oil is already trading above $110 a barrel for the first time since 2014, and if the situation deteriorates further, it could reach $140 a barrel.

For economies this increase in energy prices will have a number of effects. Increasing energy costs such as fuel costs will dampen consumer confidence and reduce disposable income. Whether this affects consumer spending depends on the magnitude of the reductions and consumer confidence in their finances. This in turn could lower economic growth.

At a time when central banks are tightening monetary policy, high supply side inflation, rising interest rates and lower growth is not an ideal scenario and could tilt economies towards slowing GDP growth.

When economies do begin to reach their peaks near the top of the business cycle, increasing interest rates are used to slow growth. As this is not a normal economic restart and the main cause of inflation is on the supply side (not overheating demand), increasing interest rates too far could cause more harm than good and could result in stagflation (rising inflation and slowing or no growth).

In previous times of high geopolitical risks, especially from the outbreaks of wars, the effect on global markets has been short-lived. Longer-term effects have been caused by other issues such as economies going into recession.

If the US did go into recession in 2022 there would be large losses for equity markets. However, analysts think the chance of this happening this year are small. It will be important to look at US consumption data in the coming months to see how GDP growth will be affected by current events. Any surprises on the downside (lower GDP growth and/or lower consumer consumption) and the market will react by selling highly-priced equities, such as those in the technology sector.

In terms of Russian or Ukraine equity, the effects will be small for diversified portfolios. Emerging market funds tend to hold small weightings towards Russia (2.9% on average) and are diversified so the damage caused to equity in the region will not be felt too hard. The Russian stock market (as measured by the MSCI Russia) had fallen by one of the third largest single day losses in history, wiping 40% off the index's value.

The value of the Russian Rouble has crashed and in response to this Russia has more than doubled its interest rate to 20%.

Supply issues

During the pandemic consumers demand shifted from services to goods, and the growth in durable goods has been too high for supply to keep up. However, recent data suggests the demand for durable goods will decrease and the demand for services will increase (as economies reopen further and covid restrictions are relaxed) which will ease some of the strain on supply.

Long-term structural issues for the supply of goods revolves around transportation and infrastructure.

The shortage of labour for the trucking industry and decline in airfreight capacity are increasingly difficult logistic challenges, and ones that will are not expected to subside until late 2023.

New technology requiring increasing raw materials is also affecting supply. Take the electric vehicle (EV) for example. The use of raw materials in EVs has only just started to pick up and this has pushed prices up. Lithium is a key material in EV batteries and the demand for it has pushed the price of lithium up over 400% in the last year. The supply is just not big enough and many other industries require this raw material, so there is high competition for orders.

The basic infrastructure that is needed for the supply of lots of products and commodities is just not available at the current time and is something that will takes years to develop.

This will be a key issue for the consumer as these supply constraints will keep inflation at elevated levels regardless of Central Bank policy.

UK

CPI Inflation in the UK rose to 5.5% in January, the highest level seen in 30 years. This was slightly higher than the 5.4% reading in December but well above the BoE target rate set at 2%. The BoE has forecasted inflation to peak above 7% in the Spring, when the government introduces the new level for the energy price cap. For the rest of the year the level is expected to remain above 5%. This is not considering the effects that the Russian invasion of Ukraine will have on inflation.

The main drivers of the higher inflation have been the higher energy costs and food prices. As the situation in Ukraine continues to unfold energy prices could be pushed even higher and fuel costs increase further, which will add onto the high current levels. Despite the UK only relying on Russia for 6% of its imported fuels, the reduction in global supply will have a knock on effect by pushing prices up.

The outlook for the UK economy is getting bleaker as high inflation has the potential to reduce consumer spending. Increased taxation via NI rate hikes in April will further dampen consumers disposable income.

Price inflation outstripped wage inflation causing real wages to fall by 0.8% in January. Increasing financing costs for UK businesses will also reduce corporate profits and expansion which will be a drag on the economy. Usually, inflation is a sign of a growing economy, but as mentioned, present inflation is being driven by supply issues rather than overheating demand.

The above point is further supported when we look at economic data and surveys such as the consumer confidence index. This measures how consumers are feeling about their personal finances and the wider economic prospects. The score has fallen to the lowest since the start of the pandemic as consumers worry about rising prices and rising interest rates.

Data such as credit card spending and retail footfall has remained below pre-pandemic levels and has fallen from its peak in November.

Overly aggressive rate hikes to combat supply driven inflation will only further hurt UK economic growth and stamp out demand that is beginning to increase. For example, retail spending in the previous month grew by 1.9%, the highest level since non-essential stores reopened last April.

There is a small consensus that the reaction markets have had so far in response to the forecasted rate hikes have been overdone. The belief is that the rate hikes will not be overly aggressive to fight inflation and will only return to pre-covid policy options. The rate hikes are simply to remove unneeded stimulus and cool inflation, but not to fight it down and in turn damage growth. Investors who are wanting a bigger policy reaction are thinking short-term and not about the long-term.

The market forecasts that the BoE will stop raising interest rates when they reach 1.75%. However, some believe the bank could stop at 1.25%. That is to say, the Bank should recognise the factors which are driving inflation up and real income lower, and not act hastily to assert its commitment to the inflation target by overstretching.

Higher fuel prices will benefit companies such as Shell and BP. There is a general shift and preference for value stocks in the current market climate. Sectors such as financials, energy and industrials are performing above growth sectors such as technology. As previously reported, the UK has a higher weighting in these sectors, the UK is looking like a more attractive investment environment.

With US stock valuations still stretched (despite their recent pullback) investors are looking elsewhere to trim their risk and provide the best returns.

Since the beginning of the year, the FTSE 100 has been the best performing index returning -3.05%, while the S&P 500 has returned -7.53%. Over the past year the FTSE 100 has also been the least volatile index averaging 7%, compared to the next closest index the France CAC which had volatility of 9.46%.

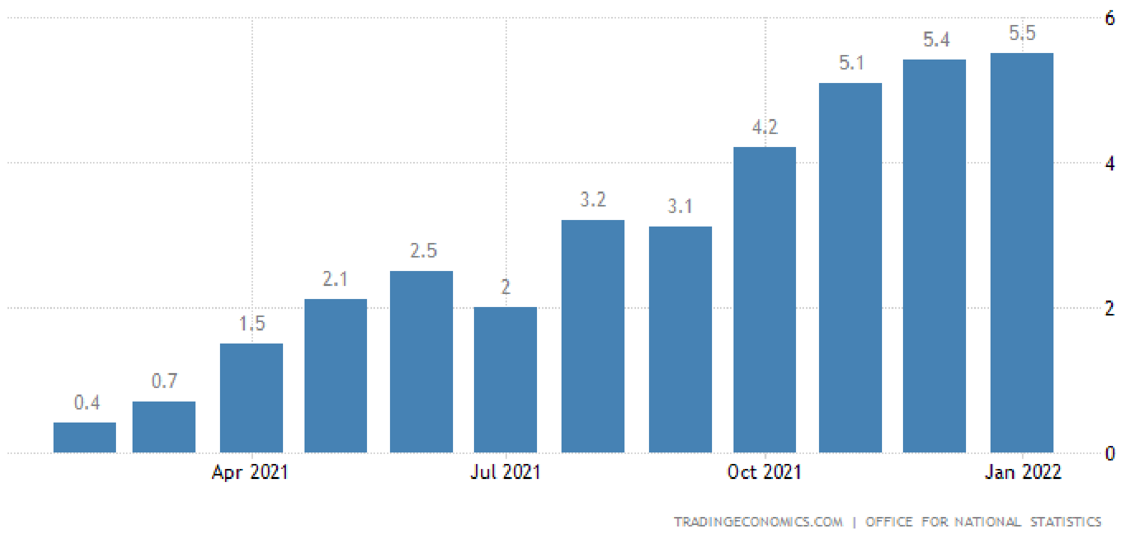


Chart from ONS showing the monthly annualised CPI rate

US

Inflation in the US has reached 7.90% in February, the highest level in 40 years. This has sparked fears of rate rises being brought forward. The next anticipated rise is expected to be by 0.25% in mid-March, although there is a possibility that it will be a 0.50%. The possibility of a 0.50% rise has declined steeply in the last few days as the effects in Ukraine are being felt worldwide. This will be followed by 5 or 6 more rises of 0.25%, ending up with interest rates at 1.50-1.75% at the year's end.

Although the pace of rate rises has increased, the sum total of the rises has not materially changed, and this is more important for long-term equity valuations.

The biggest risk for the US is whether consumer consumption data shows the economy is still on track and is not at risk of entering a recession. Analysts have put a low probability on this happening but the risks of it happening are present. While previous geopolitical risks have resulted in markets rising after a year, markets did not end up rising and dropped further when the US entered a recession after a conflict.

US stocks have had a hard start to the year with the NASDAQ performing the worst out of most major indexes. This is due to high growth technology stocks (whose valuations are based on earnings further into the future). Increasing interest rates means that these earnings must be discounted at a higher rate, immediately lowering the stock valuations.

There is also a shift away from stocks that benefited from consumers staying at home. As economies re open and consumers spend less time at home, stocks that rely on retail consumer footfall are picking up.

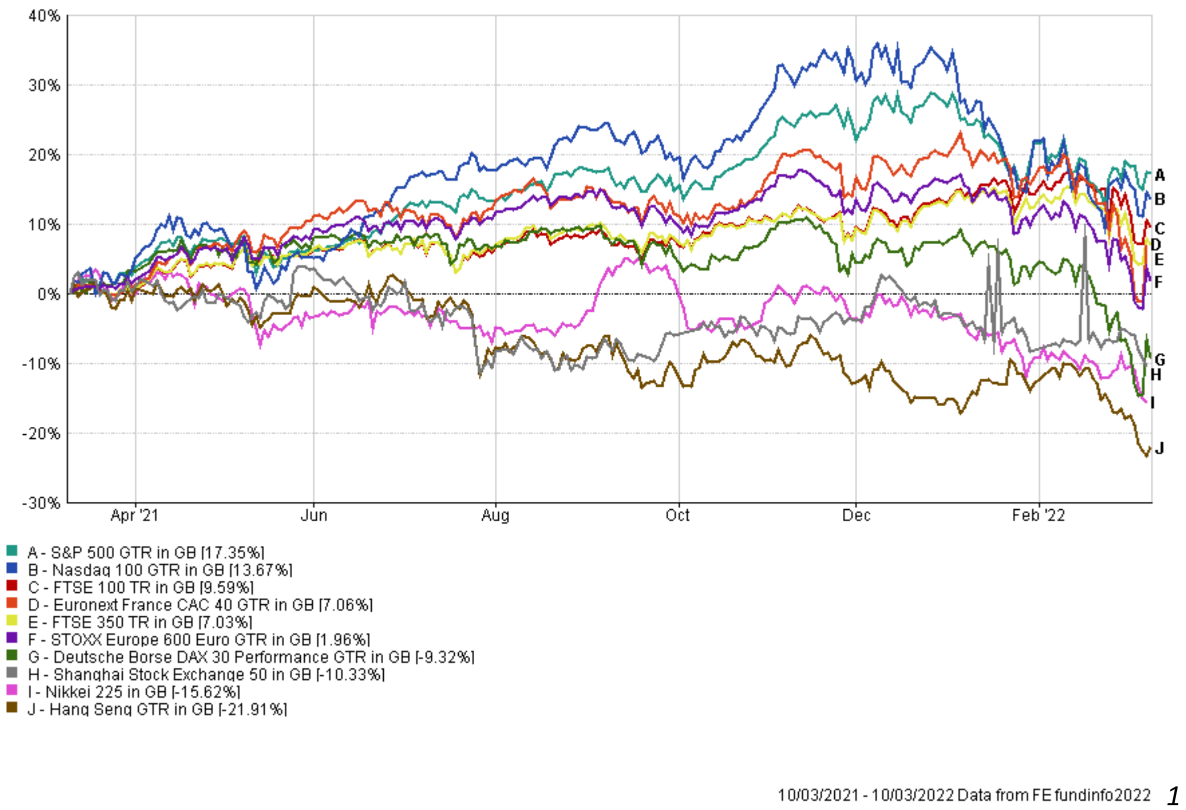
Many investors have cut their exposure to the US in their portfolios as other regions are expected to perform better in the current and upcoming environments. There are still plenty of opportunities in the US, but after a number of years of strong returns, growth stocks are no longer in favour.

Europe

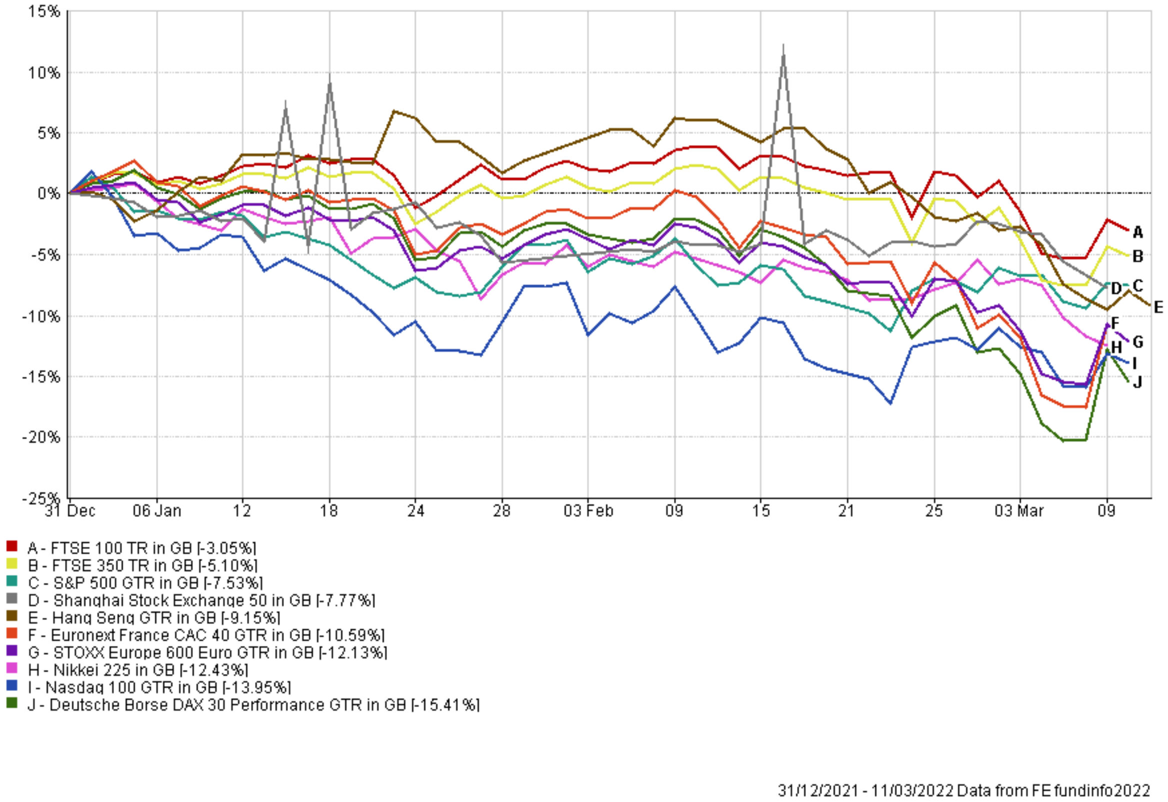
Inflation in the Eurozone – persistently low for years – hit 5.1% in January and there has been talk in the ECB about tightening monetary policy sooner than expected. Growth in the bloc has started to slow but has been roughly in line with economists' predictions.

Europe is the region that will be most affected by the ongoing issues in Ukraine as the region receives roughly 50% of its energy from Russia. Any reduction in energy supply would be hard to plug from other sources and the development of green energy alternatives will take a long time to fully implement.

European financial stocks have experienced drops of more than 10% as investors analyse how their exposure to Russia will affect their ongoing profitability. We could see areas such as car manufacturers and industrials suffer in the short-term if energy supply is constricted to Europe. The rising costs will put further pressure on the profitability of these industries. Data has also showed that consumers are putting off one-off discretionary purchases, such as new cars, which will further dampen the outlook.



Year performance of major stock market indices



YTD performance of major stock market indices

Emerging Markets

The difference in growth between emerging economies and developed economies is narrowing further. Emerging economy assets are typically higher risk investments but as the growth in the respective economies becomes more in line with developed economies growth, the asset class looks less attractive. That being said stock market returns are not necessarily correlated with economic growth.

When we look at the present situation in emerging economies, they make the investment case look even weaker. Covid is still the main issue in these regions with vaccination rates still low. High debt levels to help with the ongoing issues caused by the pandemic have increased the burden the economies are facing.

Most emerging market debt is typically in US dollars. With higher interest rates in the US looming and a strengthening US dollar, the increase of default and the increased hardship of servicing these debts is a real risk.

The outlook is not all doom and gloom. Although debt levels are high, many EM countries have surplus current accounts (as opposed to deficits in the past) and increased foreign currency reserves which is enabling them to weather economic shocks better than they have in the past. Although this has been dented severely by the pandemic.

Emerging economies which export large quantities of commodities have benefited as commodity prices have increased. South Africa is one country where this is the case. Many South American countries who export commodities have had this overshadowed by local political or social difficulties.

Overall, there are high levels of risk in emerging markets. Output growth in China has slowed and the change in the priorities of the Chinese government threatens to keep growth at lower levels than in the past which will hurt countries reliant on demand from China. Social inequality caused by the pandemic means implementing fiscal policy to control economic growth will be harder. Declining global trade levels will further hurt developing countries as they rely on this for much of their economic growth.

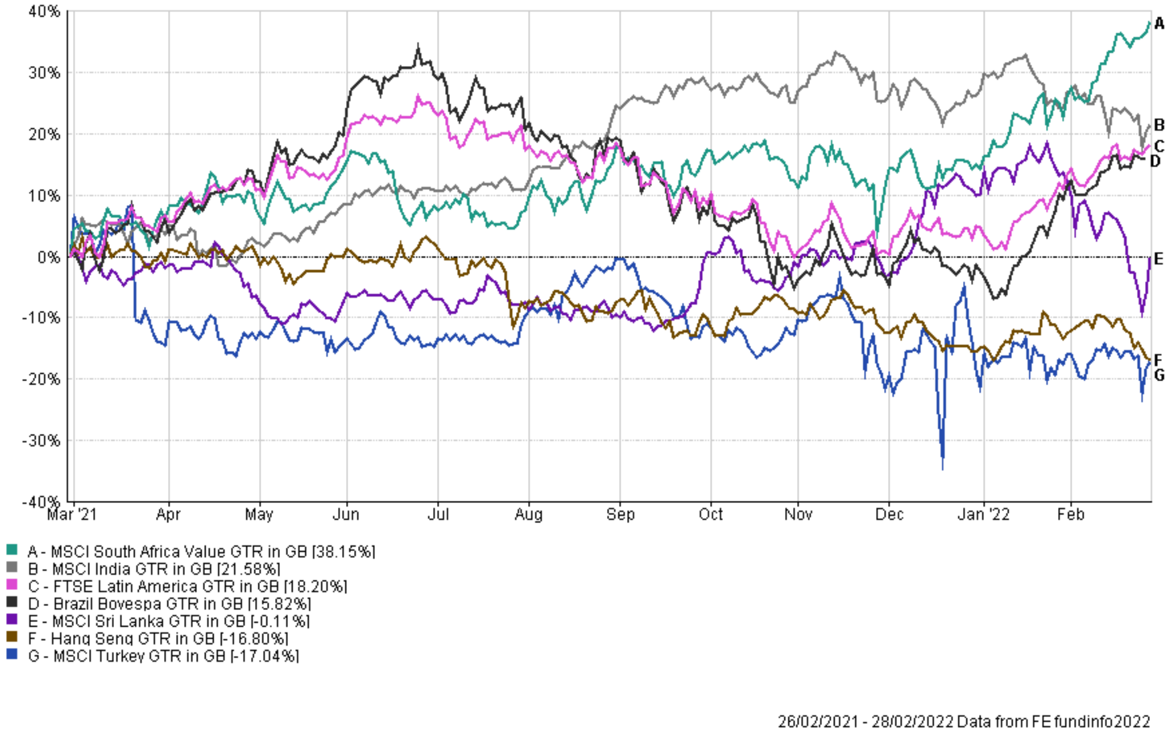


Chart showing 1 year performance of various Emerging Market Indices

Fixed Income

While fixed income yields have fallen recently as investors have moved to less risky assets amid the Ukraine tension, the medium-term outlook for bonds is that yields will be higher as investors demand a higher premium for holding bonds amid inflation and interest rate risk.

Inflation is expected to settle at a higher rate than pre-covid times and inflation protected securities are preferential over government bonds in the tactical view.

Emerging market debt issued in hard currency could be a potentially attractive investment in the next year. Emerging countries such as Brazil raised their interest rates last year in an attempt to stop inflation running away (as it has in the past). The interest rate in Brazil is expected to peak at 12% before falling back slightly. CPI is currently at over 10% but is expected to fall back to 5%. The combination of the high interest rate and lower inflation is attractive for fixed-income investors due to higher bond real yields.

Local currency debt is still a risky area, and this has not performed well in the past 10 years due to weak local currencies and falling interest rates. With interest rates rising, local currency debts do become more attractive.

Commodities

The price of gold has risen in recent days to a near 18-month high as investors move to safe haven assets, and it is generally regarded as an inflation protected asset. How long the conflict in Ukraine continues will determine how well the price of gold is supported at these levels. That being said, high inflation will now be around for longer to provide support.

However, in more recent times investors have called into question its usefulness and have turned to other asset classes such as infrastructure and property.

Other precious metals such as palladium have seen their prices rise as Russia is a major miner and producer of the metal, accounting for over 40% of the world's supply. This metal is used for catalysts in cars.

Since the announcement from the US, Europe, and the UK to restrict the purchase of Russian energy, prices have risen with heating oil rising by more than double. The price of oil has risen to above $110 dollars a barrel and the price of natural gas has also risen.

ESG

ESG funds have been out of favour relative to the broad market and have seen big drops YTD. The reasons for this are mainly linked to the market cycle and short-term preferences.

One reason for ESG stocks being out-of-favour is the recent environment which has pushed energy prices up (oil and gas). The increase in the cost of these "brown" sources of energy has pushed investors to take advantage of this inflation and in turn has moved them away from producers of renewable energy such as solar and wind.

Another cause is the rotation from non-cyclical companies to cyclical companies. Renewable businesses tend to be non-cyclical and in industries such as technology. They are not as capital intensive and use low carbon emission business practices. As well as this ESG funds tend to screen out more cyclical businesses. At the moment the favour is on companies operating in areas such as industrials, financials, airlines and energy and this has led to less demand for non-cyclical businesses.

ESG funds tend to have a higher proportion invested in the health care sector. So far this year this sector has underperformed. The S&P 500 Health care sector index is down over 10% YTD. Health care stocks tend to fit into ESG portfolios well as they look at sustainable access to healthcare for people and focus on issues to help improve social inequality.

The cost of materials used for sustainable energy products such as solar panels have increased considerably and this is driving down investment in these areas.

These are some of the main reasons why ESG funds have decreased in value lately. It should be noted that these are mainly shorter or medium-term issues and do not look long-term to the support sustainable stocks will provide for economies and the place they will have in helping them grow.

The issues around climate change for example are not disappearing. At the moment investors are focused on other issues, but when these subside and climate comes back to the fore these stocks will perform well. A recent report showed that the effects climate change is currently having are more pessimistic than previously thought, and there has been much damage that is irreversible. The occurrence of natural disasters and extreme weather is only going to increase.

Robert Dougherty, March 2022.

This article is not a recommendation to invest and should not be construed as advice. The value of an investment can go down as well as up, and you may get less back than you invested.