Manager's Report

QUARTER TO 30 JUNE 2022

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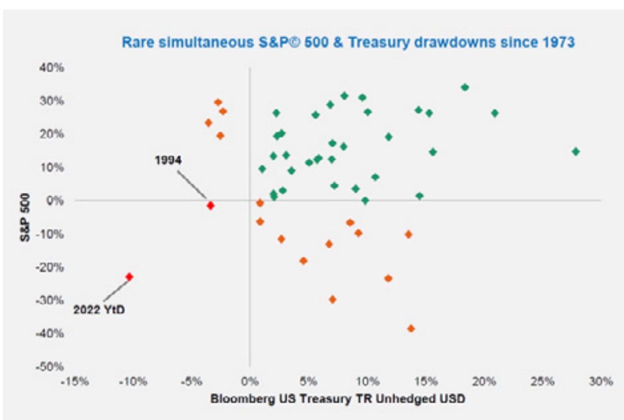
This year so far has been a very challenging one for investors, and one in which both stocks and bonds declined in tandem, offering no benefit from diversification.

This is highly unusual; in fact, this was the first time both the S&P 500 (and other major stocks markets) and US government bonds (and other major developed bond markets) declined in unison since 1994; making it only the second such occurrence since 1973:

Chart 1) Rare negative performance simultaneously on Equities and bonds



Source: Bloomberg, Candriam Multi-Asset Strategy

The only assets that performed well have been commodities and commodity related equities, which carry relatively small weightings in most stock indices. Recently even these asset classes have started to roll over, as investor fear is now shifting from high inflation to the possibility of an imminent recession, brought on by aggressive Central Bank monetary tightening.

Chart 2) Majority of asset classes underperformed this year

Source: Bloomberg Finance L.P. Data from 31 Dec 2021 to 29 June 2022

To recap from our first quarter report: at the start of the year, it was clear that interest rates were set to rise as the world was emerging from COVID related lock downs and recession.

In anticipation of this new, rising interest rate regime, we had, in the final quarter of 2021, shifted to an underweight position in bonds, and cut our previously overweight equity allocation to neutral. We had added to the "Alternatives" section of the portfolios.

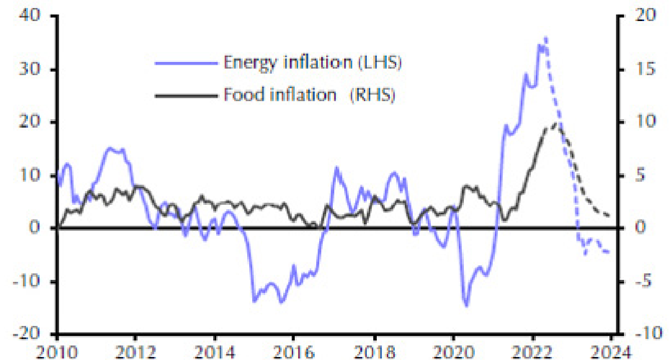
At that time the rise in interest rates, as signalled by Central Banks, was expected to be measured and gradual. Also, economic growth was expected to remain strong as the world emerged from COVID lock downs. Consumers were flush with unspent savings, and keen to resume their normal lives including travel. Meanwhile, COVID-related supply chain issues were expected to ease, relieving the upward pressure on inflation.

Russia's war on Ukraine disrupted this benign scenario, with its stagflation effects. Next to that, China began implementing repeated lock downs in major cities in pursuit of its "zero covid" policy, prolonging supply chain bottlenecks and dampening global growth further.

In addition, there have been outbreaks of Avian flu in the US and parts of Europe, which, coupled with severe droughts in different parts of the world, exacerbate the food scarcity and food inflation brought on by the ongoing war in the "breadbasket of the world", Ukraine.

In other words, the global economy is finding itself in the eye of a perfect storm, where central bankers have been scrambling to catch up with the current realities and transition from supporting growth to combatting the highest inflation we have experienced in decades.

Chart 3) Soaring Energy and Agriculture Prices Main Culprits behind High Inflation. Dotted lines indicate Capital Economics' forward estimates



Source: Refinitiv, Capital Economics

Another factor contributing to high inflation is the tightness of labour markets. In the US and UK especially, labour participation rates, though improving slowly, remain below pre-COVID levels.

Chart 4) US Headline Inflation (CPI), Core Inflation (PCE) and Wage Growth (ECI) are Highest in Decades

Source: Bloomberg Finance L.P.

Central Banks have little control over food and energy inflation, as these are caused by lack of supply rather than red-hot demand. Also, they are gradually expected to disappear from the year-on-year inflation statistics. Central Banks do however worry about high inflation expectations becoming embedded in higher wage demands, as this would be a more lasting and pernicious form of inflation; like the price-wage spiral which economies suffered in the 1970's.

This spiral was only successfully broken in the 1980's, after a period of very high interest rates which effectively pushed the economy into a deep recession.

It is for this reason (to get ahead of inflation emphatically before expectations of permanently high inflation become embedded in wage and price setting) that Central Banks have suddenly become so much more hawkish.

The US Federal Reserve delivered a 0.75% rate hike this month; the Bank of England hiked by 0.25% but could well deliver a 0.5% hike next time; the Swiss National Bank hiked rates by 0.5% (to -0.25%) for the first time since the Great Financial Crisis. Even the ECB, previously expected to stay put this year, is now likely to deliver its first rate hike since 2011 in July, moving from currently negative rates to 1.25% by the end of this year and a peak of 2% next year.

Thus, expectations of the peak in Central Bank target rates have been brought forward dramatically in time, and the expected peak levels have risen considerably from just a few months ago.

In the US, the Fed is now expected to raise rates in increments of 0.75% and 0.5%, from the current 1.75% level to 3.75% by the end of this year and a peak of 4% in the first months of 2023. Chairman Powell has made clear that fighting inflation is now the Fed's top priority, and they are willing to go above the "neutral" interest rate (which is estimated to be around 2.5% for the US economy).

This will mean purposely dampening growth and lowering employment to slow the rate of inflation.

The Bank of England has perhaps an even bigger struggle on its hands. The UK is a net importer of energy (like the eurozone, and unlike the US) and the tightness of its labour market has been exacerbated by Brexit.

Current expectations are for the Bank of England to hike rates from the current 1.25% to 2.25% by year end, and a peak of 3% in the first half of 2023.

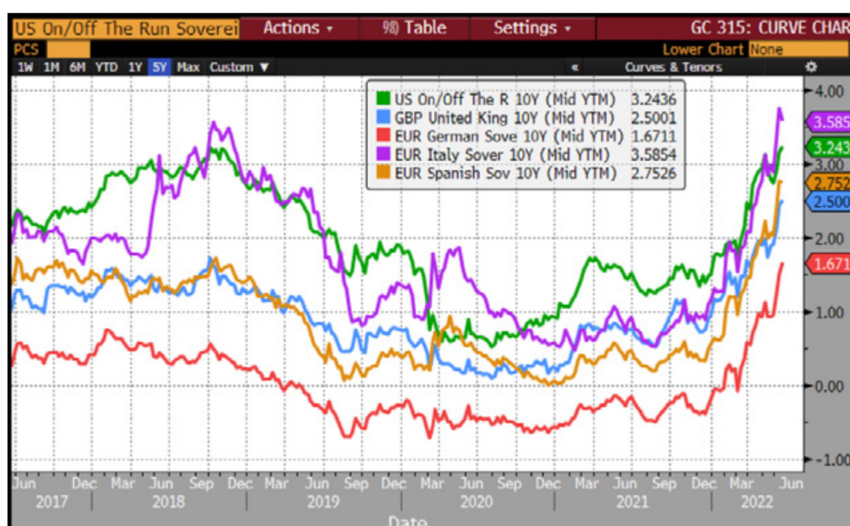
Government bond yields have risen rapidly in anticipation of these moves. We expect that they now incorporate most of the expected rate hikes, though they will probably move a bit higher still, in line with the expected Central Bank rates quoted above.

In the Eurozone, the rise in bond yields has been accompanied by a marked increase in the spread between German Bunds and Italian, Spanish, Portuguese, and Greek bonds.

The ECB is expected to announce a "defragmentation" tool to prevent this spread from widening too much. All in all, we believe it is too early to move back to a neutral position, and neutral duration, in bond portfolios and remain underweight the asset class as well as overweight short-dated bonds and inflation linked securities.

Having said that, the combination of higher risk-free rates and increased "risk spreads" on corporate, High Yield and Emerging Markets bonds is making the Fixed Income asset class more attractive for long term investors than it has been for many years, when the world was awash with "negatively yielding" paper. We will be coping with a tough transition phase for some more months but after that, expected future returns on Fixed Income portfolios will be significantly higher than they have been for quite a while.

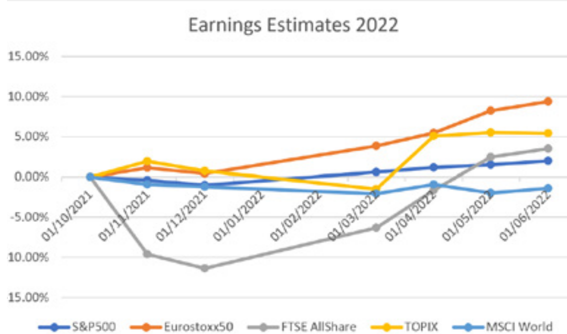
Chart 5) Government Bond Yields Have Risen Dramatically this Year



Source: Bloomberg Finance L.P.

Until now, the rapid rise in rate hike expectations and the fast rise in "real yields" has been the main driver of equity weakness, as corporate earnings estimates have held up well, and even increased after 1st quarter earnings announcements.

Chart 6) Earnings estimates have steadily increased this year (all estimates in local currency; for the MSCI World Index in USD)



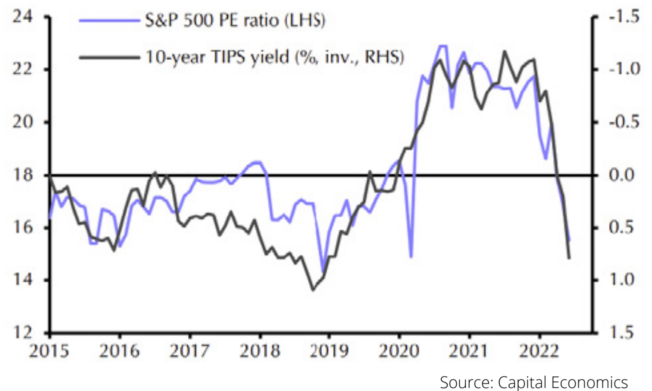
Source: Bloomberg Finance L.P.

The reason the estimates for the MSCI World Index, per the chart above, have declined slightly is due to the fact these are quoted in US Dollars, and the dollar has strengthened considerably against all other currencies this year.

But as the "discount rate" of future cashflows lies at the core of asset valuation, higher rates have quickly eroded the "risk premium" embedded in stocks.

As can be seen on Chart 7, the PE ratio of the S&P 500 index has declined rapidly this year, from over 20 to around 16. This PE lies below the post-WW2 median PE for the index and can be considered decent value. The reason the market remains nervous at these levels is a) uncertainty around the Federal Reserve's rate hike path – will they be able to contain inflation at a peak Fed Funds rate of 4% (we believe they will), and b) will company earnings this year and next year be as resilient as analysts currently expect?

Chart 7) There is a clear inverse relationship between the real discount rate (as expressed by the yield on Inflation Protected Securities, or TIPS) and the stock market's Price to Earnings ratio



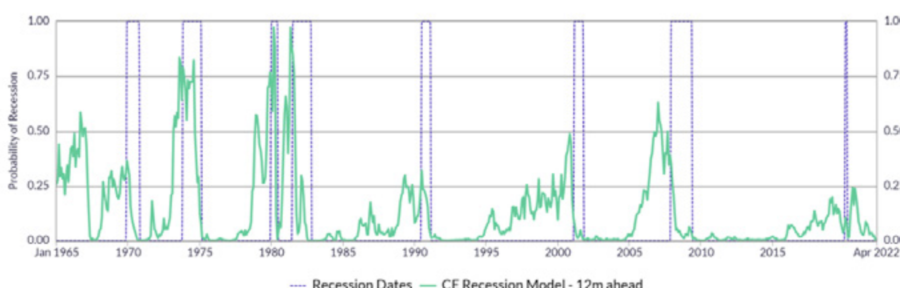
Source: Capital Economics

The answer to this question is uncertain. Until now most companies have been able to pass on higher input prices to their customers, and corporate profit margins, which are currently at historically high levels, have remained resilient. But as the Fed walks the tightrope between slowing down demand enough to curb inflation, without causing a recession, maintaining current margins will obviously become more challenging for companies, especially for those that do not possess an "economic moat".

How likely is it that Central Banks will push their economies into a recession?

Many market commentators seem to believe this likelihood is very high. We think the likelihood of a technical, shallow recession in the Eurozone and the UK, both of which are highly dependent on Russian oil and gas, is present. For the US, we believe a "soft landing" (of 2.5% GDP growth in 2022 and 1.7% in 2023) is still achievable, though clearly the risk of a less benign scenario has risen.

Chart 8) Multi-factor Recession Model still shows low likelihood of a US recession in the next 12 months

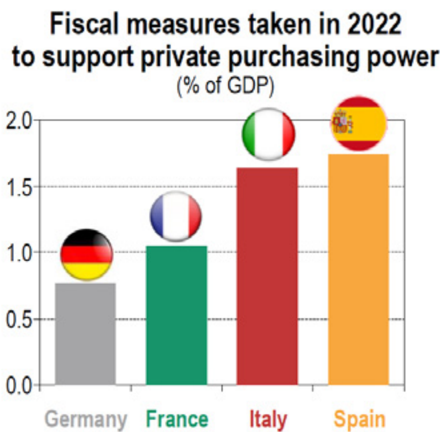


Source: Capital Economics

Several forces are already slowing demand in the US. Mortgage rates have risen rapidly, and housing market activity is now falling. High inflation is eroding real income growth despite the strong labour market and rising wages, and US consumer confidence is at a multi-year low. Consumer spending has remained resilient so far, but consumers have clearly started dipping into their savings. The continued strength of the US dollar will weigh on exports.

In Europe, the rise in energy prices is expected to shave 3% of households' purchasing power in 2022, while food inflation will shave off another 1%. This is partly offset by varying levels of government support, and a high savings rate.

Chart 9) Fiscal Measures taken in the Eurozone Vary per Country



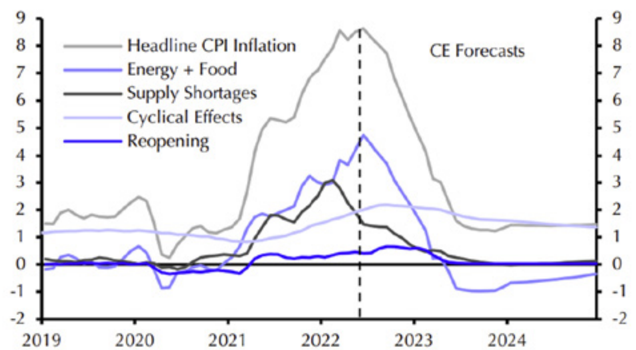
Sources: Refinitiv, Datastream, Candriam

Meanwhile, there are no signs of potentially destabilising debt imbalances for consumers, companies, or financial institutions (which are much more resilient than before the Great Financial Crisis).

All in all, we should be close to a peak in inflation, though the June readings will probably still make uncomfortable reading.

Despite this, Central Banks will push ahead with their tightening plans to firmly get inflation back under control

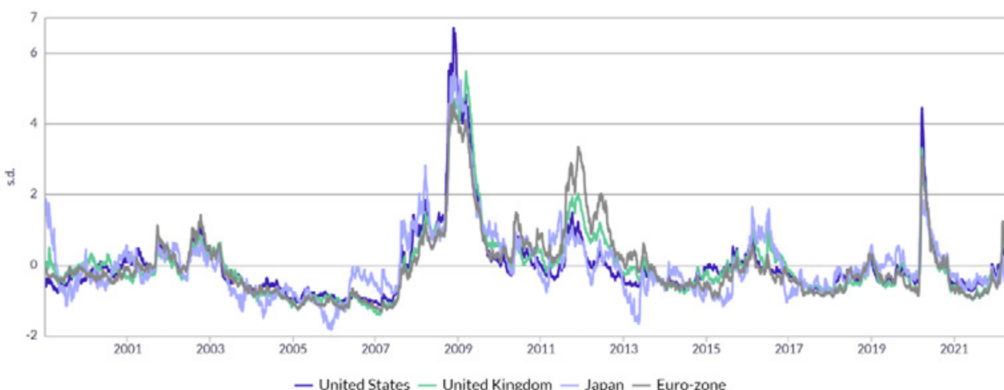
Chart 10) Expected forward path of CPI inflation in the US, split over its components



Source: Capital Economics

Meanwhile the tightening in financial conditions (which has already been considerable, see below) coupled with uncertainty around company earnings will probably keep markets volatile over the summer.

Chart 11) Global Financial Conditions have tightened rapidly, and are likely to tighten further



Source: Capital Economic; CE Financial Conditions Index

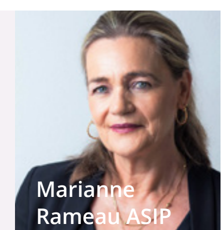
Given all the above, what actions have we taken in Portfolios, and what is our strategy going forward?

- We are sticking with our underweight allocation to bonds, and our short duration stance within bond portfolios, until we are closer to the expected peak in interest rates. At that point Fixed Income will be an attractive asset class again, offering higher yields than in recent years. Attractive long-term opportunities in High Yield and Emerging Markets bonds are already starting to emerge as credit spreads are widening.
- Having moved from an overweight to a neutral equity allocation late last year, we used a temporary rebound in May to raise some cash within Equity portfolios, which we have invested in a Money Market fund for USD and Sterling portfolios, now that money market rates are once again positive (and rising). For Euro clients, money market rates are still negative, but this will soon change. The cash positions are meant to have some "dry powder" available when attractive opportunities arise in this volatile environment.
- The cash in equity portfolios was raised from more "growth" oriented funds, which suffer disproportionately from a rise in real interest rates (which erodes the net present value of future growth in earnings). Equity portfolios are now balanced between value and growth factors. A slowing economy will again make "quality" characteristics of companies more attractive, including the ability to maintain margins and earnings growth.
- Geographic allocations are also kept neutral. While the US economy appears more resilient than those of Europe or the UK, the latter two markets are already trading at quite cheap levels. The Japanese equity market is vulnerable to a global slow down due to its high weighting in Industrial companies, but the Bank of Japan, along with the People's Bank of China, are the only two major Central Banks that are easing policy right now. Emerging markets have suffered in the risk off environment but as their Central Banks have been well ahead of the curve to tighten monetary policy, and most Emerging Markets have built up much more resilient finances than during previous crises, they are well positioned.
- We retain our overweight position to Alternative asset classes for now, diversified over long/short equity funds, some commodity funds, event driven and arbitrage strategies, volatility trading, private equity, and global real estate.
- Until we are closer to the peak in interest rates, we intend to maintain this relatively defensive positioning. Raising further cash does not make much sense to us at this point, as "timing the market" is usually a futile exercise, and a big part of the initial market recovery usually happens very quickly.
- Looking out over the longer horizon, there are many exciting areas of future growth and investment including in sectors of the economy that will enjoy strong secular tailwinds such as technology, the energy transition, the need to build more sustainable cities and infrastructure, food sustainability, healthcare, etc.
- During this period of "Reset", or "The Great Transition", reduced valuations in both fixed income and equity markets means that expected future returns for investors are rising considerably.

All we can do at this point is be patient, hold fast and watch for incremental opportunities to arise. Meanwhile, diversification remains key.

As always, please do not hesitate to contact us if you have any questions or comments, about the contents of this report or your portfolio in general. We hope you are safe, and well, and managing to keep your hope alive in these turbulent times.

Portfolio Management, Team ISGAM AG



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