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market outlook.

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affinity
FINANCIAL AWARENESS

contents.

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The UK Economy

Over the past 3 months (31st January - 30th April 2022), the FTSE 100 has returned 1.07%, whilst the mid cap, FTSE 250, lost 5.55%. This divergence in index performance was largely driven by the underlying sector exposures of each index, i.e. the FTSE 250 has much lower exposure to the sectors which have been driving the performance of its larger peer, whilst it also has a larger concentration of the detracting sectors.

The biggest contributors to FTSE 100 returns were basic resource, health care, utilities and energy. Whilst the biggest detractors were retail, technology, Travel & Leisure and insurance. Broadly, the themes driving returns have remained the same; continued resumption of demand following the lifting of COVID-19 restrictions and supply chain disruptions (as China maintains a Zero-Covid policy), however, more recently, the war in Ukraine has been adding further stress to production whilst sanctions levered against Russia have resulted in elevated energy market volatility.

The US dollar has been particularly strong over the period, which has also had a greater positive impact on the FTSE 100, as a larger proportion of its revenue is derived offshore when compared to the more domestically biased FTSE 250. Whilst US dollar strength has had a positive impact for international companies (when translating their earnings back into sterling), it does lift the cost of importing some goods which in turn adds to consumer inflation.

The Bank of England (BoE) raised interest rates to 0.75% in March, having already increased rates in December and February. Looking forward, it remains highly likely the BoE will increase interest rates again this year, however, how much further they will go is up for debate.

Consumption is a large component of UK economic growth and there are currently many headwinds facing UK consumers. Fiscal policy is tightening and energy prices have remained elevated, inflation is currently running at 7% year-on-year and wage growth has been lagging. This is squeezing the real income of consumers which was evidenced in March, when retail sales fell 1.4%.

Monetary policy is likely to have little impact on inflation, as it remains largely a supply side issue and raising rates will only stifle demand, which in turn will hamper growth (which the BoE will want to avoid). Consequently, we do not anticipate interest rates going much higher in the near-term. We also still believe headline inflation will eventually subside, not only as supply disruptions pass but also technically, as prices have not continued to climb aggressively, as time passes, the more recent elevated prices become the base for year-on-year comparisons.

The Japanese Economy

The Japanese markets have struggled in the current environment, as with shorter term inflationary pressures driven by COVID-19 supply chain shortages, and Russia/Ukraine driven energy/commodity redistribution issues, the inherent deflationary issues historically embedded into Japanese society have been exacerbated. Despite record levels of monetary stimulus for well over a decade, it appears only the recent global supply issues (primarily in the commodity space) that is staving off deflation (CPI was 1.2% in March, but -0.7% excluding food and energy). The Bank of Japan (BoJ) are cognisant of the impact should supply chains normalise, and have reaffirmed their commitment to stimulus going forward.

With global inflation expectation rampant, the markets inability to distinguish between regional markets can be seen clearly when looking at the Japanese yield curve in recent months. As many developed market central banks talked up interest rate increases, yield curves steepened in these markets, even in Japan - a market that is locked into a stimulus programme for the longer-term. In order to stem off any distortion of the Japanese yield curve, and to reaffirm the BoJ's policy stance, Haruhiko Kuroda (the Governor of the BoJ) reaffirmed the commitment to stimulus numerous times in recent months.

With monetary policy in the west tightening, albeit slowly, commitment from the BoJ to stimulus has seen, and will likely continue to see, the weakening of the Yen (Japanese currency). Whilst this should aid with inflation, the BoJ is likely to face a cost of living crisis should wages not increase. Long term wage increases are something that we have not seen in Japan for decades! That being said, Japanese Prime Minister, Fumio Kishida, has insinuated that fiscal support packages will be forthcoming.

Whilst it has been one of the worst performing markets year to date, in sterling terms, largely due to inflationary pressures and a weakening currency, there are still clear opportunity sets. Even though small cap names have underperformed due to COVID-19 lockdowns over the past year, it is one of the most under researched areas in the developed world. With the large and mega cap space largely 'efficient', over the long term, as the full reopening from the pandemic resumes globally, pent up valuations further down the market cap spectrum in Japan are positioned well to resume a longer-term trend of outperformance.

The Emerging Markets & Asia Economy

China's stance on COVID-19 has driven large parts of global markets over the past quarter since President Xi Jinping announced the hard lockdown stance in March of this year, as part of China's Zero-Covid policy. What followed was the complete lockdown of China's most populous city, Shanghai, following a large COVID-19 outbreak. We have also since seen an outbreak in Beijing, with the market pricing in a lockdown there. However, with mortality rates strong, and short-term economic data impacted by draconian lockdowns, it shouldn't be long before these measures are removed, investors return, businesses and sectors reopen, and pent up valuations (trading close to their biggest discount to global peers on record) are released.

First quarter Chinese growth (GDP) came in well above expectation, in spite of the staged reopening of the country. Whilst 4.8% is modest by its own historical standards, it is significantly more than most western developed nations. With the People's Bank of China (PBOC) setting a growth target of 5.5% this year, it seems reasonable to think that the Zero-Covid policy stance of the government will likely be eased. This would release pent up China demand, and with funding for small businesses and the unemployed announced, the property sector blow up largely contained, and the unfettered market support announcement by Xi's government, it appears one of the most attractive regions globally.

Following years of turbulence on the political front, it appears a large part of the Latin American region looks set to stem its volatility. With larger countries in the region (such as Brazil and Mexico) largely ignoring the pandemic until mid-2021, and with left wing Mexican President, Andrés Manuel López Obrador ("AMLO"), going against expectation introducing little by way of support package during the crisis, volatility has been rife. However, looking ahead, with Brazilian elections due in October, and with Lula da Silva ahead in the polls over the controversial incumbent President, Jair Bolsonaro, the potential for a steadied ship is high. In addition, with pressure on Mexican President, AMLO, to stem the fastest inflation in decades, it has spurred him into life, putting in place pricing pacts with Mexican companies. With political stability key, and valuations the most attractive they have been in many years, much of Latin America is arguably beginning to look a viable opportunity set.

Following a strong 2021 for Indian markets, one would be forgiven for taking profits out of an arguably overheated Indian economy. That being said, the longer-term investment case remains. As the market valuations normalise, it remains arguably one of the most attractive investment opportunities for longer-term investors, with a growing wealth for its population of circa 1.4 billion people. However, with short-term valuation issues, coupled with inflationary pressures surrounding the spike in energy and the oil price (driven largely by Russia/Ukraine conflict), it is worth remaining cautious over the short-term, as with India being one of the world's largest oil importers, pricing pressures and inflation over the shorter term will be difficult for them to navigate. That being said, Indian Prime Minister, Narendra Modi will likely look to address any longer-term cost of living issues ahead of the 2024 election, especially as two thirds of the Indian population works in the agriculture sector, a sector most threatened by pricing pressures!

It is worth noting that due to the political threats and uncertainty, Russia is no longer part of Emerging Market asset class for many index providers, with the rest likely to follow suit. At present, the Russian market is not tradable by non-Russian investors.

The US Economy

Despite a lot of talk surrounding interest rises over the past few months, the Federal Reserve (Fed) have only raised the headline interest rate by 0.25% to 0.5% (at the upper bound). With the broader market pricing in a significant interest rate rise cycle this year, it is important to note that the Fed have historically used 'narrative' as a means to manipulate expectation, and this seems a sensible approach. As such, the market seems distorted, a distortion which breeds investment opportunity.

Whilst it is likely that interest rates will be 'lower for longer', it is important to highlight that this doesn't mean rates will remain static! It appears apparent that we are in a prolonged environment of increasing interest rates, it just seems likely that it will be more glacial than the broader market is pricing in. As one must remember that prior to the commodity disruptions driven by Russia, and prior to the global pandemic, there were more deflationary pressures than inflationary ones. However, recent events have introduced some short-term supply chain constraints, and whilst inflation will likely remain elevated, increasing interest rates dramatically to combat inflation appears risky, especially given that there will likely be natural deflationary forces when supply chains normalise. As such, the Fed will not likely want to risk a compounded deflationary recession.

In light of the majority of market forces in recent years being geared around the interest rate rise cycle, in the 'here and now' it appears that inflation expectation is the driving force. As such, recent narrative from the Fed Chair, Jerome Powell, has been overly hawkish in citing the Fed's accommodativeness to interest rate increases. It appears evident that with inflation expectation not truly reflecting the likely path of inflation, that the Fed are again using narrative to talk down the markets inflationary worries.

Going into 2022 many economists saw the normalisation of the yield curve, with it steepening at the longer end. However, it was prudent to have been nervous, as with the war in Ukraine as well as the tail end of global uncertainty surrounding the pandemic, the yield curve has reverted and even teetered with inversion. As such, US equities have bounced and will again potentially be viewed as a bond proxy, with a slow interest rise cycle favouring value sectors such as financials, over growthier sectors such as traditional technology.

The European Economy

The European markets, more than most global equity markets, have been largely driven by the Russia/Ukraine backdrop in recent months. Whilst this humanitarian crisis is horrendous, valuations in many European countries are beginning to look attractive, compressed by shorter term factors.

Inflation has been prevalent in European countries, with a considerable factor being Russian sanctions. With Europe consuming approximately 45% of its gas from Russia, sanctions such as cutting Russia off from the SWIFT payment system and growing global restrictions on Russian energy consumption, has put pressure on energy supplies elsewhere, increasing prices. It is, however, important to remember that this will likely be a shorter-term phenomenon, as this is not a supply/demand issue, but rather a resource redistribution issue - supply chains are likely to sort themselves out as many politically neutral nations reallocate energy and oil contracts to Russia, easing supply elsewhere.

Head of the European Central Bank (ECB), Christine Lagarde, has made it clear that the ECB will remain accommodative. Whilst it is clear that as a region of many countries and many central banks, it is more difficult to rotate policy, it is also apparent that the ECB is aware of what policy tightening in the US/UK means for trade, as a strengthening dollar and pound, under tightening policy conditions, means a weakening Euro. So, whilst any policy moves from the ECB will likely be glacial, it seems sensible to assume the ECB will address the negative 0.5% interest rate at some stage, as a currency control measure at the very least!

Even though European equity markets look attractive, an element of short-term caution should be heeded given the uncertainty surrounding trade with Russia. That being said, opportunity sets and valuations remain strong, with any resolution to the Russia/Ukraine conflict likely being their catalyst. Given the slow cyclicality in western markets, value sectors such as financials and even energy (which make up a large portion of European markets), potentially stand to benefit from a rotation.

Fixed Interest

Government debt has remained volatile to start 2022, with shorter dated government bond yields across developed markets reaching levels not seen in a decade, as markets price in a number of rate hikes from most major central banks.

The Bank of England, have announced plans to sell down their bond holdings. This includes their holdings of corporate bonds, creating a weak technical environment for both government bonds, and corporate bonds in the UK. Corporate bonds sold off on the announcement, with prices already largely reflecting the coming sales.

It is important to point out corporate balance sheets remain strong. While the picture for growth and inflation remain uncertain, defaults, particularly from investment grade credit, should not be a major concern unless we see a material worsening in the economy. Companies are largely well positioned for any short-term headwinds.

The weak technical environment, combined with high inflation, has made headline yields in the corporate bond space more attractive - all in yields are now higher than they've been for a while - sterling corporate bonds are now yielding a similar amount to the levels seen during March 2020 COVID-19 sell off, despite default risks being much lower. However, real yields are less attractive, and we believe equities are likely to offer better returns in the medium-term.

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

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