Winter
2022

market outlook.

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FINANCIAL AWARENESS

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The UK Economy

Given the recent high inflation readings across the globe, there has been a stark rotation of investor preference to companies trading on lower valuations. To explain, companies which have high growth expectations, tend to have higher share prices relative to their current earnings per share. In modelling the current value of a company, investors use something called a discount rate and inflation plays a big part in how much expected future earnings are valued in today's terms. Consequently, the higher the discount rate, the lower the value of future expectations and this weighs on high "growth" companies, relative to more mature, somewhat predictable, lower growth companies. Additionally, in a period of suddenly higher nominal GDP growth, the relative attractiveness of "value" companies increases. Consequently, given the prevalence of "value" sectors in the FTSE 100 (such as banks, oil and gas, miners etc.), relative to its mid and smaller peers and other global equity markets the FTSE 100 has been one of the strongest performers over the past quarter.

As we have highlighted in the past, the larger names in the UK equity market have a very weak relationship with the UK economy, and whilst the outlook for UK business investment remains positive due to the declining uncertainty around COVID-19 and Brexit, the outlook for the UK consumer (which makes up around 60% of the UK economy) is less certain. With inflation remaining high (across the globe and in the UK), the Bank of England felt it needed to respond in the only way it can, by increasing interest rates, which it has done twice over the period and is expected to continue to do so throughout 2022. Rates have been historically low for an extended period of time however, we do not anticipate we are embarking on a period of high interest rates as the economic recovery remains fragile.

Rising interest rates will have a muted, immediate impact on household spending, as the biggest burden this will have is on mortgage payments, however, the majority of households have fixed rate mortgages for a set period of time. Consequently, in time, as consumers fixed rate mortgage deals end, should inflation cool (as its drivers have been supply constraints and not demand) the bank will have to remain vigilant and adjust policy accordingly in order not to derail the economy. More immediately impacting the UK consumer will be the rise in National Insurance and energy price caps. Whilst this will no doubt put a strain on household expenditure, provided pandemic measures continue to loosen, it is likely that the consumer confidence will improve. Whilst household finances will take a hit in the short-term, they are starting this period in robust health. Confidence could see excess savings which have been accumulated during the pandemic being spent or even a resumption of spending on credit, as personal credit balances have declined markedly over the past two years. Consequently, some resumption of spending habits more in line to those prior to COVID-19: on items such as clothing, commuting, dining out and other such services, coupled with pent up demand for larger purchases such as holidays, would bode well for the near-term outlook for UK economy, it may also help alleviate some of the supply constraints feeding into current levels of high inflation.

The Japanese Economy

New Prime Minister (Fumio Kishida) has seen his approval rating drop already following a jump in COVID-19 cases. Whilst he has increased the vaccination rollout in order to abate the infection rate, he is staring down the barrel at upper house elections in June which adds fuel to the fire of speculation that Japan has re-entered a period of leadership rotation and instability.

In amidst of the majority of developed economies looking closely at policy tightening measures, we saw the governor of the Bank of Japan, Haruhiko Kuroda, announce in January that the current record levels of monetary stimulus would be maintained until, at the very least, the 2% inflation goal has been achieved. With deflation arguably looming in Japan in an environment of global inflationary pressures, economic instability accompanied by political uncertainties makes 2022 a tough environment for the region.

With investor trepidation apparent in Japanese markets throughout 2021, and into 2022, driven largely by lack of local COVID-19 policy, investment appetite for the region has been low. In addition, recent local lockdowns and uncertainty have seen a resurgence of large cap names utilised by some as a ‘safety play’, with assets further down the market cap spectrum seeing outflows. That being said, this appears to be a short-term phenomenon as Japan navigates COVID-19, with a future re-opening likely to drive domestic level spending, driving small and midcap company valuations over the long-term.

Japanese yields tipped over from negative on the government 5 year, suggesting that global expectations of central bank hawkishness is non-discriminatory. This supports the view that sentiment is short-term, and with it unlikely that the Bank of Japan will look to tighten policy (following the Bank of Japan’s dovish comments in February), it suggests that perhaps hawkishness is overpriced in the markets. This, however, presents buying opportunities across global equity markets… albeit, Japan still represents arguably the least attractive opportunity sets in the equity space.

The Emerging Markets & Asia Economy

Headlines surrounding the property sector have been rife, with China's largest property developer, Evergrande, appearing now to falter on its debts. However, it must be remembered that the property sector has represented a disproportionate amount of the Chinese economy for many years... something the government has been trying to curtail. With that in mind, whilst it is uncertain whether the Chinese government will bail out specific corporates, they have made it clear that they will provide financial support to homeowners/buyers, and also sell off parts of faltering firms. Already we are seeing part state-owned financials buying land, which means we may go on to see state owned businesses purchasing parts of defaulting property firms, debts and all. This largely isolates the issues to the sector, preventing contagion. Let's also remember, China has over $3trillion in reserves to support the transition of the sector if needs be!

Regulatory changes to the education, healthcare and technology sectors in 2021 held markets back. Whilst for sectors such as the education space, the changes have been detrimental, as it has been largely made 'not for profit', the regulatory changes to sectors like technology are hugely beneficial for long-term investors. The introduction of competition laws make the sector more investible, as fair competition breeds innovation.

Whilst it is clear we have seen a significant reduction in Chinese growth (GDP of 4% for Q4 2021), it must be remembered that this has largely been driven by strict COVID-19 lockdown rules. The no tolerance approach to COVID-19 outbreaks had a short-term impact on domestic consumption, production and of course, travel. This saw the market valuations compress significantly. Many Chinese corporates are in good health, with valuations arguably more attractive than they have ever been, requiring the catalyst to release them... that catalyst likely being the progression of an effective vaccine production, as this by and large would provide increased population immunity. With the Omicron variant already seeing less hospitalisations, and a significantly stronger set of mortality data in many provinces, we are already seeing China begin to reopen (seeing the city of Xi'an reopen in January).

Markets have been plagued with much short-term volatility, driven largely by unsubstantiated expectations. However, it is clear that Russia has played a key part in not only inflationary pressures by throttling European Gas supplies, but also introducing global political pressures by amassing troops on the Ukrainian border. Whilst it is clear that Russian intentions may involve encroaching on Ukrainian territory, Russian President, Vladimir Putin has been clear that tensions could be diffused should talks progress, citing the US as their protagonists. Any incursion will likely cause short-term volatility in global equity markets, which in turn could introduce a further 'non-fundamentals driven' contraction in valuations allowing for significant buying opportunities.

The Indian budget was announced early in 2022, seeing a skew towards social spending and support packages. This comes as no surprise in an election year for some key states, seeing Prime Minister Modi wanting to garner favour from the agricultural community, which represents the majority of the Indian population, ahead of the 2024 general elections. This, coupled with higher than usual valuations in the region, makes the market appear slightly expensive over the short-term.

The US Economy

US President, Joe Biden's social spending plan stalled at the final hurdle as Democrats chose not to pass the cut down $1.75trillion funding proposition late in 2021. Whilst Biden's approval ratings are slipping, it is likely individual constituents of the original spending plan will be resubmitted for approval, with many likely to be approved. With that in mind, this should see a bolster to many sectors and the broader economy, in addition to aiding to stabilise Biden's popularity. It must also be remembered that US data remains robust, with unemployment, labour force participation and growth (GDP) data strong.

For a long time now global markets have been focused on the narrative coming from the US central bank, the Federal Reserve (Fed). As inflationary pressures have built globally, following COVID-19 driven supply chain disruptions and the current energy supply issues, Fed chairman, Jerome Powell changed the banks narrative late in 2021. Powell dropped the term 'transitory' when referring to inflation, which when coupled with narrative surrounding rate rises (due to stickier than anticipated inflation) in the Fed's first meeting of 2022, led the market to price in sharp policy tightening. This can be seen as a market error. The narrative from Powell, as with many global central banks, cited caution and data dependency. So whilst they removed the term 'transitory' when referring to inflation, one could certainly apply it to the Fed's stance on 'Hawkishness', in that it is transitory… once supply chain issues resolve, and energy supply pressures are alleviated, the need for tightening policy should ease.

It could be argued that 2022 will be driven largely by the bond yields. With markets getting ahead of themselves, pricing in 4 or 5 rate hikes by the Fed in 2022, this has seen a steepening of the yield curve. However, with market expectation largely 'jumping the gun' on the Fed's hawkishness, this could introduce volatility in the curve, with the potential for inversion. With that in mind, it is the yield curve that could derive whether we see a cyclical rotation, as whilst there are value sectors such as the financials that will be aided by even a glacial rate rise environment, nervousness surrounding the yield curve will likely drive investment flows away from bonds and back into large cap growth names that have arguably been treated as bond proxies for the past decade. With this uncertainty, one would be forgiven for taking a more balanced stance between growth and value due to cyclical uncertainty, but either way, equities continue to look attractive.

The European Economy

The ECB (European Central Bank) chose not to alter monetary stimulus in its first meeting of 2022, leaving its headline interest rates at -0.5%. However, the narrative from the central bank's President, Christine Lagarde, was levering on the near-term impacts of inflationary pressures, suggesting policy could potentially tighten. With market expectations rushing to price in a hawkish stance, it could be thought that the market is now mispriced, as the commentary from Lagarde suggested that any hawkishness was transitory and surrounded inflationary worries in the near-term. Let's remember, supply chain disruptions will be eased at some stage, putting downward pressure on inflation. As such, central banks do not want to tighten too much, too soon, as when supply side issues ease, this could present deflationary worries.

Following the markets interpretation of the first ECB policy meeting of 2022, it is important to remember that central banks are not just responsible for staving off inflation/deflationary pressures, but rather the stability of the entire economy. With that in mind, and with other western world central banks talking about beginning to raise rates (albeit glacially!), the ECB would have been amiss not to talk about the potential for interest rate rises just purely on the basis of global trade, wanting to maintain the competitiveness of the Euro.

Italian presidential elections were held at the end of January (2022). Despite the former European Central Bank head and current Prime Minister, Mario Draghi gaining traction as the favourite, reigning president, Sergio Mattarella, maintained the seat. Whilst this appears a non-event to a certain extent, the mechanics are largely significant, as Draghi largely favoured a Mattarella victory for stability of the nation. A Mattarella victory means that Draghi remains Prime Minister, somewhat ensuring political and policy stability in the country.

One of the key stories impacting Europe in recent months has been the frictions surrounding the supply of gas from Russia. With Russia pressing the Europeans to utilise the new, and more direct, Nord Stream 2 pipeline, they dried up supplies via the usual routes. This throttling of supply, coupled with political pressures surrounding the Ukraine/Russia military frictions, has generated a supply side driven spike in energy prices. That being said, despite pressures from the US, the European's are choosing a diplomatic approach to Russian frictions, in addition to pressing ahead with signing off the utilisation of the Nord Stream 2 network. With that in mind, over the longer-term, this could see the easing of energy pricing pressures… even if they do remain slightly elevated!

Fixed Interest

Government debt remained volatile to close out 2021, with that volatility continuing into 2022. Given high inflation, markets are unsure on the pace of tightening out of central banks, which means this volatility could continue for some time, particularly, as there is a wide range of opinions on how fast the Federal Reserve will increase rates in the US.

Despite high inflation, long dated government debt has remained relatively subdued. There are some technical reasons for this, however multiple rate hikes this year would likely lead to very flat yield curves, without a move up in longer dated government bonds yields. Typically, longer dated debt would have a higher return, to compensate for a number of risks. Central banks may find this worrying, and they could target policy to try and avoid flat or inverted yield curves.

The most recent quarter differed from the rest of 2021, in that corporate bonds also saw weakness, with credit spreads (the additional yield over government debt) also widening. Given the Bank of England's announcement that they will sell down their corporate bond holdings, we could see some further volatility in corporate bonds in the short-term. However, corporate fundamentals remain strong, with healthy balance sheets, and risk of defaults remaining low. Providing growth remains robust, corporate credit health should also remain strong, so defaults, particularly from investment grade credit, should not be a major concern in 2022.

The recent weakness in corporate bonds, does mean yields are now higher than they have been for some time. However, yields are still low, especially when we consider current levels of inflation. For the sector to become more attractive, further repricing is needed, particularly at the long end. Pockets of value do remain, however we believe equities are likely to offer better returns in the medium-term.

If you would like to discuss this or any other aspect of your portfolio, please do not hesitate to contact us on **0800 049 2011,** Monday to Friday 9am-5pm or you can email us at **affinity.advise@wealthatwork.co.uk**

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