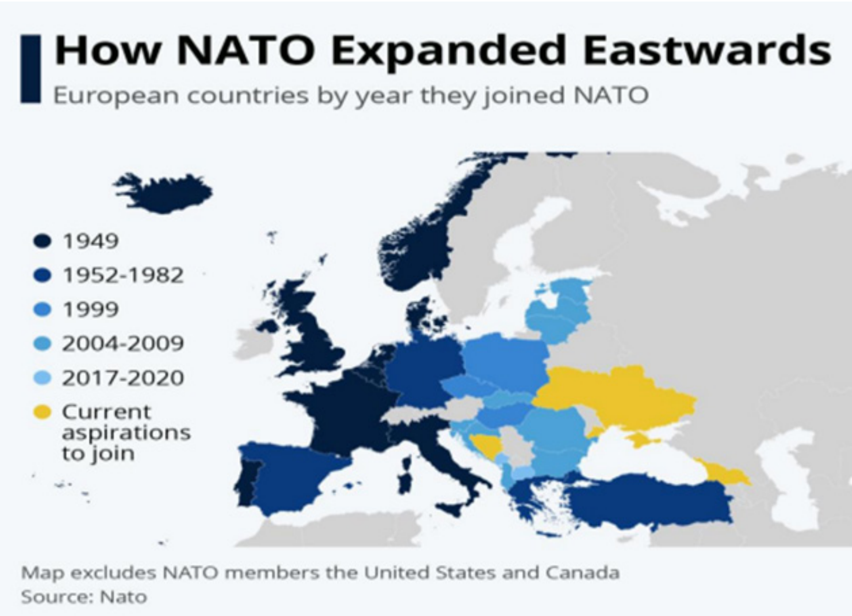
# LEARN FROM THE PAST, PLAN FOR THE FUTURE

### Introduction and Market Overview

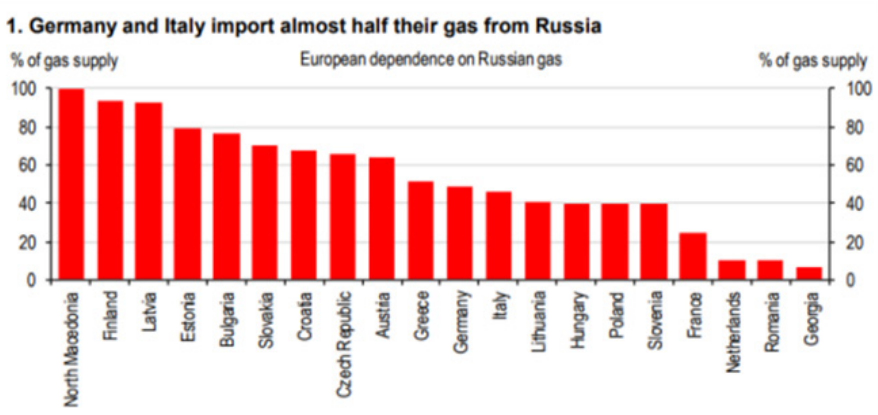
Set against the terrible crisis in the Ukraine, that as I write sees over four million refugees from the conflict, it still seems rather surreal that equity markets have made up some of the lost ground since their early March lows despite there being no end in sight for both the war and also no let-up in rising inflation.

Whilst most global equities finished the quarter in negative territory, they have recovered to their levels seen before the invasion of the Ukraine, despite the headwinds that they have had to face, such as a US Federal Reserve (Fed) tightening rates into a slowing economy, oil prices up 40%, wheat prices up 30% and gas prices up 80% year to date. Against this, the old portfolio diversifier at times of market stress, that of bonds, have seen some of their worst returns we have experienced in decades. We have written in our weekly narrative to clients about the various factors that may have influenced Putin's decision to invade Ukraine.

One of the reasons given for Russia's invasion has been the expansion of NATO across Europe since the Cold War, and perhaps the more recent discussions about a neutral Ukraine could placate Putin.




Unusually high and stubborn inflation rates are certainly causing trouble around developed markets. A fragmented global supply chain in 2021 failed to meet the demands of a resurgent "post" Covid economy and prices and inflation pressures started to rise last year, and the onset of war in Ukraine has only added to these with a commodity price surge. Such is the reliance of so much of Europe on Russia's gas supplies, there has been a clamour for "energy independence" and a renewed focus on fossil fuels alongside new cleaner forms of energy. Overall, the energy sector has seen a strong rally in both share price and demand.




Source – EU Agency for the Co-operation of Energy Regulators

Away from the humanitarian crisis, whilst the war in Ukraine has been damaging to the global economy, it has not yet pushed us meaningfully towards a recession, as the global GDP estimates from Sarasin show below. The % figures in brackets are the global GDP estimates from December 2021, before they have been subsequently revised. The estimates of global growth rates remain healthy in 2022 and into 2023 and it is easy to see why China, on the face of it, remains an attractive investment consideration.

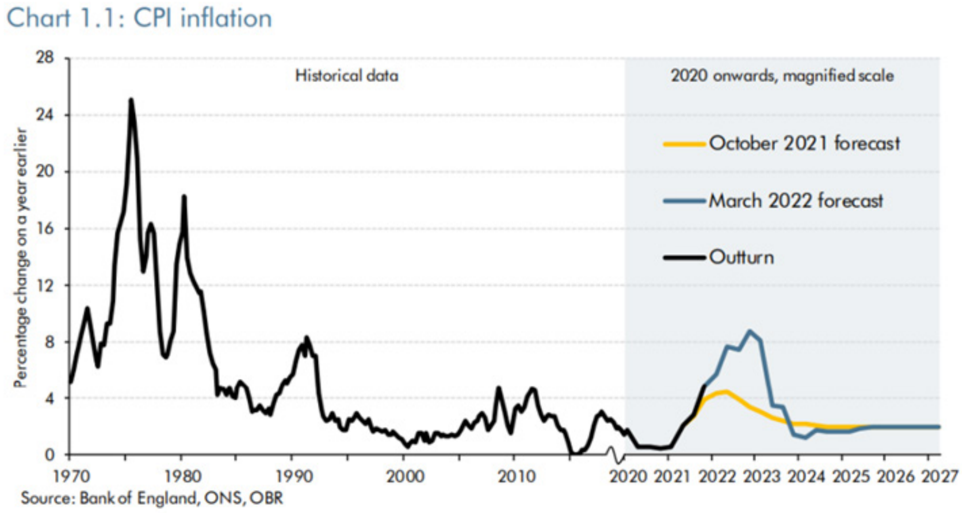
| | 2021 | 2022 | 2023 |
|---|---|---|---|
| China | 8.1 | 5.1 (5.0) | 5.0 (5.0) |
| US | 5.7 | 2.9 (3.8) | 1.6 (2.3) |
| Eurozone | 5.2 | 2.8 (3.8) | 1.8 (2.4) |
| UK | 7.2 | 4.2 (3.9) | 1.1 ( 1.8) |
| Japan | 1.7 | 2.3 (2.1) | 1.5 (1.1) |
| **World** | 5.8 | 3.7 (4.1) | 2.8 (3.1) |

Note: Figures in parenthesis are GDP forecasts at time Dec 2021

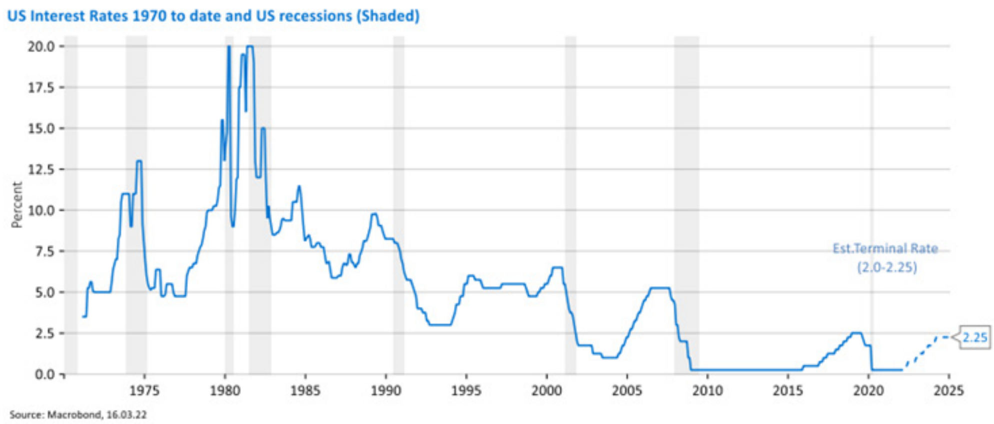
Source - Sarasin

The speed and size of interest rate rises over the coming year are very important, as is the dialogue that accompanies them. It is expected that the Fed will look to try and squeeze in one or two 0.5% base rate rises, as opposed to the previous 0.25% rate rise. The aim will be to try and give them some room to manoeuvre in the future should the situation eventually deteriorate causing them to change tack and start cutting rates instead.

A continued market recovery would also require there to be a gradual reduction in the rate of inflation, the Office for Budget Responsibility expect inflation to peak later in the year at over 8% in the UK as year on year energy prices start to fall, and should settle back to around the target of 2% by late 2023 into 2024 – so whilst this remains a painful inflation "shock" the duration of it may not prove as damaging as some fear.




We should also consider the risk of a policy mistake leading to a recession as a worst case scenario, so we can look back in history to see how a rapid rise in interest rates have previously led to recessions. The chart below shows rising rates leading to the grey shading of a recession shortly after the interest rate peak was reached.




We share this slide with you as a reminder of how high interest rates have been in the past to trigger a recession, much higher than the expected 2.5% level we may see in the next year or so.

You may well point to 2020, however we believe that that is an outlier in the data due to the unprecedented global lockdown that was in place as a result of the initial Covid pandemic. The lowest interest rate preceding a recession aside from 2020, since the 1970's, was 5% - double the interest rate that we are led to believe is around the corner.

Recent talk has turned towards a "yield curve inversion". OK, so what does this mean to investors? Recently, yields for 2-year US Treasury bonds moved higher than those of 10-year Treasury Bonds – not a normal occurrence – usually the yield curve is upward sloping, which echoes the fact that holders of longer-term debt have taken on more risk. An inversion is when this reverses and investors place a higher weighting on near-term risks to the economy.

Historically, this has signalled an imminent recession. This time around, however, the inversion has more do with near-zero interest rates and strong demand for long-term Treasuries as a defensive play than the health of the economy. "Overall, the yield curve has become less of a recession indicator over the last two economic cycles," says U.S. Chief Economist Ellen Zentner. "And when we look at factors in the economy that are typically signals of a recession, such as job growth, retail sales, real disposable income and industrial production, we don't see an approaching recession." Good news, for now.

We have already mentioned the global supply chain issues and rising commodity prices impacting on inflation, and as always this argument can be countered by existing global trade imbalances, with Chinese exports continuing to apply downward pressure on global goods due to their competitive pricing. It will be interesting to see how Covid and the Ukraine crisis could impact on Governments looking to stay closer to home for their goods and energy resources.


Whatever the outcome for the war in the Ukraine, and also inflation and interest rate rises, what remains clear is that the investment world has never reverted back to "normal" since the great financial crisis in 2008. The central banks experimental policies since that date have certainly helped to stimulate the global economy, and we are finally seeing the high inflation that many have feared since then. We must remember that the estimated global GDP figures underline that there are still plenty of opportunities in today's marketplace.