# Monthly market blueprint

## Investment management service

March 2022

mazars

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Foreword

# Cancelling Russia isn't cheap

Cancelling a person, right or wrong, is no small feat, and there are repercussions. "House of Cards" was a series that literally made Netflix, yet it features much less prominently after Kevin Spacey's cancellation. The cancelled actor/celebrity will have worked with other people, who will now see their incomes reduced as works of art are withdrawn and themselves smeared by association. Cancelling a single human being may have outsized repercussions for everybody associated with them. Cancelling a state in a globalised world is a much, much bigger affair.

We are witnessing a historical novelty, however. The essential cancelling of an existing state, a nuclear superpower no less, and its people. It's not just banks and oligarchs. It's Russian athletes and sports teams, Russian expats and Russian culture, including the Ballets. Electronic Arts updated its flagship "FIFA 22" game to omit all Russian Teams. Developed markets mean to behave as if Russia simply is an ex-entity.

But western sanctions over the Ukrainian war are great and far-reaching, way beyond Russia and its nationals. The war and the sanctions are throwing everybody's post-pandemic economic calculus into chaos.

Russia is a key producer of energy, nickel and palladium (used for car manufacturing), wheat (along with Ukraine 1/3 of global production), copper, gold and alumiunum. Supply chains that were just beginning to recover after tremendous pressure are now facing another massive hit. Input prices will, in all probability, soar. The IMF predicted 4.4% global growth for 2022, but risks are now to the downside. Rising prices will also change the central banks' inflation calculus in ways we can't yet predict. By some estimates, oil prices could reach $150 per barrel.

The Fed's decision between supporting risk assets and fighting inflation is getting a lot more difficult. Failure on those fronts could compromise its independence. Europe, meanwhile, is preparing for a cold winter. It's not just the price of energy at stake but also its availability.

The point we are trying to make is that the war in Ukraine and the concomitant reactions will have consequences we can't yet imagine or, frankly, predict and plan for. As economic concerns take a backseat over geopolitical objectives, so will final decisions and, inasmuch as policy affects them, the returns for risk assets. This is what textbook "systematic risk" looks like, and it is un-hedgeable. But unlike anything we have seen in the past forty years, this instance comes with high inflation, which prevents central banks from mitigating the bulk of that risk. It also makes holding cash as an alternative a very expensive proposition.

The repercussions of this war and the West's response will be felt across the globe on both the economic and political front for many years. Investors with a high tolerance for risk may choose to roll the dice. As with any significant milestone in financial history, the next few months will see new winners and 'gurus' emerge, while failed strategies will be forced to throw in the towel. But for the critical mass of investors, those for whom risk is a measurable quantity and financial planning is part of the equation, we think that the best course is to avoid taking significant action before the dust settles and trust in the long term properties of diversified portfolios.

**George Lagarias**
Chief Economist, UK

# Market performance
## The month in review

### February saw a continued sell off in risk assets as the scale of the Russian offensive in Ukraine wrongfooted investors.

In February, concern about inflation and the speed of central bank rate rises gave way to concerns about the invasion of Ukraine, economic sanctions that levied on Russia by Western governments.

The equity market most affected was Europe, falling -4.1% over the month. Europe neighbours Ukraine and is also heavily reliant on Russia for natural gas and oil exports, leaving it exposed to the escalation of events and the sanctions placed on Russia. European banks are also the most exposed to Russia, albeit to a limited degree.

The US market was similarly affected with equities falling -3% for the period. Despite corporate earnings growth coming in above expectations, the market was preoccupied with events in Ukraine and the uncertainty it entails.

The UK fared well in relative terms, with equities falling only -0.5%. The UK continues to benefit from rising commodity prices due to the large weight of energy and basic materials companies within its index.

Emerging markets moved down in line with the risk off sentiment that affected developed markets. Japanese equities were resilient, falling by -0.4%

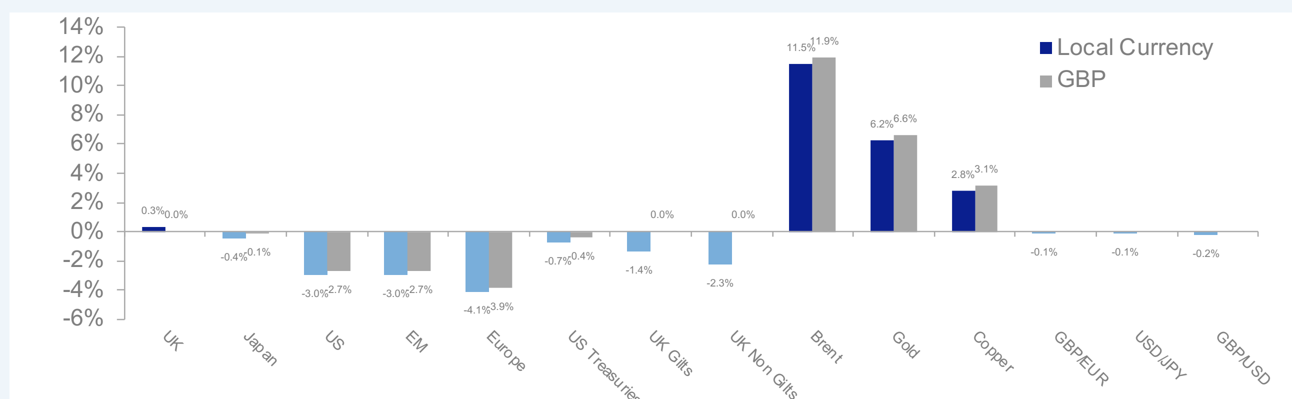
Fixed income securities faced a tug of war in February but ended the month lower. There was no sign of central banks letting up in their attempts to curb inflation by tightening monetary policy. Whilst this put downward pressure on prices, the flight to safety in the second half of the month saw large swathes of buyers come in, lifting prices in the process.

The UK 10-year government bond yield moved from 1.30% to 1.41%. The US 10-year government bond yield rose from 1.78% to 1.83%. The German bund, which had only just turned positive in January, continued its advance to end February at 0.14%.

Commodities proved the biggest movers of the month, driven by the war in Ukraine. Gold moved up +8.1% as a hedge against volatility, having been struggled to advance prior to February. Crude oil was the largest mover, ending the month up +11.5%, as concerns about constrained supply from Russia in the face of war and sanctions.

All movements are stated in local currency. Returns of assets denominated in foreign currency were flattered by GBP weakening -0.2% and -0.1% against the US dollar and the Euro respectively.

## Basic asset classes




Charts Source: Mazars Calculations

Asset allocation

# Changes in our Strategic Asset Allocation

## Outlook and portfolios

In January our Investment committee voted to keep our asset allocation unchanged. Despite mounting risks we maintain a neutral position in equities and an underweight position in fixed income.

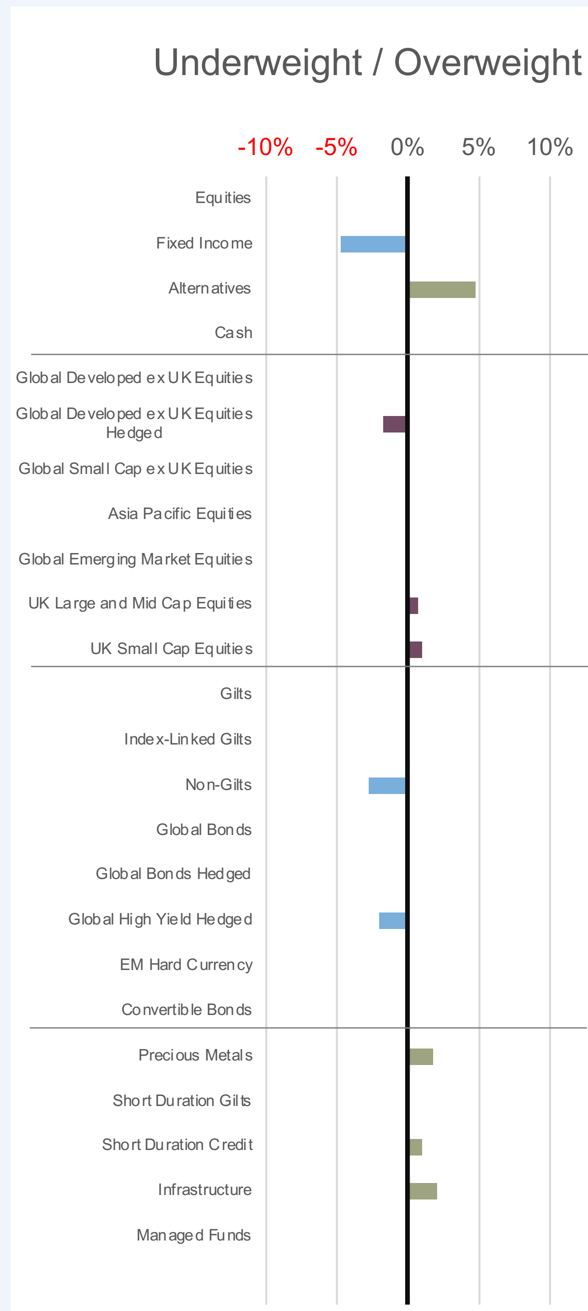
The biggest risk in our view comes from central bank tightening. Less QE and higher interest rates slow liquidity growth in the financial system and create tighter economic conditions. This leads to financial markets which are less forgiving when negative news inevitably arises, whether it is economic data or pandemic-related. This is the main reason we reduced our equity overweight in October and why we maintain that position.

It is also worth noting that within our equity portion we are tilted away from international equities towards UK equities, albeit marginally. We expect our allocation to US value companies to drive outperformance as some of the more expensive areas of the US market come under scrutiny.

Central bank tightening and inflation lead us to remain underweight bonds in portfolios. As central banks move closer to raising interest rates, as has already happened in the UK, the relative attraction of bonds is diminished. We maintain an underweight position and have taken further steps to reduce duration (sensitivity to rising interest rates) within our more conservative portfolios.

At a fund level, this quarter we have introduced Morgan Stanley Global Asset Backed Securities to Defensive, Cautious, Balanced and Income portfolios to reduce duration. To reduce concentration in any single fund we have spread our Japan equity exposure across an index tracker to sit alongside Lindell Train Japanese Equity and we have reduced our allocation to Foresight Global Real Infrastructure fund and added M&G Global Listed Infrastructure.

### Mazars balanced portfolio as of 3 February 2022



# Risks

## The Omicron is receding but inflation is running away

2022, is not expected to be the year when things got back to normal. It is a year of great uncertainty and a wide variety of outcomes. Volatility in the beginning of the year is at record highs.

Exactly two years after the emergence of the last exogenous crisis, the Covid-19 pandemic, and before recovery was achieved, the global economy is now experiencing renewed convulsions as a result of the war in Ukraine.

As a response to Russia, sanctions by G7 countries have been unprecedented. Russia's raw material and energy produces are now in question. Global supply chains, which were under pressure even before February, are now facing another unprecedented shock. Global inflation is bound to rise and growth will, in all likelihood, be affected. So will corporate earnings. A (very possible) Russia default could have further repercussions on Risk Assets.

The confluence of risks is significant.

Risks from the pandemic seem to abate, however we can't rule out the emergence of a new variable which, along with lockdown fatigue, could significantly stress economies and consumers.

Meanwhile, the Chinese economy is slowing down due to the clamp down on the real estate market. The repercussions from that could also be significant.

At the current juncture, our top area of concern is the potential of runaway inflation and the Fed's inability to fight a war on two fronts (price pressures and market volatility). Slower growth could mean a stagflationary environment, to last 1-3 years.

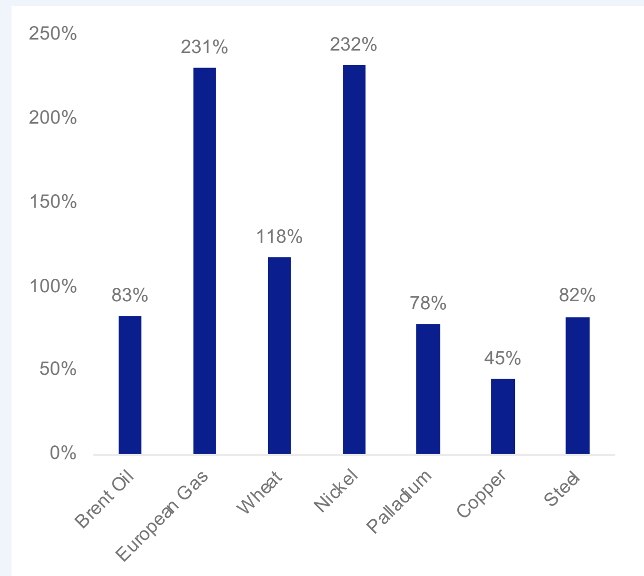
Given low bond returns, investment arsenals is primarily confined to equities and certain liquid alternatives.

Upside risks, however, also exist and are not priced in. The pandemic could end due to the speed of the Omicron variant, or Russia could retreat from Ukraine.

The Fed's focus on inflation means that all the above risks could have a bigger impact on risk markets than previous years. We expect macroeconomic and market volatility to last well into mid 2022.

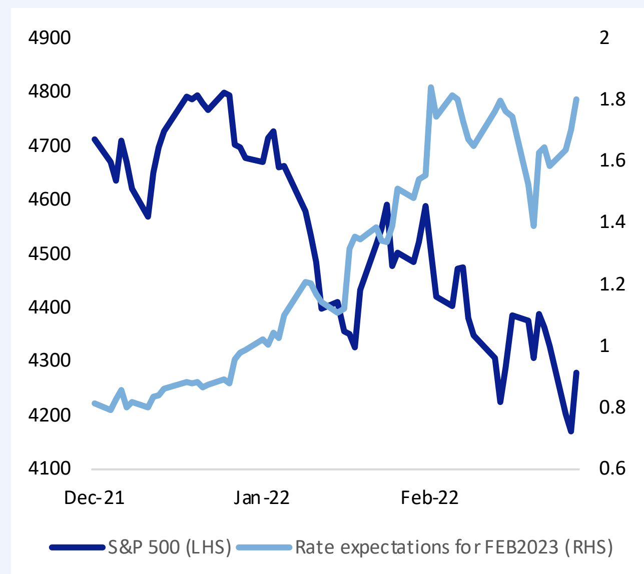
### Prices for key commodities are soaring

**Price versus 5 year average, %**




### Going into this without the Fed's safety net

**Rate expectations, S&P 500**




Charts source: Johns Hopkins, Mazars Calculations

# Global

## It has been one of the worst starts to the year for risk assets in general, as inflation momentum has pushed the US central bank out of its previous perch as a guarantor of market stability and into the role of inflation-buster. Meanwhile, systemic risks from the Ukraine war are rising fast. Higher input prices are already ripping through fragile supply chains and will put further pressure on consumers.

For February, global stocks fell by 2.5% (2.2% in GBP). The highest performing sectors were Energy and Materials while the worst performers were Telecoms and IT. Equities were trading at 17.68x times forward earnings, 4.5% above long-term average. Gold rose 6.2% and oil prices rose 8.6%.Early March is seeing more pressures

Nominally, the global economy continues to expand well above its pre-pandemic rate, albeit in an unbalanced manner. In the runup to the Ukraine wars, supply-side inflation pressures were abating and mutating into demand-side, as persistently higher prices have fed into wage demands.

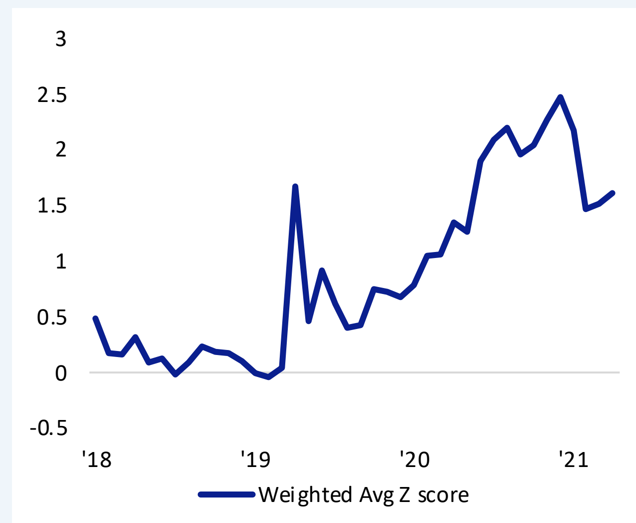
However, the Ukraine war is throwing the post-pandemic economic calculus in disarray. Soaring commodity pressures are putting further pressure on prices, consumption and central banks. Policy makers are divided between hiking interest rates and risk further destabilizing the recovery, or keeping rates low and risk runaway inflation.

Meanwhile, lack of availability for key commodities threatens to completely destabilize supply chains. We believe this will impact global growth for 2022, which is currently projected to be around 4.4%

**Outlook:** : We believe that macroeconomic and market risks are greatly elevated. Global supply chains will have to by-pass Russia altogether. New supply chains will be created to cover for Russia's absence. The long term consequences of 'cancelling ' Russia, are a domino, whose effects are hard to gauge. Some consequences are simply unforeseeable. In the past 12 years, the danger of a recession because of such events would be mitigated by central banks printing money. However, because of high inflation, they can't really do that now. This means that governments, already limited by the high debt they incurred to fight Covid, also have a limited arsenal.

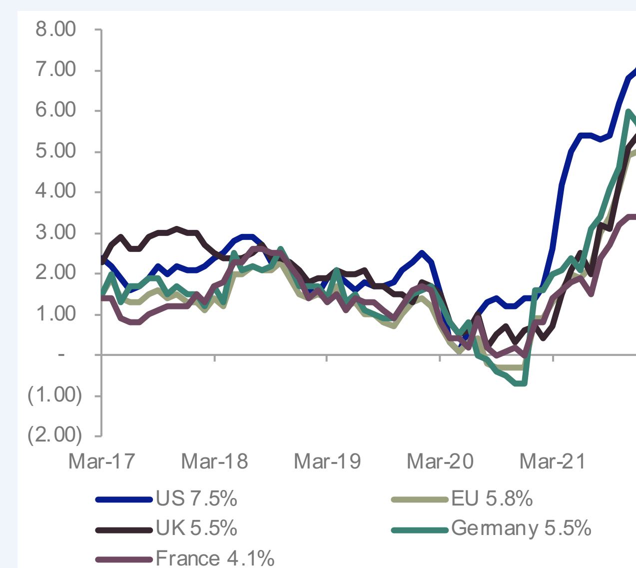
### Supply chain pressures are re-intensifying

**Z-score of eight key supply indicators**




### Inflation is rising

**Consumer Price Index, Year on Year**




Charts Source: Mazars Calculations

# UK

## UK equities remain stronger than global equities due to the larger weight to energy and basic materials and the less demanding valuations.

The UK has been resilient in 2022 and have outperformed global equities. To some degree this is a linked to valuation and in another way it is that the makeup of the UK market is suited to the current environment.

As tension in Eastern Europe has turned into war, the weight to the Energy and Basic materials sectors of the UK market, which total 19%, have meant the UK market has not been as badly affected as other developed markets. Supply concerns linked to the war in Ukraine have pushed oil, gas, and other commodities' prices up dramatically in recent months and this benefits the bottom lines of companies operating in these sectors.

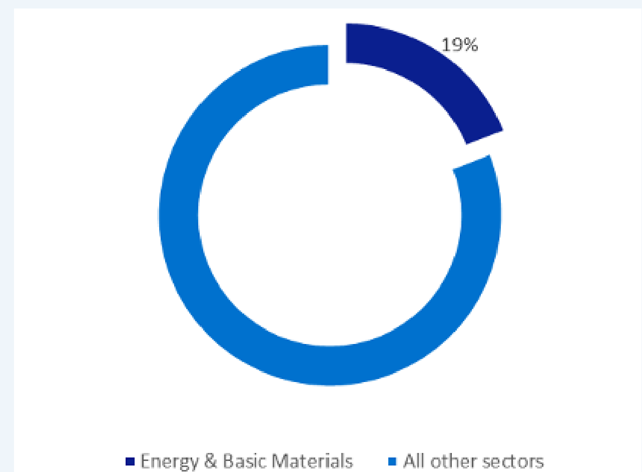
Before 2022 investors had closed their eyes to valuation gaps between different equity markets for some time. This allowed the UK to trade below and the US to trade significantly above their long term average price/earnings ratios. The last three months has seen that valuation gap close as investors have preferred to sell down more richly valued parts of the market.

**Outlook:** The future for commodity prices is dependent on the war in Ukraine and concerns about supply. While uncertainty remains we can expect that to support the energy and basic materials sectors of the UK.

The valuation gap between UK and US equities existed for some times and is unlikely to close completely, given the greater growth prospects of US companies. However, while risk off sentiment remains in the market one would expect that to weigh more on the richly-valued US market, than on the UK.

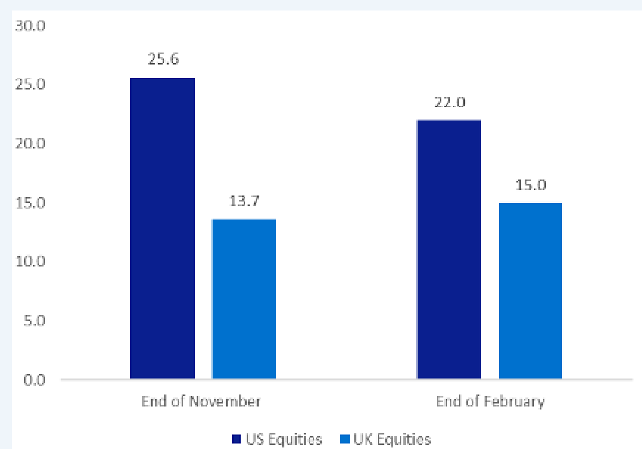
### Energy & basic materials have a large weight within the UK equity index

**Percentage weight within UK equity index**




### The valuation gap between US and UK equities has reduced over the last three months

**Price earnings ratios at the end of November 2021 and at the end of February 2022**



# Macroeconomic backdrop

## US

**For the month of February, US stocks fell by 3% (2.7% in GBP). The highest performing sectors were Energy and Industrials, while the worst performers were Homebuilding and IT. Equities were trading at 19.58x times forward earnings, 9% above long term average and 10.8% above the MSCI World. 10y bonds rose 5 bps at 1.825%.**

Data released from the US in February showed that the effects of the Omicron variant of COVID-19 had a smaller effect on economic activity than many had anticipated. Many key indicators which were expected to take a hit from increased virus restrictions instead produced positive surprises. The US jobs report, for example, featured large upward revisions in the number of non-farm payrolls added in December and November and a steadily increasing labour participation rate. Retail sales also rebounded strongly, increasing by 3.8% over analyst expectations of 2%.

Manufacturing activity also been positive in spite of Omicron. In January, the Federal Reserve reported that industrial production growth rebounded to 1.4%, while PMI data for the month of February showed that manufacturing growth rose at a faster rate than the previous months.

This shows that on the growth front, there have been many positive signs for the US economy, and indeed, the Q4 estimate for US GDP was revised up to 7% this month.

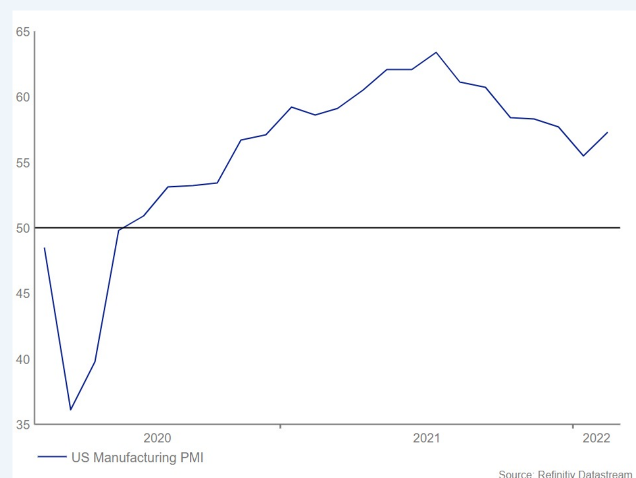
Things are less rosy on the inflation front, where we saw that the Q4 CPI grew at a rate of 7.5% year-on-year, a 40-year high. As global oil prices rise following the Russian Invasion of Ukraine, it has become far more likely that inflation could remain elevated for a prolonged period.

In spite of the uncertainty caused by the war in Ukraine, Jerome Powell has indicated in a congressional testimony that he expects the Federal Reserve to continue with its planned tightening of monetary policy this year. Markets are now expecting 6 hikes of 0.25% until the end of 2022.

**Outlook:** While the US economy remains relatively insulated from the effects on economic sanctions on Russia, it is possible that higher commodity prices could keep inflation elevated over the next few months. Much will hinge on how the Federal Reserve will react to this scenario.

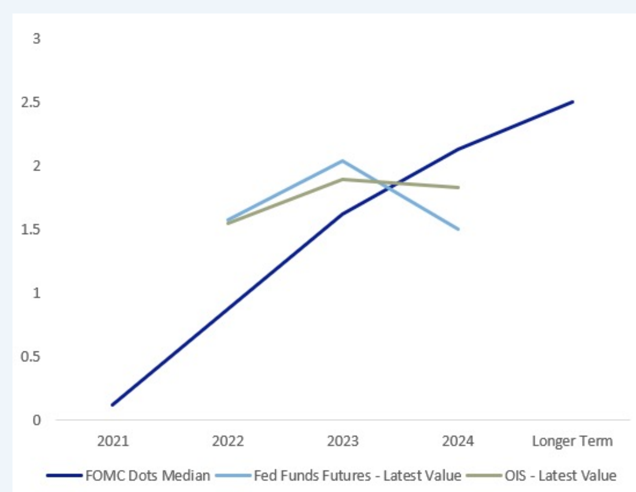
### US Manufacturing Picked Up in February

**US Manufacturing PMI**




### Markets are pricing in steeper rate hikes than the Fed

**Market Implied and Fed assumed rate expectations**




Charts Source: Mazars Calculations

# Europe

## In February, European stocks fell by 3.9%. The highest performing sectors were Materials and Utilities, while the worst performers were Financials and Retail. Equities were trading at 14.74x times forward earnings, 5% below the long term average, and 17% below the MSCI World. 10y Bunds rose 12 bps at 0.135%.

February was a month that few will forget, starting with a narrative focused on economic recovery and ending with geopolitical tensions reaching heights not experienced since the Cold War. The recent invasion of Ukraine has sent risk assets tumbling, whilst a flock to safety has seen yields on government bonds fall from their mid-month highs.

Conflict on European soil is now a worrying reality, and provides significant challenges for European governments. Germany has pledged €100bn to its armed forces and committing to increase defence spending by over 2% of GDP, as well as halting any progress on the Nord Stream 2 project. However, these actions have forced Germany into a tight spot, as a significant proportion of its non-renewable energy is imported from Russia, ultimately meaning that German consumers will bear the brunt of higher energy prices.

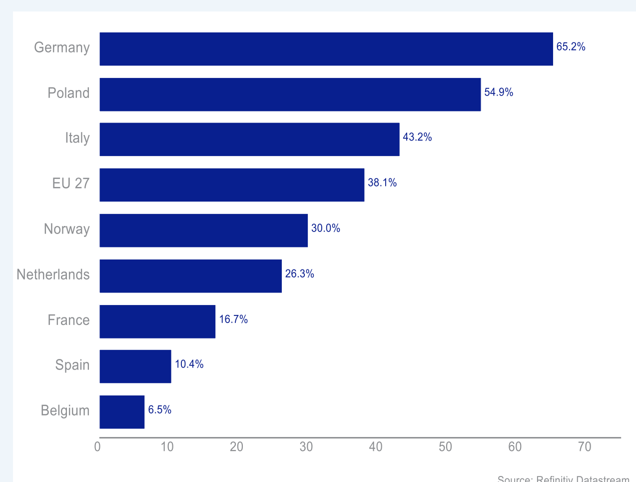
Policymakers are also debating how they should be addressing record levels of inflation in Europe. Flash estimates for Eurozone inflation indicated a record 5.8% year on year increase in February. However, there are tentative signs that supply chains issues are beginning to ease. IHS Markit Eurozone Manufacturing PMI data indicated that supplier lead times lengthened by the lowest recorded amount for over a year.

Nevertheless, the invasion of Ukraine is a significant risk to already fragile supply chains in Europe and any disruption could force inflation even higher; a situation that the ECB are desperate to avoid, as any policy mistakes are sure to be amplified in such a rapidly changing economic environment.

**Outlook:** Substantial market volatility is expected over the next few months as the current conflict evolves and policymakers face the momentous task of facilitating growth in a challenging economic environment.

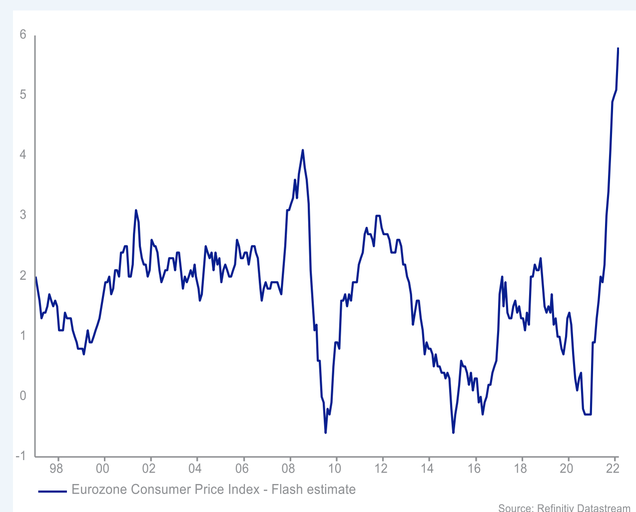
### European natural gas imports from Russia

**% of total natural gas imports, 2020**




### Eurozone inflation continues its record climb

**Eurozone CPI, year-on-year, % change**




Charts Source: Refinitiv Datastream

# Japan and emerging markets

**For the period, EM stocks fell by 2.7%. The highest performing sectors were Materials and Industrials while the worst performers were Energy and Consumer Discr. Japanese stocks fell by 0.1%. The highest performing sectors were Utilities and Telecoms while the worst performers were Consumer Discr. and IT.**

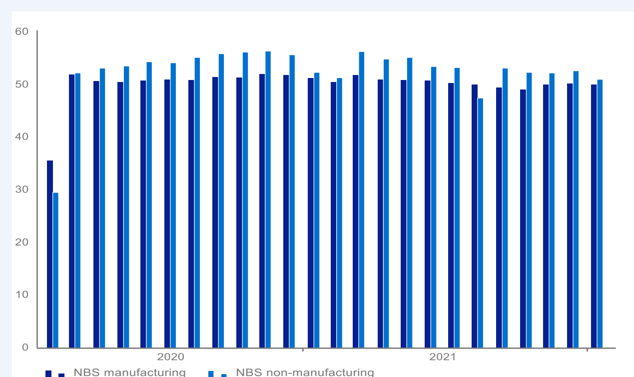
While developed market central banks push for tighter monetary policy, China is moving in the opposite direction. Slower GDP growth in the last quarter of 2021 confirmed the economic deceleration brought by the troubled property sector. As a result, the PBOC cut a number of policy rates to stabilize economic momentum. China's annual inflation rate fell to 0.9% in January from 1.5% a month earlier. This was the lowest reading since last September, as the cost of food dropped the most in four months. Producer price inflation eased to 9.1% YoY in January from 10.3% in the prior month. This was the lowest reading since July, reflecting the effect of the government's measures to secure supply and control surging commodity prices. The official NBS Manufacturing PMI for China unexpectedly inched higher to 50.2 in February. The latest reading marked the fourth straight month of growth in factory activity, amid the seasonality impact of the Lunar New Year holidays and despite a slowdown in production during the Winter Olympics.

The Japanese economy grew by 1.3% in Q4 2021. The upturn marked the strongest pace of quarterly growth in a year, as both household consumption and business investment bounced back, amid a decline in Covid-19 cases and easing restrictions. Japan's factory output shrank for the second month in January as the auto sector grappled with production suspensions due to the pandemic. Retail sales dropped a seasonally adjusted 1.9% from the prior month, the second monthly downturn in a sign of the negative impact a surge of coronavirus infections was having on momentum.

**Outlook:** Volatility could continue until investors have clarity of when the US Fed's hawkish stance would end. While China continues to ease its policies, rising tensions between Russia and Ukraine have added a layer of uncertainty on EM growth and inflation outlook. For investors, diversification remains key.

## China's economic recovery remains fragile

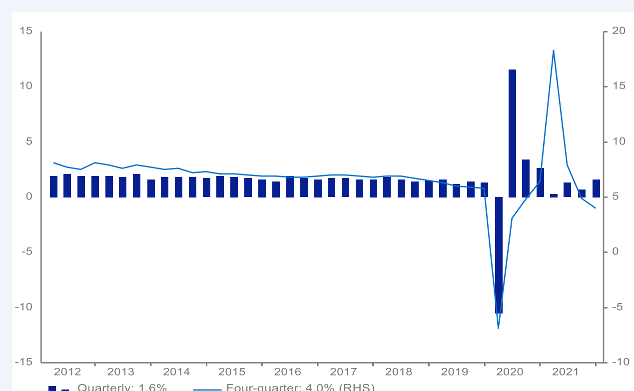
**China PMIs, 50 = no change**




The official NBS Manufacturing PMI for China unexpectedly inched higher to 50.2 in February. The latest reading marked the fourth straight month of growth in factory activity.

## China GDP growth slows to 4.0% in Q4 amid COVID, property woes

**Percentage changes, both axes**




China's gross domestic product growth slowed to 4.0% on the year in the fourth quarter of 2021, delivering a full-year result of 8.1%, as a Covid-19 resurgence and a real estate downturn combined to restrain economic momentum.

Charts Source: Refinitiv Datastream

# Our themes

# Macro theme 1
# Normality suspended – Ukraine and points of inflection

An outlier risk as it was, the invasion of Ukraine has happened. Over the short term, sanctions on Russia, a key global producer, are already pushing input prices up. Before mid-February, supply chains were staging a fragile recovery. This war, no matter how long, may very well exacerbate supply pressures and erase the progress made in the past three months. SWIFT-related sanctions may result in the defaulting of some payments, an event which may require more market liquidity. This will put pressure on the Fed, which will have to decide whether these price rises are temporary, whether it should accelerate its rate hike schedule, or whether it should turn its attention to rising market volatility.

The single greatest point of inflection, could be the priorities of the United States. Currently, the world's foremost economic and military superpower prioritises business over strategic interests. Ukraine changing this calculus could have immense economic, financial and political consequences.

The first area that could change would be tech regulation. In a heavily polarised Washington environment, an antipathy for Big Tech is probably the only issue on which Democrats and Republicans agree. In an environment where fear of propaganda by other nations will become a priority, we should expect much higher levels of scrutiny on content platforms, which could ultimately threaten their current business models. Together, tech stocks account for around 25% of the S&P 500 capitalisation.

Another area would be cryptocurrencies. Global central banks and regulatory authorities have shown tolerance of cryptocurrencies as a precursor of nationally issued digital currencies and in the spirit of innovation. However, if cryptocurrencies are seen as a way for Russia to evade sanctions, then the regulatory tide could turn against them very quickly.

The third possible area is **monetary policy and central bank independence**. The Fed (and the Bank of England) have sets their sights on inflation. Can Ukraine lead the return of accommodation? The Fed has acted in a very accommodative manner in the past decade, with the specific intent to repress risks. It is very hard to think that now, when geopolitical risks got very real, it will turn its back on market volatility.

## Areas of inflection

- Tech regulation
- Cryptocurrencies
- Central bank policy and independence
- Brexit
- US 2022/2024 elections

Especially as the effectiveness of interest rate hikes as a tool to combat supply-side inflation is questionable. The Fed is in a dilemma as it is. Will it chose to reduce market volatility or try to fight inflation? If, however, strategic interests for the US take precedence over business concerns, then this may not be Mr. Powell's decision. In plain words, it is difficult to imagine the Fed's independence remaining completely intact in an environment where geopolitical safety considerations become more important.

A fourth area is Brexit. The UK has been a proponent of hard sanctions from the beginning. Conversely, Germany has been more reluctant, more dependent on Russian Gas, and resisted a call to eject Russia from the SWIFT global payments system. In a world where business interests are more important, it has often been said by Washington insiders that a trade deal with London was at the back of a long queue. But in a world where security concerns are more important, the gains for Britain could be significant.

At the very top level, a New Cold (or Hot) War, could significantly change the political calculus in Washington, starting with the 2022 Mid-term elections, and possibly the 2024 Presidential Election.

Macro theme 2

# Risk assets and geopolitical risks, central bank reactions

The invasion of Ukraine has given policymakers a reason to reassess their current stances on both inflation and global growth. Sanctions imposed on the Russian economy by Western nations have severely crippled the country and forced the Bank of Russia into desperation: raising interest rates to 20% and suspending the sale of any foreign currency, in an attempt to rescue its economy from certain calamity.

However, these sanctions are a double-edged sword that will inevitably have consequences for global economic conditions. Restrictions on Russian imports have jeopardised Russia's role in the global economy as a noteworthy exporter of important commodities, including oil, natural gas and precious metals. This has raised fears of supply concerns and severely impacted commodity prices, which will force input costs higher for developed nations that are so dependent on these natural resources.

This dilemma poses a significant challenge to a Federal Reserve that is already facing down the barrel of inflation at a record 7.9% in February. Nevertheless, the mandate of the Fed is to support economic growth and stability. Although they cannot afford to focus solely on inflation statistics, it remains unclear how many interest rate hikes the Fed will pursue this year, and forecasts vary wildly.

Unlike the US, Europe does not have the advantage of being geographically separated from the conflict in Ukraine. As such, the pressure on critical supply chains in Europe is unlikely to abate for the foreseeable future. This, combined with Europe's dependence on Russia for non-renewable energy sources, means that the next few months will be challenging for Europeans, as the prices of consumer goods will soar without intervention.

Fortunately, the sole mandate of the ECB is to manage inflation within the Euro area. However, any attempts to intervene are likely to be fundamentally flawed. Hiking interest rates has sizeable implications for the ECB, due to its additional responsibility to protecting the highly indebted countries on the periphery of Europe. Restricting monetary supply for these common currency nations could have devastating consequences for the European Union. As a result, the ECB's recent tilt towards a more hawkish stance has unnerved markets.

The overarching narrative on the global economy is violently changing and markets are being whipsawed as a result. Ultimately, we are yet to see the full impact of the invasion of Ukraine on risk assets, as this crisis is still taking shape and de-escalation will take time. However, over the longer-term, this conflict has raised the risk for a stagflationary environment moving forward, as inflation is likely to remain increasingly persistent as global growth expectations moderate. Central banks across the world have a monumental task ahead of them and, unfortunately for central banks and risk assets alike, printing money is unlikely to be the solution.

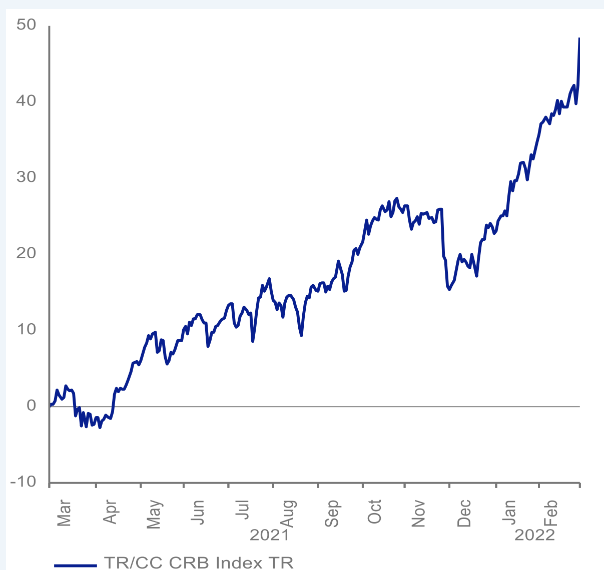
## The ECB needs to protect the periphery

**10-year bond yields, spread over German Bund, %**

Charts Source: Refinitiv Datastream

## Key commodity prices have spiked

**Commodity CRB Index, % Change**




Charts Source: Refinitiv Datastream

Macro theme 3

# China's property sector woes

China's Evergrande Group has rapidly become Beijing's biggest corporate threat as it wrestles with debts of more than $300 billion as a result of years of aggressive expansion. But that was just the tip of the iceberg. The total combined debt of China's major property developers is now estimated at more than $5 trillion. To make matters worse, 20 of the top 30 property firms by sales have breached at least one of three debt limits set by the Chinese government to rein in real estate speculation, meaning they're unsustainable.

With property being a key driver of economic growth – contributing about 29% to China's GDP – any major real estate crash could threaten the entire Chinese economy. Its important to note that China has about 65 million empty homes, which is equivalent to the total number of households in France and the United Kingdom combined, due to a massive building boom and rampant speculation.

Betting on sustained growth, a large proportion of China's population has money tied up in residential property. According to China's central bank, 93.6% of urban households owned homes last year, one of the highest rates in the world. The real estate market has continued to expand because investors, developers and home buyers have generally believed that the sector is too crucial to the economy for the government to allow any significant correction.

While new-home sales dropped 32% last month as the Evergrande scandal unnerved investors, huge differences in the way the Chinese real estate market operates could limit the impact of any bubble bursting. One reason for that is that typically a Chinese buyer will only take a 60% bank loan to buy a property. Down payments are therefore 40%, compared to just 3-6% in the US, 5-15% in the UK, and 20% in Germany. So, even if property prices drop 20-30% and there is a rise in defaults, the banking sector can manage.

That's not to say that some of China's biggest property developers won't go under. In recent weeks, Evergrande and others have struggled to offload assets to help repay their debts. Any collapse of a company like Evergrande — which employs more than 200,000 people and indirectly sustains 3 million jobs — is likely to be carefully managed by Beijing to limit the fallout to the wider economy.

In November last year, the PBOC cut the reserve requirement ratio for most banks by 0.5%. A move that unleashed 1.2 trillion yuan ($188 billion) for business and household loans. It further slashed its key lending rates for corporate and household loans for a second straight month at its January meeting as policymakers sought to cushion a slowdown in economic recovery due to multiple headwinds.

Beijing has been very cautious about intervening in China's economic recovery during the pandemic. It hasn't cut the country's benchmark lending rate since early 2020, and has refrained from flooding the economy with stimulus. But China has faced a slew of challenges to growth in 2021, including a power shortage, shipping delays and a crisis in real estate. The central bank's rate cuts sends a signal that policy will turn more accommodative.

## China signals easing due to property sector downturn

### China reserve requirement ratios, %

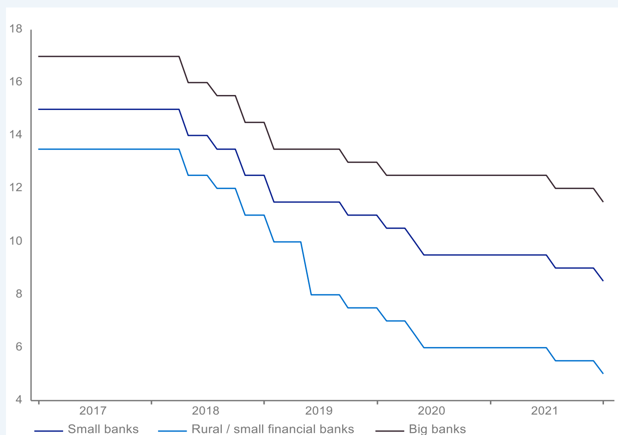



Chart Source: Refinitiv Datastream

## China real estate woes weaken property investments

### China investment in real estate development

Chart Source: Refinitiv Datastream

# Equity spotlight
## Ukraine swallowed a good earnings season

The Ukraine war and the concomitant economic shock have whiskered the spotlight away from another good earnings season. While we project a slowdown in earnings going forward, as supply chains will again be hard pressed to deliver and commodity inflation is enough to crush demand, we note that this will happen against a backdrop of companies that, broadly speaking, have recovered from the pandemic.

In the US, the S&P 500 companies saw net income growth of 30.7%, almost 10% higher than originally thought. More than three quarters of companies beat expectations on top line revenue and net earnings. Good earnings and stock market volatility have pushed valuation below it's five year average for the first time in two years.

Europe also exhibited healthy growth, with Eurostoxx 50 companies seeing an earnings rise of 69.5% and sales growth of 17.58%.

British companies saw similar growth of 78% and 11% respectively. However, unlike Europe and the US, growth was not as broad based and focused on materials and financials, the two dominant sectors in the industry.

Going forward, we don't expect the euphoria to last. 62 S&P 500 companies have issued negative earnings guidance, more than double those who issued positive guidance. The forecast is for a very modest 4.8% earnings growth.

Supply chain disruption as a consequence of the war in Ukraine will, in all probability, weigh negatively on earnings going forward. Capital expenditure will certainly be deferred. But our view is that most large cap companies in developed markets have robust enough capital structures and comfortable cash cushings to weather the storm. Thus, while the war is a systemic event with unpredictable consequences, we don't yet see evidence that it might cause the destabilisation of the stock market and threaten the long term benefits of asset allocation.

### Good earnings have lowered valuations

**S&P 500 Forward P/E**

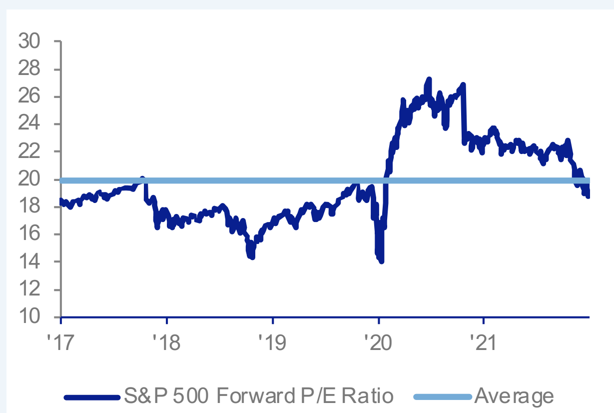



Chart Source: Refinitiv Datastream

Fixed income spotlight

# A flattening yield curve

Like equity markets, fixed income markets have seen negative returns and experienced significant volatility so far this year.

Until a few weeks ago it had been a story of markets interpreting rising inflation, and increasingly hawkish central bank comments, such that there could be as many as 8 rate rises in 2022 in the US. There are also expectations that global central banks will start to reduce their bloated balance sheets this year.

In reality, markets likely went too far. Yes, several rate rises are still likely, but given inflation is mostly a supply side issue, 7-8 hikes would likely have been a policy error that slowed the economy without having much effect on rising prices. What is more, although oil prices continue to spike, base effects mean that it is very difficult for inflation to remain as high as it has beyond the next few months.

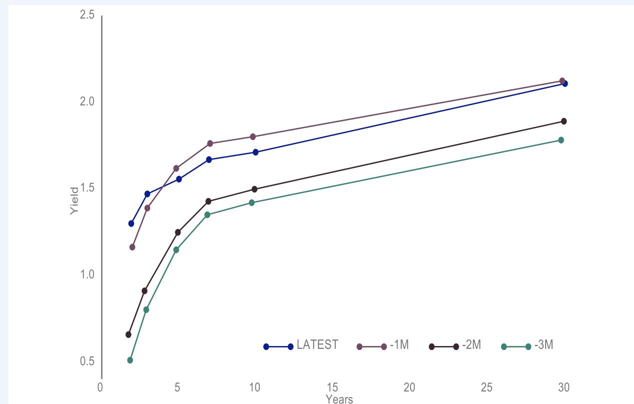
10 year yields had already fallen slightly from their highs before the Russian invasion of Ukraine. Since they have fallen just under 30 bps as investors have sought safe haven assets. However the invasion has only made the outlook more uncertain. It is likely to further stoke inflation as oil and energy prices have shot up. Meanwhile sanctions targeted at Russia are likely to exert at least a small amount of downward pressure on GDP in the west. Slowing growth and rising inflation appear to have put central banks in a bind.

The result so far is that the US yield curve has flattened significantly. As mentioned 10Y yields have fallen 30bps, meanwhile shorter end yields have risen.

It can be hard to say what markets are expecting based solely on the yield curve, as there are many factors at play. However the flattening it does suggest that hikes could come more quickly to begin with, but that there may be fewer overall as a slowing economy reduces the need (or ability) to raise rates in the future.

## The US yield curve has flattened significantly

### US yield curve over the last three months

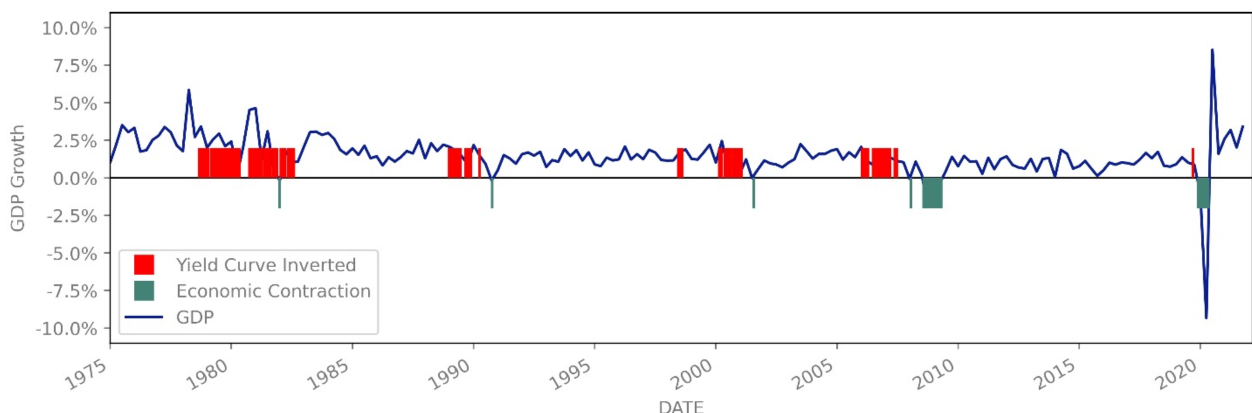



Source: Refinitiv Datastream

If the yield curve did invert it could be a signal for a coming recession. The chart below shows in red the periods where the US yield curve has been inverted since 1975, and it has been a good predictor of recessions highlighted in green.

There are arguments that central bank interference in bond markets has removed the predictive nature of the yield curve, although there is a functional effect in that it makes it harder for banks to profit from lending.

Given the invasion of Ukraine could upend the global order since the end of WWII, we would caution against reading too much into the shape of the yield curve.



# The function of gold

## Although gold surged during the pandemic, it has remained relatively stable since mid-2020. Since the start of the year, gold has outperformed stocks and bonds for a relatively low level of volatility.

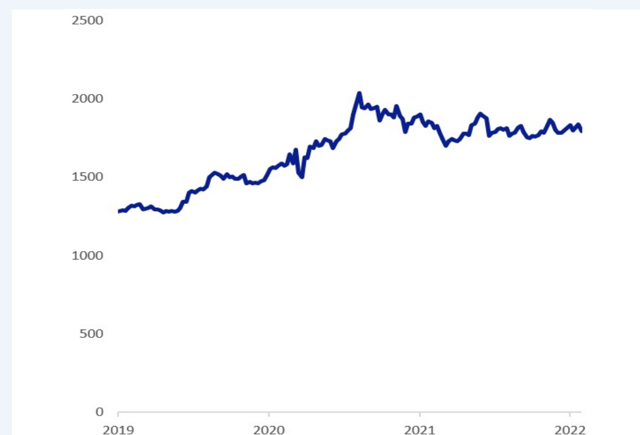
Gold saw large returns over the first half of 2020, rising to over 30% above its pre-pandemic level at one point during the year in GBP terms. During the pandemic, investors saw gold as a safe haven for their money in a year of much financial turmoil and looming inflation. Since then however, gold has slipped from its pandemic-era peak, settling at levels around 1800 U.S. dollars

We have written previously that we do not believe that **gold is not necessarily a good hedge against inflation:** it can be a good trade if one is able to anticipate inflation before it happens, but may not be as profitable if one buys and holds after the fact. Instead, investors should consider gold as a part of a wider long-term portfolio, to take advantage of all the reasons one would buy it and to protect some of their assets against unexpected changes in the inflation expectations of others.

Within this context, we believe that gold plays an important role in our portfolios and accordingly, we remain overweight. Following the surge in the price of gold at the height of the COVID-19 pandemic, gold has traded within a relatively narrower range around $1,800. Since the start of the year, gold has fallen by 1%, avoiding the sharp downturns seen in global stocks and global bonds, which fell by 4.4% and 2% respectively. Thus, gold has outperformed stocks and bonds for a lower volatility. Perhaps just as importantly, gold acts as an essential source of diversification, being an asset class which currently has a low correlation with stocks and bonds.

### Gold has been relatively stable since the height of the pandemic

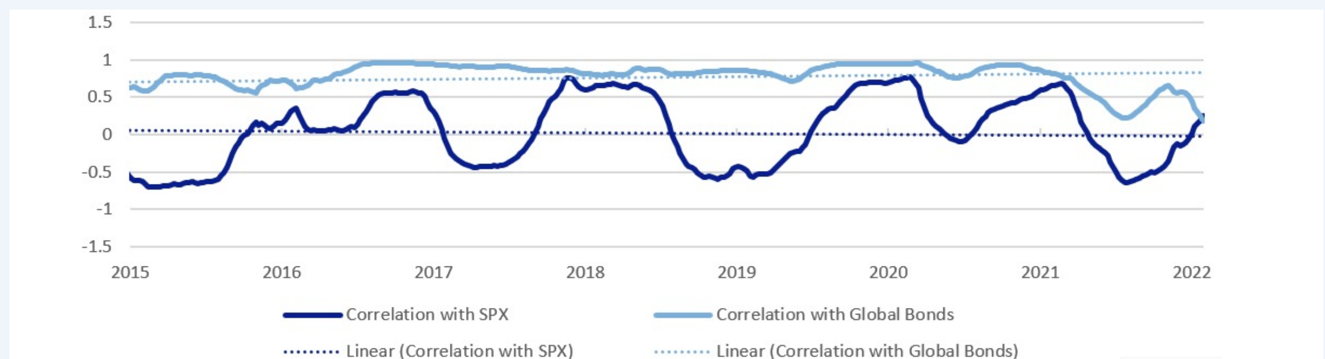
**Gold price in USD**




Source: Refinitiv Datastream

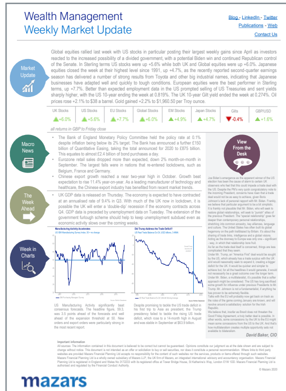
### Gold currently has a low correlation with global stocks and bonds

**Correlation between gold and global stocks and bonds over time**




Charts Source: Mazars Calculations

# More reading...



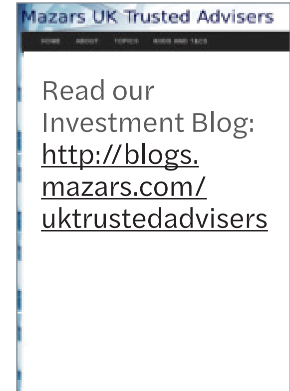



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Chart Sources: Bloomberg. The information contained in this document is believed to be correct but cannot be guaranteed. Opinions constitute our judgment as at the date shown and are subject to change without notice. This document is not intended as an offer or solicitation to buy or sell securities, nor does it constitute a personal recommendation. Where links to third party websites are provided Mazars Financial Planning Ltd accepts no responsibility for the content of such websites nor the services, products or items offered through such websites.

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