Monthly market blueprint

Investment management service

April 2022

Contents

Foreword
Remaining invested, even in the face of a recession

It takes a confluence rather than individual risks to cause catastrophe, as any veteran of the Global Financial Crisis will attest. We believe that there's a mounting probability that we are seeing such a confluence of risks now, one that could significantly hurt growth:

- **A weak economic backdrop**: Economies had barely recovered from the pandemic before the Ukraine war caused prices to spike.
- **Broad-based high inflation**: Inflation in raw materials is much broader.
- **Policy mistakes** from central banks who might suffocate growth instead of combatting inflation
- **Policy mistakes from Government Treasuries** who may opt for reducing debt instead of fostering growth.
- **A possible 'stealth' Chinese slowdown**. China spent the last year trying to burst a Real Estate Bubble, both commercial and residential. The US (1996-2006), Spain (1985-2008), Japan (1985-1991) all experienced deep recessions immediately following the bursting of real estate bubbles. To the real estate pressures one must add higher energy costs, a clampdown on tech and other sectors, high municipal debt, wild demand fluctuations and a fresh Covid outbreak.

In this environment, we have to boldly state that we are not sure what the Fed means by suggesting it can "engineer a soft landing". Even without the confluence of so many anti-growth factors, western economies are driven primarily by consumption, which means they are influenced by sentiment, and sentiment has been hurt by the pandemic, a decade of secular stagnation and rising supply-inflation.

Instead of keeping hopes up for just slower growth, the world should prepare for the possibility of a bona fide global economic recession. This could be slowed possibly by bank de-regulation or a swift Chinese economic rebound, however we have seen evidence of neither yet.

What does this mean for asset allocators?

First of all, we are raising the possibility of a significant slowdown in global growth, not the certainly. We think the scenario is gaining momentum, but a lot of the above conditions would have to play out at their current trajectory and at the same time for the scenario to materialise. Policy changes could alter the result.

A global recession is a systemic event, which is bound to affect all assets. Maintaining cash is not a good choice in a high-inflationary environment. Stocks will suffer from slow growth, bonds from inflation and commodities from high volatility and speculation. As in 2008, this is probably a tunnel which all portfolios will have to go through.

The point of asset allocation is the belief that on any given major event, there's high uncertainty. So we can't accurately predict what will outperform and what will not. Equities tend to do better, since they offer the possibility of high return, as opposed to the assured loss in real terms of bonds and the wild speculation of commodities. In our latest investment committee we maintained our headline equity exposure, instead shifting internally towards dollar assets and divided paying companies.

But what matters is to remain invested. But by and large, those who remain invested with a diversified portfolio far much better than those who don't, or those who attempt to time the market (despite all evidence suggesting that this is virtually impossible).

At its core, asset allocation is the belief that, in the face of all difficulties, capitalism adapts in a way to deliver returns. The point is not lost to those who clearly see the possibility of an economic recession, but equities and equity allocations still at very high levels.

George Lagarias
Chief Economist, UK

Market performance

The month in review

March saw a rebound from the equity volatility endured during February. Bonds resumed their downward descent. Oil was strong on the back of supply concerns.

The war in Ukraine had caused a sell off in markets at the end of February. March saw some of those losses clawed back as global equities rose +2.7% and investors added risk back into portfolios. Bonds sold off as their safe-haven status was less valued and central bank rate rises returned to the front of investors' list of worries.

Japan was the strongest of the developed market equity indices in February, rising +4.3%. In part this was driven by the yen which weakened against the USD and benefitted the export-driven economy.

The US market was up +3.7% as equities rebounded following the selloff of February. Utilities and energy were strong, owing to elevated commodity prices, while the tech sector also regained some composure.

The UK market was up +1.4%, boosted by a buoyant healthcare sector, with energy & utilities stocks continuing to benefit from strong oil & gas prices.

In Europe the gain was more modest, with equities rising +0.8% as concerns about lack of energy independence and the Russia-Ukraine conflict bled into poor consumer confidence figures.

Emerging markets fell -2.3% in March, weighed down by China's Zero-Covid policy which saw more cities being closed off and caused concern about supply chain disruption.

The US 10-year treasury sold off most heavily, with yields rising by +0.51% to 2.34%. The UK 10-year gilt ended the month at 1.61%, +0.2% higher than it started the month.

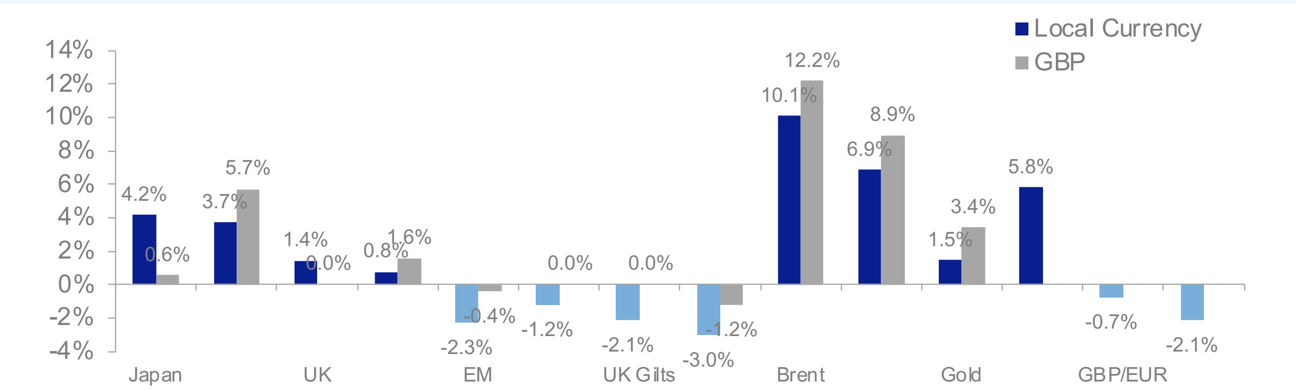
Benchmark yield curves have been flattening globally, reflecting the market's scepticism about the economy's ability to withstand higher interest rates. The US 10-year treasury yield fell below that of the 2-year bond at the end of March, i.e. an inverted curve, which has been a reliable predicter of a recession in the past.

Commodities remained strong in March. Brent was +10.1% higher over the month. Gold ended the month marginally higher, +1.5% above its initial level.

This masks the yellow metal's volatility in March as it had been up as much as +8.5% at one point.

All returns are in local currency and GBP inventors holding foreign assets benefitted from a weakening of the pound by -2.1% against the USD and -0.7% against the Euro.

Basic asset classes



Charts Source: Mazars Calculations

Asset allocation
Changes in our Strategic Asset Allocation

Asset Class	Stance	Comment
Equities	Neutral	We believe equity volatility will continue throughout the year. However, we also see the post-Covid recovery continuing and therefore keep equity weight at neutral to participate in economic growth. Within our equity allocation we include positions in value equities and dividend paying stocks in order to tilt the portfolio away from the sectors more sensitive to economic growth and rising interest rates.
Fixed Income	Underweight	We believe that the bond re-rating has further to go. Interest rates will continue to rise and inflation may persist for at least the rest of the year. Fixed income has limited scope to provide its hedging benefits to equities within a portfolio. We are particularly underweight investment grade corporate bonds which offer little protection against rising rates and inflation.
Alternatives	Overweight	Given that we are in a central bank tightening cycle and equity market valuations remain elevated we see an overweight to alternatives as a suitable hedge within portfolios. We express this through overweight positions in gold, infrastructure and asset backed securities.

Outlook and portfolios

In April our Investment Committee voted to keep our overall asset allocation unchanged yet we increased the defensive nature of our equity exposure. We maintain a neutral position in equities, an underweight position in fixed income and an overweight position in alternatives.

Much of the discussion in the Investment Committee was focused around the ever-growing inflation numbers, the commitment of central banks to hike rates, elevated commodity prices and the pressure on consumers. While current forecasts still predict healthy economic growth this year, the ability of central bankers to raise rates without eventually bringing about recession is yet to be seen. Therefore, we see room for the narrative around economic growth to worsen.

Given the point in the cycle, we think that the equity market will experience a flight to quality, as some of the more speculative areas of the market are sold down and replaced with companies with resilient earnings that trade at a reasonable price. Within fixed income we favour reduced duration, given that interest rates rising cycle has only just begun in the US and the UK. Our committee also noted that given geopolitical tension and a more febrile global economy there is scope for the USD to strengthen relative to other developed market currencies.

At this meeting, within the equity portion of the portfolio we reduced our European exposure and added to our US value fund, Dodge & Cox US Stock. We also reduced our broad GBP-hedged equity exposure in favour of an unhedged global equity income fund, Fidelity Global Dividend. We made no changes to our alternatives or fixed income portions, given that we had positioned those more conservatively over the previous two quarters.

Risks

Growth under fire

2022 is another year of great uncertainty and a wide variety of outcomes, the third in a row. Volatility in the beginning of the year is at very high levels.

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 the war, are now facing another unprecedented shock. Global inflation is rising fast and growth will, in all likelihood, be affected. So will corporate earnings. 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.

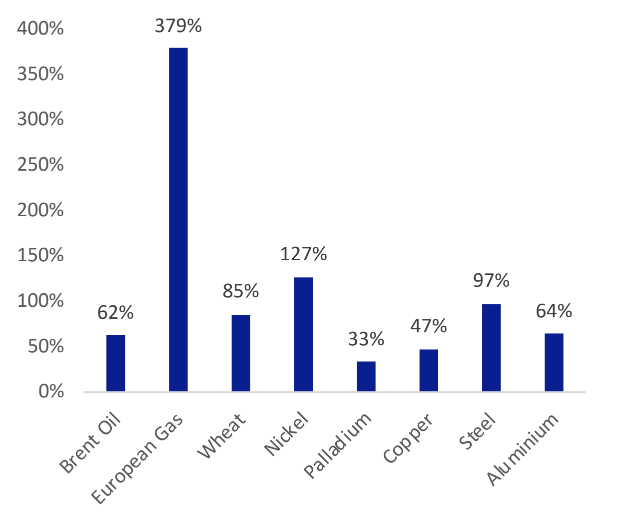
Upside risks, however, also exist and are not priced in. The pandemic could end quicker than expected or Russia could retreat from Ukraine. Having said that, at the time of writing, we see an increased probability of a protracted war and long term sanctions.

The Fed's focus on inflation means that all the above risks could have a bigger impact on risk markets than previous years. We now begin to doubt even the core risk investing in the past 22 years, the Fed Put. Simply put, the central bank safety net for markets is not that certain any more. Priced in, this could significantly elevate risks.

We expect macroeconomic and market volatility to last well into 2022.

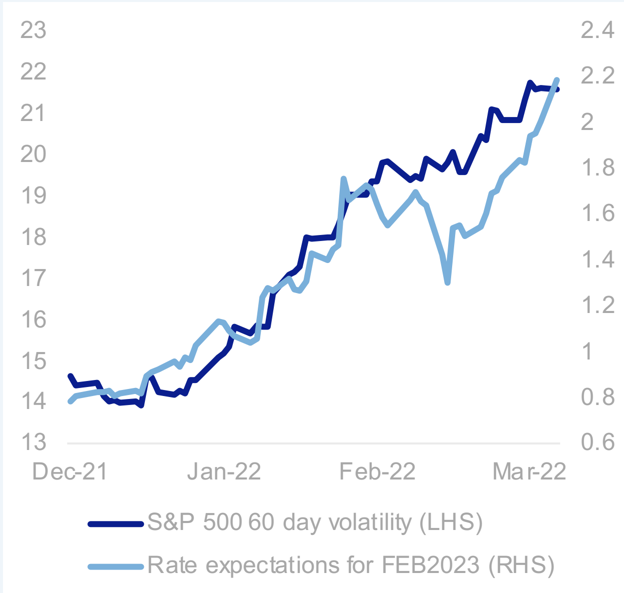
Prices for key commodities are soaring

Price at 7 April 2022 versus 5 year average, %



Volatility is rising as Fed becomes more hawkish

Rate expectations, S&P 500 60 day volatility



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, threatening the post-pandemic economic. Higher input prices are already ripping through fragile supply chains and will put further pressure on consumers.

For the period, global stocks rose by 2.7% (4.7% in GBP). The highest performing sectors were Energy and Materials while the worst performers were Cons. Staples and Financials. Equities were trading at 17.91x times forward earnings, 5.6% above long-term average. Gold rose 1.5% and oil prices rose 4.8%.

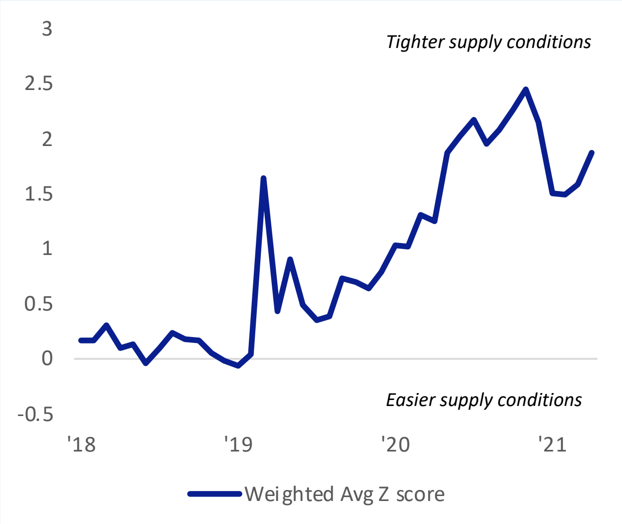
Nominally, the global economy continues to expand well above its pre-pandemic rate, albeit in an unbalanced and possibly unsustainable manner. In the runup to the Ukraine wars, supply-side inflation pressures were abating and mutating into demand-side, as persistently higher prices have fed into wage 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 have opted to hike interest rates and risk the economic recovery. Meanwhile, lack of availability for key commodities threatens to completely destabilise 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 adapt to a new geopolitical order, i.e. Russia not directly cooperating with the West. Given the small time scale, 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, this is no longer the case. This means that governments, already limited by the high debt they incurred to fight Covid, also have a limited fiscal arsenal. In this environment, we believe that recessionary risks are rising. High inflation means that equities are still the preferred asset class, but only in comparison terms.

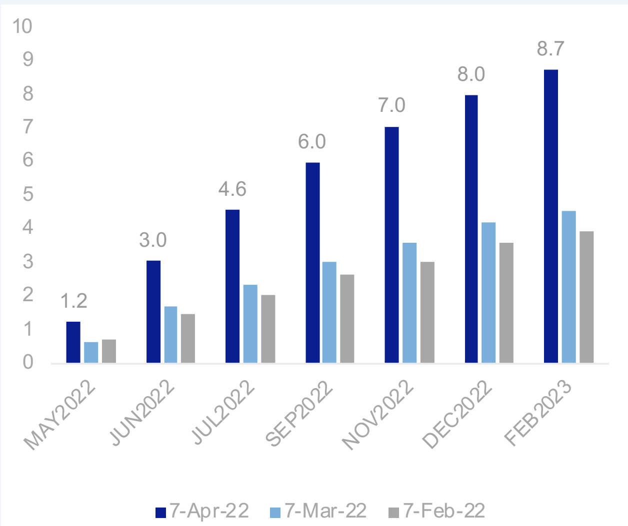
Supply chain pressures are re-intensifying

Z-score of eight key supply indicators



And central banks constrict growth

Fed rate hikes expected



Charts Source: Mazars Calculations

The recovery in UK equities in March was more muted than for global and US equities, having fallen less in February. Large cap equities have been resilient, but the economic picture is not so rosy.

The UK equity market has been resilient in 2022 because of its large weighting to the energy and basic materials sectors. The overall market trades on a less demanding valuation relative to both global equities and its own historic average. It is worth remembering that the UK economy and its large cap equity index are not the same thing and the UK economy is facing high inflation and a tightening central bank, which are both squeezing the consumer.

At present, the Bank of England's Monetary Policy Committee is expected to raise interest rates to 2% over the next 2 years as they aim to cool inflationary pressures. This may lead to hiring managers holding off on adding to their workforces but it can't do much about input costs. Meanwhile, it will also push up the cost of consumer borrowing.

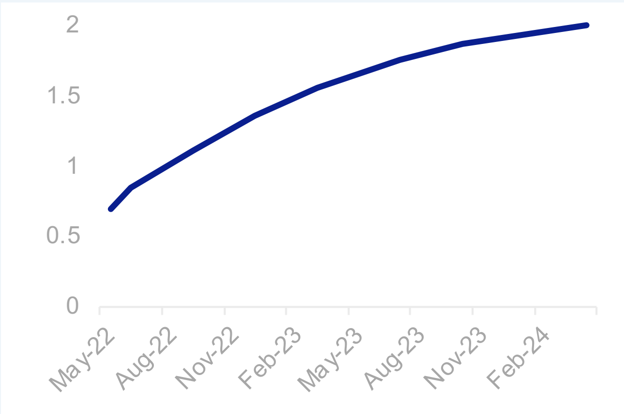
Input costs in the UK have risen sharply on the back of supply concerns resulting from the war in Ukraine and sanctions placed on Russia. April saw domestic gas prices rise by more than 50% while crude oil prices have risen by more than 36% year to date. The latest figure for CPI shows UK inflation running at 6.2% and it is expected to go higher when data for March and eventually April comes in. The so-called "cost push" inflation we are seeing does not benefit the UK economy and just leads to reduced consumption while purchasing power is lost to higher inputs costs.

Followers of the UK's large cap equity index could be forgiven for thinking that the UK economy was somehow resilient to the economic hardship being faced, in spite of the cost of living crisis. However, the UK small cap index is a better gauge of the domestic economy, and that picture is not so rosy.

Outlook: Large cap equities may continue to benefit from strong commodity prices. Small and mid cap companies will remain volatile as the UK consumer is under pressure.

The market's expectations for GBP interest rates

Percent



The return of UK smaller companies gives a better picture of the domestic economy

6-month performance of UK large cap and UK small cap companies

Charts Source: Refinitiv Datastream

Macroeconomic backdrop

US

In March, US stocks rose by 3.7% (5.7% in GBP). The highest performing sectors were Utilities and Energy while the worst performers were Financials and Telecoms. Equities were trading at 20.06x times forward earnings, 11.3% above long term average and 12% above the MSCI World. 10y bonds rose 51 bps at 2.338%.

March saw the start of the US Fed's tightening cycle, initiated by a 0.25% increase to the Federal Funds target rate. Despite the increased geopolitical risks brought about by the war in Ukraine, officials indicated that taming inflation would be a priority for the central bank, even if at a cost of slower growth.

This has spurred fresh speculations that the Fed's actions could end up being a policy mistake. In our current environment, it is unclear if higher interest rates will be enough to offset the effects of rising oil and wheat prices, which will inevitably push inflation higher from the bottom up.

Many economic indices are also pointing towards a slower rate of growth. Consumer confidence in particular, has plummeted recently, and accordingly we have seen drops in levels of durable goods orders, retail sales and consumer credit. Consumer spending alone accounts for around 70% of US GDP.

Manufacturing growth was relatively steady in March but the closure of factories in China could apply significant pressure on the sector going forward. Activity in service sectors was more positive, as PMI data pointed to robust growth.

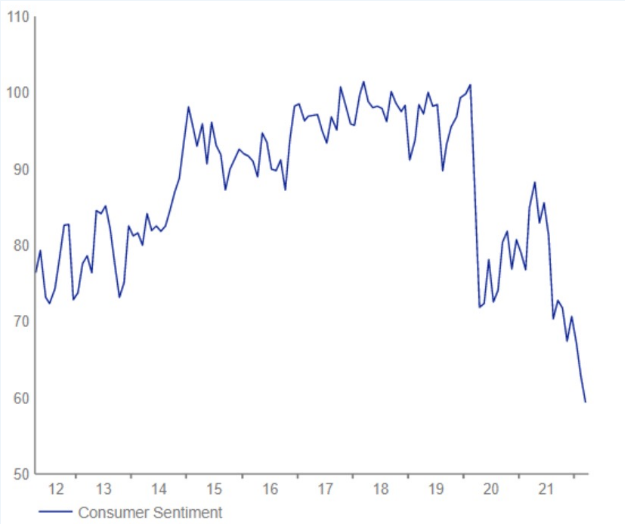
Employment was perhaps the most positive part of the economic picture, as a stronger than expected 431,000 rise in non-farm payrolls points to a healthy job market. Moreover, we saw labour force participations extend an upward trend seen in recent months, driven by a return of many younger people to the workforce.

Outlook: Given weakening economic data and a hawkish Fed we expect that US growth will be considerably slower.

However, we do not believe that this justifies a move away from US risk assets, as many other economies face similar challenges from hawkish central banks and slowing growth. We also believe the dollar stands to benefit from higher interest rates.

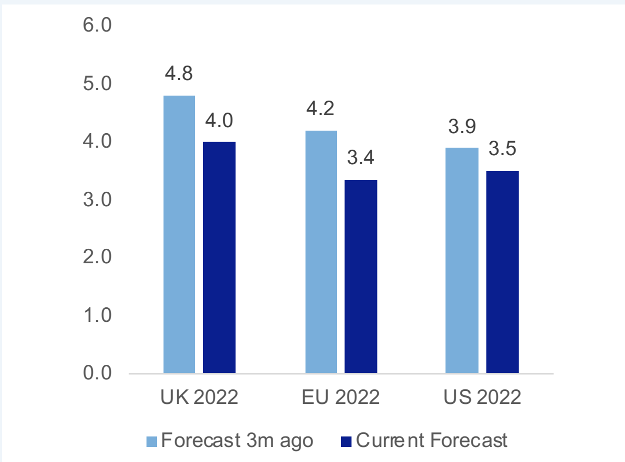
Consumer sentiment has plummeted in recent months

University of Michigan Consumer Sentiment Survey



Economists are revising growth estimates downward

Market Implied and Fed assumed rate expectations



Charts Source: Mazars Calculations

Macroeconomic backdrop

Europe

In March, European stocks rose by 1.6%. The highest performing sectors were Materials and Healthcare, while the worst performers were Automobiles and Retail. Equities were trading at 14.50x times forward earnings, 7% below the long term average, and 19% below the MSCI World. 10y Bunds rose 41.3 bps, yielding at 0.548% at the end of March.

It has been over a month since the war in Ukraine started, and whilst European equity markets have been marginally positive in March, there is little evidence to suggest that this conflict will end any time soon. This war was inevitably going to put additional strain on European economies, which had only just begun to recover following the pandemic.

In March, data began to surface indicating that the pressures being faced by European economies were already being exacerbated by the war. Business confidence in Germany plummeted, whilst Eurozone flash PMI data revealed that the war has encouraged further supply chain deterioration and fuelled increases in the cost of goods. This will inevitably lead to higher inflation for European consumers.

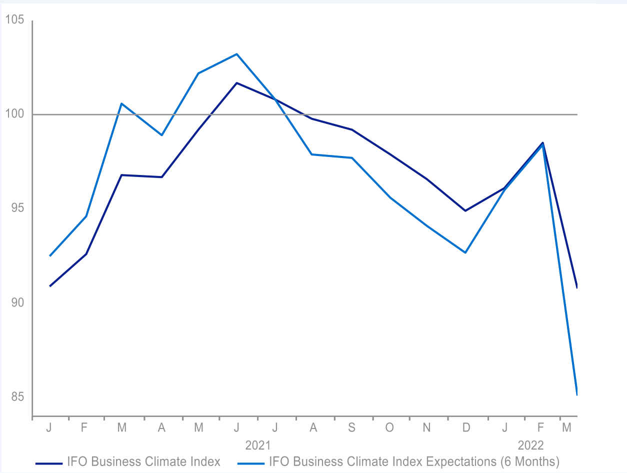
The number of downside risks to European growth is steadily rising day by day, and the recent adoption of a more hawkish rhetoric by the ECB in recent weeks may only spell further trouble: any policy mistakes are sure to be amplified in the current economic environment.

As investors, we must consider whether markets have priced in this unpleasant news. Indeed, European markets are trading below both their long-term average and the MSCI World Index. However, the recent risk-on rally in markets is not backed by fundamentals. Markets have been conditioned over the last decade to 'buy the dip' in an environment where quantitative easing has consistently reassured markets. Nevertheless, these accommodative conditions are being withdrawn, and the ECB is far less likely to revert back to ultra-loose monetary policy as the prospect of double-digit inflation looms closer than it has in the last 40 years.

Outlook: Fundamentals are expected to further deteriorate across Europe as policymakers attempt to facilitate growth in a challenging economic environment. This is likely to be accompanied by substantial market volatility.

Business confidence plummets on Russian invasion

Germany IFO Business Climate Index and Expectations, 2015 = 100



Inflation in Eurozone surges past analyst expectations

Eurozone HICP & Core* HICP, twelve-month change, %

Charts Source: Refinitiv Datastream

Japan and emerging markets

For the period , EM stocks fell by -0.4% and -2.3% is Sterling and local terms respectively. Japanese equities returned +0.7% and +4.3% in Sterling and local terms respectively. In EM, the highest performing sectors were Energy and IT while the worst performers were Consumer Staples and Healthcare.

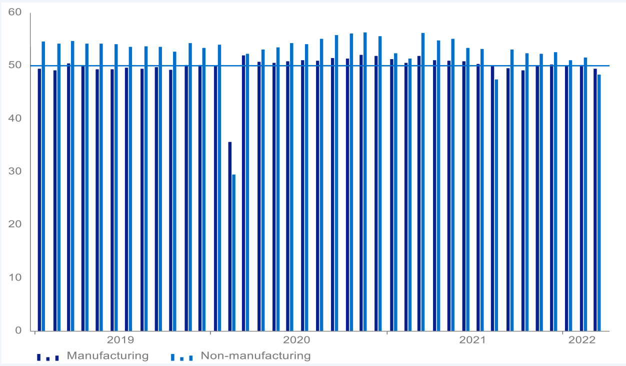
While developed market central banks push for tighter monetary policy, China is moving in the opposite direction. Slower GDP growth in the last quarter of 2021 confirmed the economic deceleration brought by the troubled property sector. As a result, the PBOC cut a number of policy rates to stabilize economic momentum. China's annual inflation rate stood at 0.9%, unchanged from the previous month and in line with market forecasts. Still, the reading was the lowest level since last September, as the cost of food dropped the most in five months. Producer price inflation 8.8% yoy in Feb 2022 from 9.1% previously. This was the lowest reading since last June, reflecting the further effect of the government's measures to secure supply and control surging commodity prices. The official NBS Manufacturing PMI fell to 49.5 in March from 50.2 in February. This was the first contraction in factory activity since last October, reflecting the impact of widespread Covid-19 outbreaks in key cities, including Shanghai and Shenzen

The Bank of Japan left its key short-term interest rate unchanged at -0.1%, as widely expected. Japan's economy has picked up despite some weakness due to Covid-19 and supply-side issues; fresh risks from the Ukraine crisis are destabilising financial markets and sharply pushing up raw material costs. The monetary policy board reiterated it will not hesitate to take extra easing measures if necessary while expecting short-and long-term rates to stay at their present or lower levels.

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

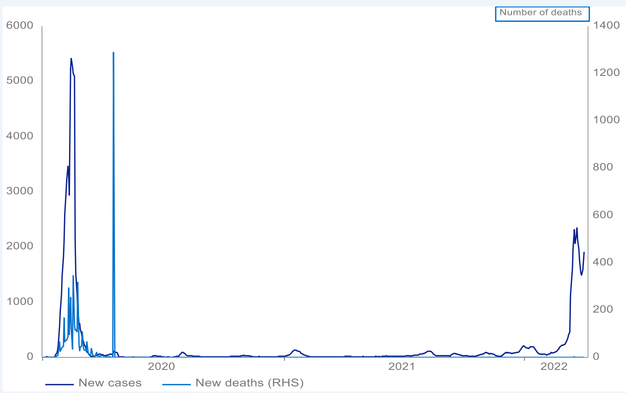
China PMIs, 50 = no change



The official NBS Manufacturing PMI for China fell to 49.5 in March. This was the first contraction in factory activity since last October, reflecting the impact of widespread Covid-19 outbreaks.

New Covid-19 cases have surged in China over recent weeks

China new daily Covid-19 cases and deaths



The rise fresh Covid-19 cases will weigh further on consumer spending and exacerbate the difficulties the government faces in hitting its ambitious 'around 5.5%' growth target for 2022. Factory closures could also add to global inflation problems

Charts Source: Refinitiv Datastream

Our themes

Macro theme 1
A global recession?

Central banks are playing off their standard playbook. As long as unemployment and growth are unaffected, they can afford to raise rates. However, eventually, growth and unemployment will be affected, in which case they know not to raise the cost of money anymore. What's more, they can afford to do that, because of their much-vaunted independence.

Enter 2022 and the fastest inflation in fifty years. Central banks are hiking, but this time commercial banks don't have the tools or the will to mitigate the damage. Remember just two years ago, at the height of the pandemic, how banks were reluctant to lend out money to businesses, even when 95% of the loans were covered by the state? It is safe to say that the transmission mechanism is problematic, at best.

Central bankers and governments are on their own. And the probability of recession, following rate hikes is rising fast.

How do we know this? The US yield curve is inverting, which constitutes a powerful sign of recession. Of course the yield curve is not a magic crystal ball. Higher short term yields and lower long term yields suggest that borrowers attach a stronger probability that:

1. Central banks will hike short rates fast (short term yields rise)
2. Inflation at very high levels is not expected to persist (long term yields rising less quickly)

Yields are the consequence. Central bank policy and policy communication is the cause. What investors have to be prepared for, though, is much more significant.

There's a good probability that central banks will fail to keep prices stable, and cause stagnation or recession at the same time.

A global recession is a systemic event, which is bound to affect all assets. Maintaining cash is not a good choice in a high-inflationary environment. Stocks will suffer from slow growth, bonds from inflation and commodities from high volatility and speculation. As in 2008, this is probably a tunnel which all portfolios will have to go through.

Yield curve inversion points to a recession

US 2-10 yield curve

Currently, what supports asset prices, the S&P 500 at 4500 points and the FTSE 100 at 7550 is the abundance of residual liquidity after a decade of unfettered money printing and no real alternative to equities.

The point of asset allocation is the belief that on any given major event, there's high uncertainty. So we can't accurately predict what will outperform and what will not.

At its core, asset allocation is the belief that, in the face of all difficulties, capitalism adapts in a way to deliver returns. The point is not lost to those who clearly see the possibility of an economic recession, but the S&P 500 just 300 points shy of its all-time high.

Macro theme 2

Risk assets and geopolitical risks, central bank reactions

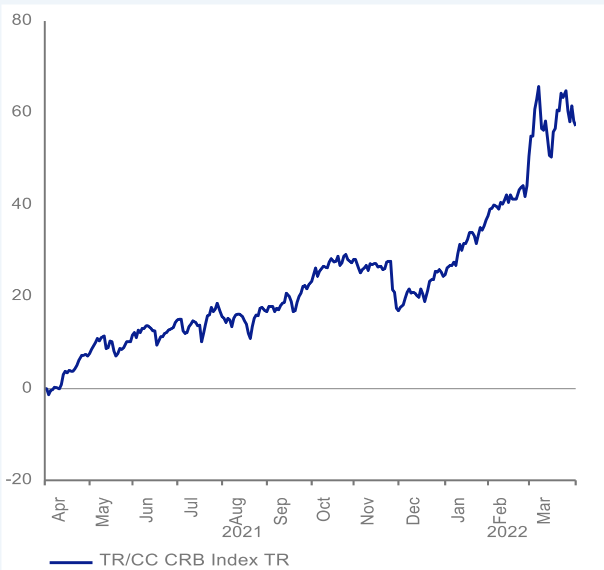
The invasion of Ukraine has given policymakers a reason to reassess their current stances on both inflation and global growth. Sanctions imposed on the Russian economy by Western nations have severely crippled the country and forced the Bank of Russia into desperation: raising interest rates to 20% and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

However, the West are also having to manage their economic situation carefully. Russia and Ukraine both have important roles the global economy as a noteworthy exporters of important commodities, including oil, natural gas and wheat. This has had a detrimental impact on global supply and severely impacted commodity prices, which, in turn, is forcing input costs higher in developed nations that are so dependent on these natural resources. Business confidence has also been knocked in many Western economies, and there is little evidence to suggest that this conflict will end any time soon.

This dilemma poses a challenge to a Federal Reserve that is already facing down the barrel of record levels of inflation. Nevertheless, the mandate of the Fed is to support economic growth and stability, which it may struggle to do if it continues to follow the hawkish path that it has laid out for itself over the coming months.

Key commodity prices have spiked

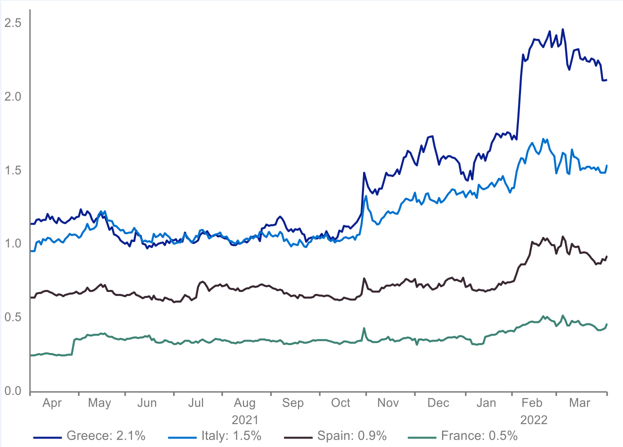
Commodity CRB Index, % Change



Charts Source: Refinitiv Datastream

The ECB needs to protect the periphery

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



Charts Source: Refinitiv Datastream

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, creates the perfect storm for a bout of cost-push inflation.

Whilst the sole mandate of the ECB is to manage inflation within the Euro area may appear convenient, 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 raises the risk of a critical policy error.

Ultimately, we are yet to see the full impact of the invasion of Ukraine on risk assets, although recent data from Europe indicates that growth is already being hampered by the influence of war. However, this war has significantly 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.

Macro theme 3

Is China facing an economic slowdown?

China was the first country to successfully emerge from the initial Covid-19 wave. People were back to the office in 2020 itself, infection rates plummeted and as a result economic growth was stellar, beating all expectations. China emerged as the winner at a time when most western countries were still coming to terms with the Pandemic and its repercussions. The last 12 months however, have been a absolute reversal.

A real estate ‘bubble’ is showing concerning signs of bursting. 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.

To make matters worse, the Chinese regulator launched a multi-pronged crackdown on its tech, gaming, gig economy, education and cloud computing companies, leaving start-ups and decades-old firms alike operating in a new, uncertain environment. New regulations tackled issues such as high borrowing levels, data privacy and ring fencing businesses to combat anti-competitive behaviour by large umbrella corporations.

China real estate woes weaken property investments

China investment in real estate development

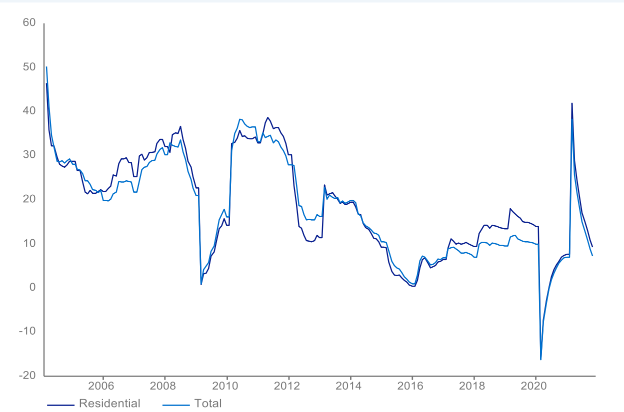


Chart Source: Refinitiv Datastream

China signals easing due to property sector downturn

China reserve requirement ratios, %

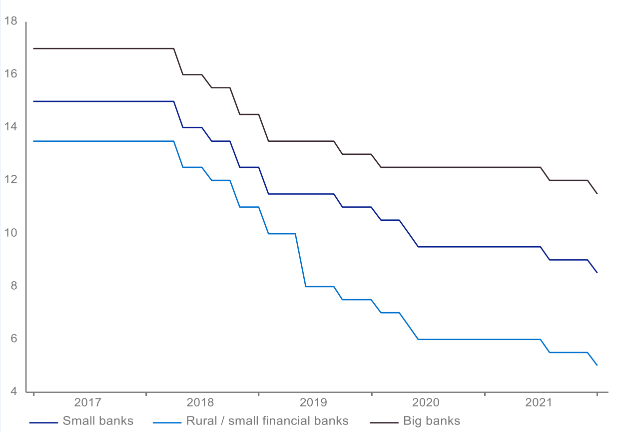


Chart Source: Refinitiv Datastream

On the macro side of things, China’s manufacturing and trade heavy sectors have suffered a slowdown amid fallout of Ukraine war and new Covid-19 outbreaks and lockdowns. Factory activity slumped at fastest pace in two years.

There is no denying that a slowdown in China is likely to have knock-on effects across the region, much of which counts the world’s second-largest economy as the biggest source of trade. However, a few points worth mentioning:

- Macro metrics such as retail sales, industrial production and fixed asset investment are slowing down – but this is after a period of exceptional growth, which was never going to be sustainable.
- Most indicators are looming around their pre-Covid levels – signalling strong growth followed by normalisation.
- Biggest risk to equities (over the last 6 months) has been regulation of sectors like education, banking, technology, data etc. However – this is bound to reduce investor concerns over the long term.
- China’s central bank remains uber accommodative – while the west raises interest rates and tightens policy overall, China is focussed on solving its economic issues.

China has faced a slew of challenges to growth in 2021, including a power shortage, shipping delay, Covid-19 outbreaks and a crisis in the real estate sector. The central bank’s rate cuts sends a signal that policy will turn accommodative if need be.

Equity spotlight
Equity Income and Share Buybacks

As with all aspects of investment, income investing is not straightforward. There are numerous inputs which determine how attractive dividend paying stocks are. How high is the level of income? Is it sustainable? Is it growing? What does the level of income say about the company and does it signify a lack of investment opportunity?

Over the last decade or so, the latter problem has preoccupied investors. If a company is returning large amounts of cash back to shareholders then there it indicates a lack of growth opportunities compared to a company that is using all its free cash to grow its business through further investment. On top of that, during the pandemic, some companies boards used the opportunity to reduce their dividend payments and shore up their balance sheets. This put additional pressure on dividend stocks while the growthy tech sector enjoyed a fantastic rally.

Now that the pandemic is behind us the market's mindset has shifted. The prospect of rising interest rates and a possible recession ensuing has put pressure on the more growthy areas of the market. Companies that are returning capital to investors through dividends or share buybacks are looked on favourably as they offer more than a company that had fantastic growth prospects and is now having to pare those back. On top of that, dividends are still being restored post Covid which is adding to that appeal.

The takeaway is that the market is looking for stocks that can provide some return over the coming 12 months. As growth looks under pressure, companies that can return capital to shareholders are better able to meet that criteria. Over the longer term it is harder to argue that a company that focusses on returning capital will fare better than a company that has opportunity to invest that money and let it compound within the business. However, there are cycles, and cycles within those cycles, and currently it is recovering, tangible cash returns which investors value at present.

Dividend Payout Ratios have partially recovered in 2022

Dividends paid as a percentage of profits earned

The outperformance of global equity funds over global equity income funds has started to reverse

Total return, per cent

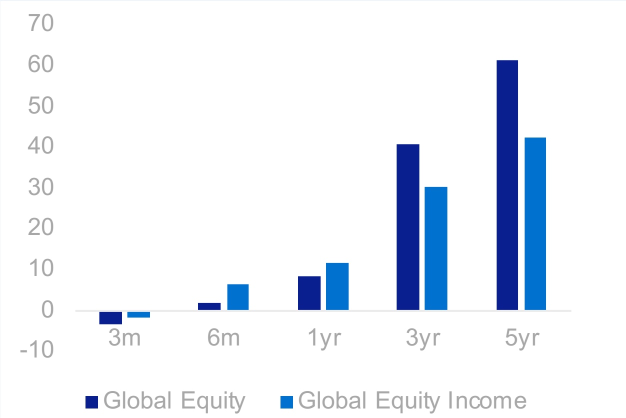


Chart Source: Refinitiv Datastream

Fixed income spotlight
An inverted yield curve

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

Until the end of February 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.

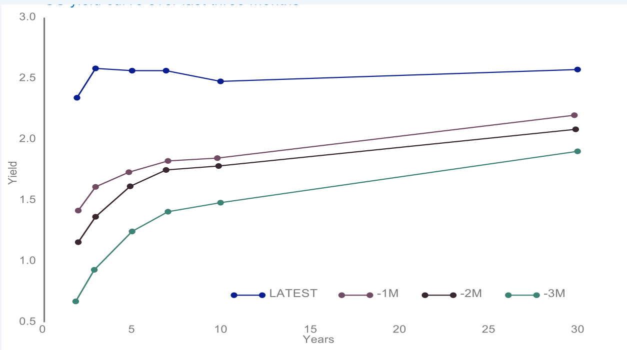
10 year yields initially fell slightly from their highs after the Russian invasion of Ukraine as investors sought safe haven assets. However as time has moved on the inflationary consequences of the invasion have become more and more apparent, as prices of all sorts of commodities have shot up due to increased supply issues. For example Ukraine and Russia supply a significant percentage of the world’s wheat.

The result is that the US yield curve has both moved up and flattened significantly, and in some places inverted, although perhaps importantly not the at the 2-10Y level.

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/inversion does suggest that hikes could come more quickly to begin with, but that there may be fewer overall , or that they could be reversed, as a slowing economy reduces the need (or ability) to maintain higher interest rates.

The US yield curve has inverted at certain points

US yield curve over the last three months

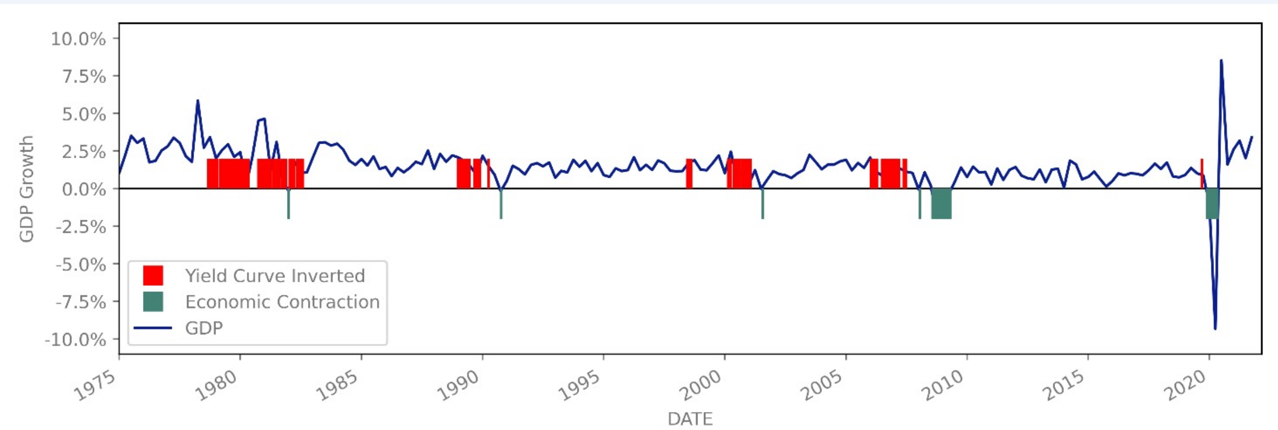


Source: Refinitiv Datastream

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.

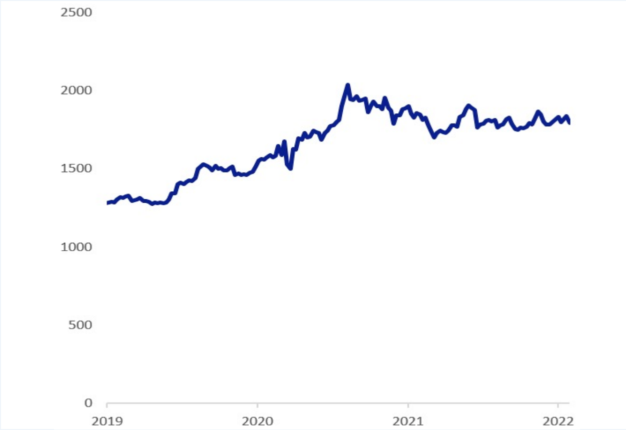
Gold saw large returns over the first half of 2020, rising to over 30% above its pre-pandemic level at one point during the year in GBP terms. During the pandemic, investors saw gold as a safe haven for their money in a year of much financial turmoil and looming inflation. Since then however, gold has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

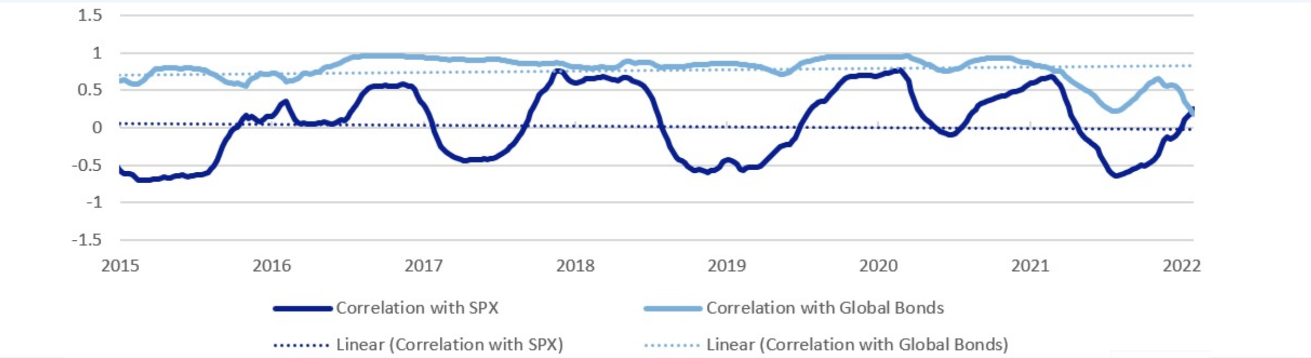
Gold price in USD



Source: Refinitiv Datastream

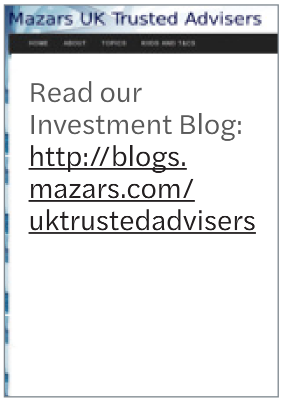
Gold currently has a low correlation with global stocks and bonds

Correlation between gold and global stocks and bonds over time



Charts Source: Mazars Calculations

More reading...



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