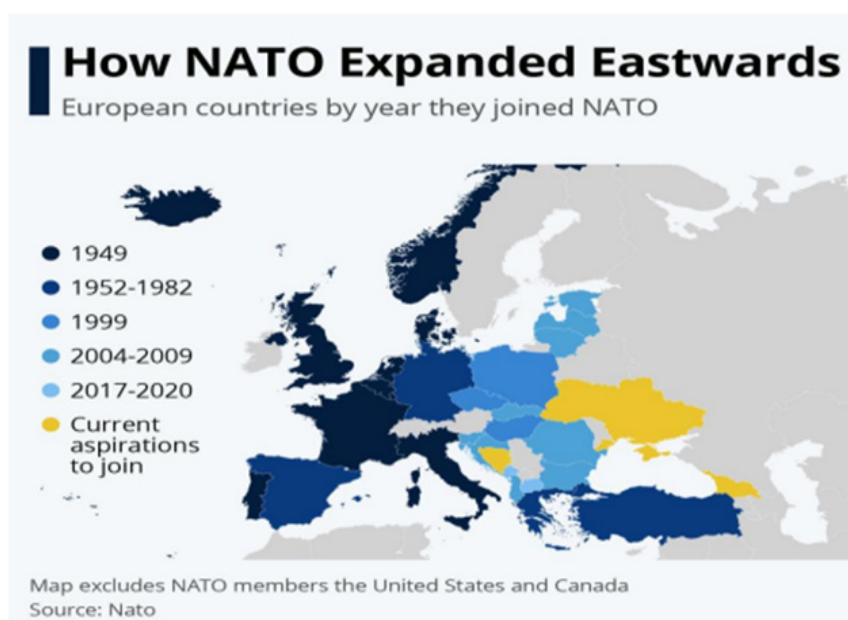
Introduction and Market Overview

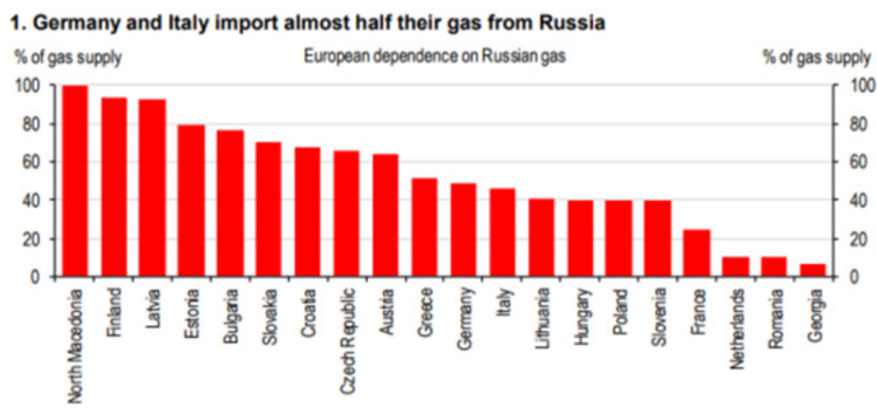
Set against the terrible crisis in the Ukraine, that as I write sees over four million refugees from the conflict, it still seems rather surreal that equity markets have made up some of the lost ground since their early March lows despite there being no end in sight for both the war and also no let-up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

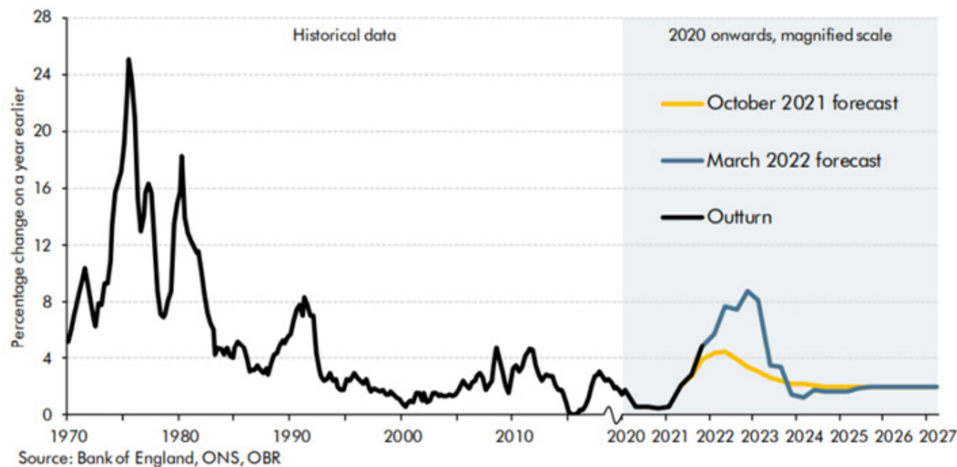
	2021	2022	2023
China	8.1	5.1 (5.0)	5.0 (5.0)
US	5.7	2.9 (3.8)	1.6 (2.3)
Eurozone	5.2	2.8 (3.8)	1.8 (2.4)
UK	7.2	4.2 (3.9)	1.1 (1.8)
Japan	1.7	2.3 (2.1)	1.5 (1.1)
World	5.8	3.7 (4.1)	2.8 (3.1)

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

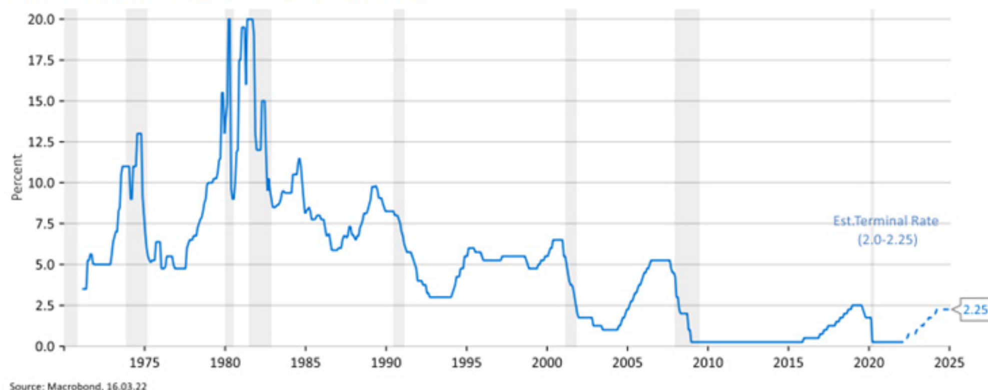
Source - Sarasin

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.



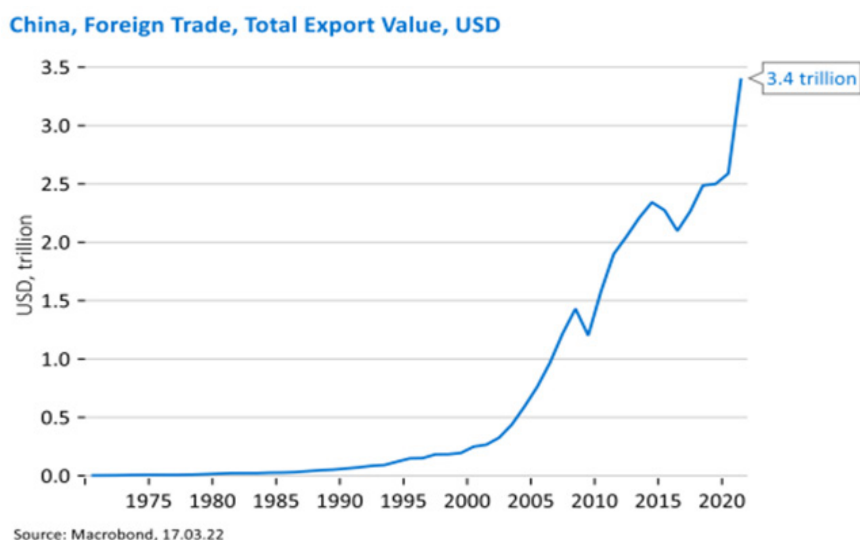
We share this slide with you as a reminder of how high interest rates have been in the past to trigger a recession, much higher than the expected 2.5% level we may see in the next year or so.

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.

Portfolio Review 1st Quarter 2022

Strategic Growth

In light of rapid developments at the start of the quarter, in January we performed a rebalance of the portfolio to correct some portfolio drift and to introduce some new positions. Overall, we did not materially adjust the allocation to equities, but we did rotate away from US 'growth' stocks towards global 'value' stocks to reduce some of the portfolio's sensitivity to interest rate rises, as well as increasing exposure to Asian equities.

Growth focussed equities were under pressure at the start of the year as their future earnings are worth less in a higher interest rate environment. We reduced exposure to some more growth orientated managers and introduced a new holding to the portfolio, the **Schroder Global Sustainable Value Fund**. The fund offers exposure to stocks classed as 'value', meaning their share price stands at a discount to their perceived 'fair value', which typically means that the price is attractive. Data going back over 100 years shows that value stocks tend to outperform growth, but the opposite has been true for the past decade. We felt that there was a margin of safety in the lower valuations exhibited by the stocks the Schroders fund favours.

We also took the opportunity to top up a couple of existing funds, offering exposure to Asian equities. The funds topped up are **Vanguard Global Emerging Markets Fund** and **Fidelity Asia Pacific Opportunities Fund**. Asian equities had a tough year in 2021, in part due to a regulatory crackdown on Chinese technology companies. However, their stocks now stand at attractive valuations, and with inflation generally being much less of a problem in the region and their GDP forecasts remaining robust, several key Asian countries are currently easing monetary conditions (e.g reducing their base interest rates), which should also be supportive.

We have also sold a fund (**iShares S&P 500 Health Care ETF**) offering exposure to US health care stocks and replaced it with a fund that invests in stocks within the US consumer staples sector (**iShares S&P 500 Consumer Staples ETF**). The consumer staples fund is passively managed and holds Proctor & Gamble, Pepsi and Walmart within its top 5 largest positions. Part of the reason for holding the healthcare exposure was as a relatively defensive position whilst the world struggled with Covid. However, the emergence of the Omicron variant means we are moving closer to Covid turning from a pandemic into an endemic disease, which means we have less need for this type of exposure. We have therefore switched into consumer staples, which continues the theme of rotating from growth to value stocks.

In the first half of March, we conducted some further switches within the portfolio. We increased exposure to The FTSE All Share Index, via the **Fidelity UK Fund**. The Index was performing well, and we expect the high exposure to the financials sector to help if bond yields continue to rise. Also, the index has a relatively high exposure to the energy sector. This should provide a useful hedge against continued rising energy prices, which is likely if there is a widespread ban on Russian oil and gas.

We also introduced an exposure to the **iShares MSCI World Minimum Volatility ETF**. The fund holds stocks that have previously displayed relatively low price volatility, which tends to give the portfolio a heavy bias to 'quality' companies, which is an attribute we favour in the current environment. The strategy also tends to hold up well during volatile periods for equities.

We remain comfortable for now with our lower bond exposure, backed up by recent comments from Fed Chairman Jerome Powell who said recently that the central bank was prepared to raise interest rates in 0.5% steps to deliberately slow the economy if it were necessary to bring down inflation. We will look for opportunities to increase the exposure to bonds if we see evidence that inflation is receding.

Our final trade of the quarter was to reintroduce the **Invesco NasdaQ 100 ETF**. The ETF has a heavy exposure to high quality companies in the technology sector that are already generating strong and growing earnings, unlike some of the smaller early-stage technology companies. Its three largest holdings are Apple, Microsoft and Amazon. Technology stocks sold off quite heavily over the first couple of months of the year, improving their valuations. They are now exhibiting much better momentum, so with the price of the NasdaQ still over 10% below its high a few months ago, we felt comfortable initiating a position.

As the first quarter finishes, we reflect on a busy period for markets, however for once investment markets took a back seat to the tragic events unravelling in the Ukraine.