Mazars Wealth Management investment newsletter

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Spring 2022

Foreword

The new year brought about a significant change of market sentiment as concerns about inflation and fundamental changes to monetary policy caused a reassessment of asset prices. The war in Ukraine has added to inflationary pressures particularly in commodity markets, as further disruption is expected in supply chains as China announces further lockdowns. Global equities sold off around -4.5%, although a strengthening US Dollar softened this fall for Sterling based investors. Geographically, proximity to the war in Ukraine told, with Europe down -7.4% compared to the US which only lost -2%. UK equities were the only major market in positive territory as previously unloved parts of the market came back into favour, not least the energy sector. The biggest moves though came in the bond markets where gilts fell by more than -7% as expectations of a higher number of interest rate rises grew. In contrast gold appreciated by nearly +10%.

From an economic standpoint, inflation is the single biggest factor exercising market analysts' minds. What started as pressure brought about by Covid induced supply side disruptions and heightened consumer demand for manufactured goods, has now developed into significant commodity driven inflation which has knock on effects for large parts of the economy. The war in Ukraine and associated sanctions on Russia have brought about shortages in a variety of energy, agricultural, and industrial commodities, and these price pressures have removed the possibility of an inflationary episode which is short-lived and quickly resolved by the reopening of economies. To make matters worse, whilst much of the western world is learning to 'live with' Covid, China retains a zero-tolerance policy and use of extensive lockdowns to combat the virus meaning that supply side disruptions persist. The impact of increasing energy prices on the cost of living coupled with tight labour markets brought about by people leaving the workforce means that companies are under pressure to raise wages.

The textbook central bank response to inflation is for monetary policy to tighten, i.e. for interest rates and the cost of borrowing to rise. Theoretically this mechanism dampens demand, slowing the economy, causing inflation to moderate. The challenge to this approach is the disconnect between local policies and inflationary forces in a globalised world. Raising interest rates in the UK will do nothing to the price of imported commodities, nor prevent the Chinese authorities imposing further lockdowns in manufacturing regions. Nonetheless, both the Bank of England and the US Federal Reserve's rate setting bodies have decided to increase the cost of borrowing in an effort to keep inflation under control, and their European counterparts are seemingly moving in the same direction.

The sell-off in global equities reflects these concerns of inflation and the ongoing uncertainty from the war in Ukraine. Markets do though continue to be supported by the volume of liquidity in the financial system, all of which needs to find a home. On the one hand higher inflation may discourage investors from holding cash and losing purchasing power, but on the other we expect liquidity to be withdrawn as quantitative easing begins to be withdrawn.

At our April meeting the Investment Committee voted to maintain our neutral position in equities, but to alter our positions so as to favour more defensive holdings and US Dollar denominated stocks. We maintain our underweight position in bonds and our overweight in gold, both of which have benefitted performance in the past quarter.

I hope you find this newsletter interesting and relevant to you, and I would very much welcome any feedback you may have. Please do feel free to get in touch with your thoughts either by phone on: **020 7063 4259**, or by email on: **david.baker@mazars.co.uk**.

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Economies and markets in brief

Cost of living crisis

It will come as no surprise to anyone that UK inflation climbed to 30-year highs. Consumer prices (CPI) in the UK rose by 6.2% in February, up from 5.5% in January. The recent surge has been driven by soaring global prices for energy, petrol, food and durable goods: The Office for National Statistics said the biggest factors driving the February increase came from transport, furniture and household goods. Prices for clothing rose especially rapidly in February, but food inflation also picked up to an annual rate of 5.1%. UK house prices also increased by 1.4%, reaching a record high in March as a lack of supply and strong demand boosted prices. The Bank of England warned last week that CPI would rise above 8% by June and could reach double digits towards the end of the year if Russia's invasion of Ukraine keeps global energy prices at elevated levels.

UK inflation rising at its fastest rate in 30 years

UK inflation, 12 month percentage changes

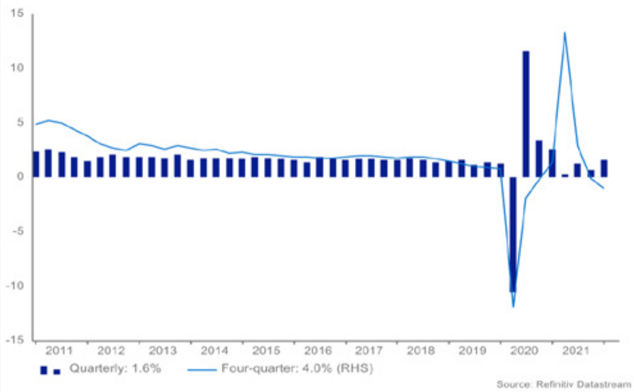
Is China headed for an economic slowdown?

In China 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 $300bn as a result of years of aggressive expansion. The total combined debt of China's major property developers is now estimated at more than $5tn.

China's manufacturing and trade heavy sectors have also suffered a slowdown amid fallout from the Ukraine war, new Covid-19 outbreaks and lockdowns. Factory activity slumped at the fastest pace in two years. There is no denying that a slowdown in China is likely to have knock-on effects across the region.

China GDP growth slows to 4.0% in Q4 amid COVID-19, property woes

GDP, precent change

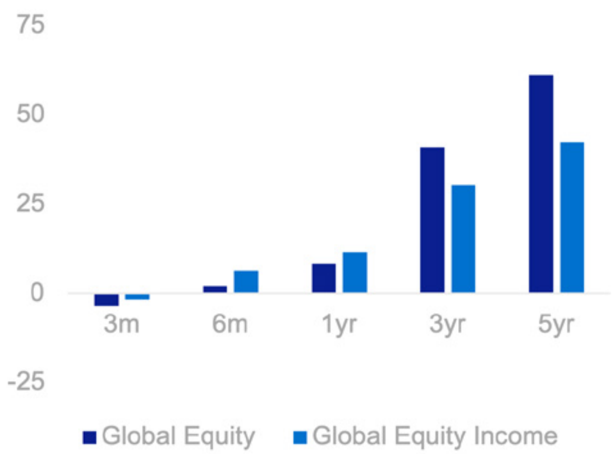


Company cash levels

During the pandemic, some companies' boards used the opportunity to reduce their dividend payments and shore up their balance sheets. This put pressure on dividend stocks while the growthy tech sector enjoyed a strong 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 which are now being pared back. On top of that, dividends are being restored post Covid which is adding to that appeal.

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

Total return, percent

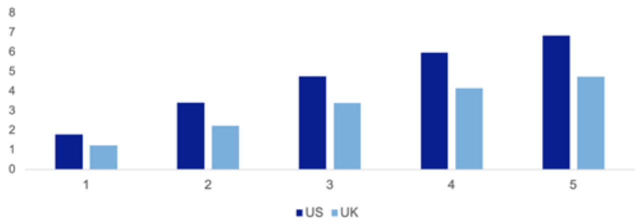


The fading global growth outlook

In the last 20 years, only the Global Financial Crisis and the initial sell-off from Covid saw a worse start to the year for risk assets. Markets were already pricing in the costs of rising inflation and the move by central banks from guarantors of market stability into fighters of inflation. However the war in Ukraine has caused systematic risks and poured fuel onto the inflationary fire. Markets now expect interest rate rises to come faster, which has further negatively affected bond prices and certain equity sectors.

US expected to tighten seven more times, UK five

Implied rate expectations for the next five monetary policy meetings

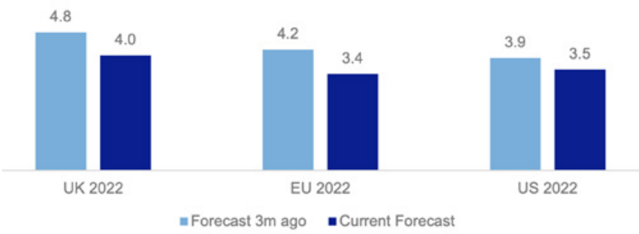


Nominally, the global economy has been expanding well above its pre-pandemic rate, albeit in an unbalanced manner. In fact prior to the Ukraine conflict, supply-side inflation was starting to abate, mutating into demand side inflation, led by wage demands. However the invasion of Ukraine has thrown the post-pandemic economic calculus into disarray. Soaring commodity prices are putting pressures on businesses and the consumer alike. Policy makers are now torn between hiking interest rates at the risk of further destabilising the recovery, or keeping rates low and risk runaway inflation.

Meanwhile the US 2-10 treasury yield curve has now inverted, with yields on 2 year US government bonds higher than those for 10 year government bonds. This rarely happens as you are in effect being paid more to lend for shorter time periods than for longer time periods, which can make bank lending unprofitable. In fact a US 2-10 inversion has been a very strong predictor of recessions in the past.

2022 growth expectations have been downgraded significantly

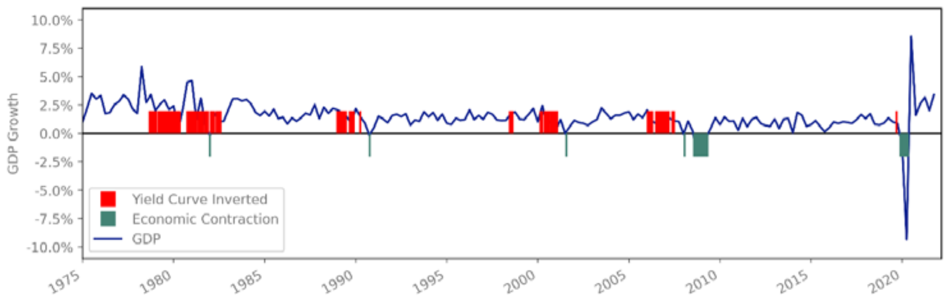
Bloomberg Economist Survey, GDP in percent



The result is that economists have significantly downgraded their estimates for global growth in 2022, with estimates for 2023 also revised down for many regions. The UK is expected to be one of the worst affected, with growth now expected to be 4.0% having been 4.8% prior to the conflict. Unsurprisingly given the proximity to Ukraine and the reliance of countries like Germany on Russian gas, EU growth expectations have also fallen from 4.2% to 3.4%, although the figures for 2023 remain unchanged at 2.5%.

US yield curve inversions have generally preceded recessions

US 2-10 yield curve



Jargon Buster – Inverted yield curve

An inverted yield curve is when the yield on longer-dated bonds is lower than on shorter-dated bonds, running contrary to the accepted wisdom that if money is lent for a longer period, it should earn a higher rate of interest because of a higher risk that the capital may not be returned. It particularly refers to government bonds and is most used when the 10-year treasury bond is yielding less than the 2-year treasury bond. This has been a very reliable forecaster of a recession in the past, particularly in America, and hence when the US yield curve inverts it generates wide coverage in the news. It is hotly debated as to whether an inverted yield curve is just a symptom of worsening economic conditions or is itself a cause of a recession.

Global equity income – In focus

We are making a change

In order to position our portfolios more defensively, we are replacing part of our broad global equity holdings with Fidelity Global Dividend.

Why the change?

As the economic outlook becomes increasingly uncertain and downside risks increase, we believe that it is appropriate to adopt a more defensive position in our portfolios. Global equity income funds target financially robust, quality companies that can afford to pay dividends on a consistent basis and provide strong dividend growth.

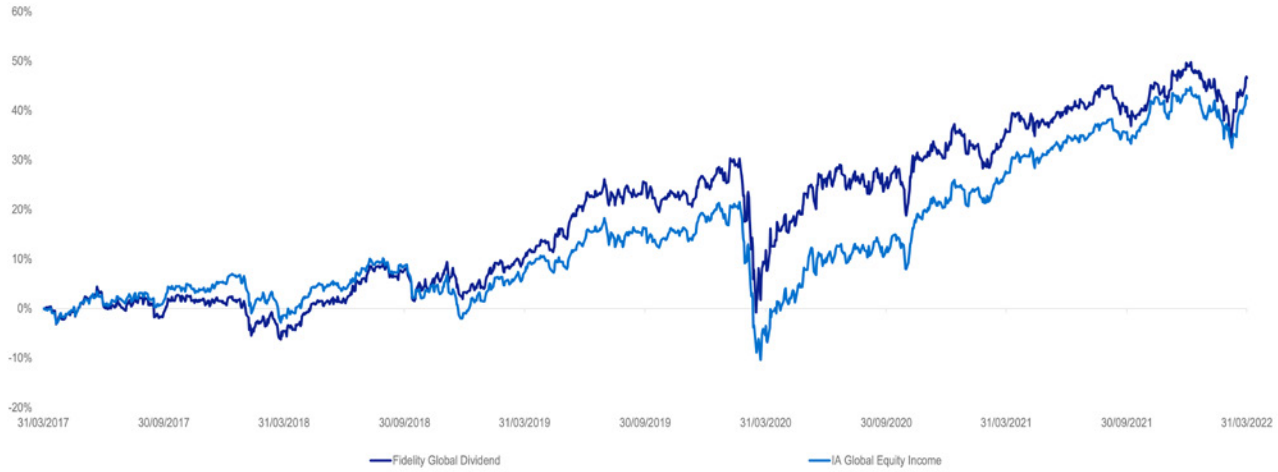
Fidelity Global Dividend is run by Daniel Roberts, who has 19 years of experience in equity markets. The fund takes an active approach to investing across a variety of geographies and adopts a more conservative investment strategy, aiming to reduce losses in the portfolio in the event of market downturns. This fund also incorporates a robust sustainability analysis into its investment process.

What is the impact?

A proportion of iShares Developed World Index Hedged will be substituted for Fidelity Global Dividend in our regular models. A proportion of Mirabaud Sustainable Global Focus Hedged and AXA World Funds Global Sustainable Equity Hedged will be substituted for Fidelity Global Dividend in our sustainable models.

Fidelity Global Dividend vs IA Global Equity Income sector

Total return, percent



Source Financial Express Gross Returns in Sterling from 31/03/2017 to 31/03/2022