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Investment Update May 2022

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As discussed last month, we sold down equities into strength very recently as our indicators were suggesting the appropriateness of such a move. Cash balances in portfolios have been swelled consequently and at the point of writing this appears to have been a well-judged move. The US S&P 500 index is down 10%+ year-to-date whilst the technology rich NASDAQ is firmly in bear market territory showing 20% of losses from the peak. Our unhedged US dollar exposure again benefitted portfolios as the Greenback rose in value across the board during April.

The Russo-Ukrainian conflict grinds on with more horrors unfolding each day. It is perhaps surprising that markets continue to look through this conflict whilst escalation appears so far contained. Rather, markets are fixated on the economic journey towards the "great normalisation" about which we first wrote in our January article of the same name (available on our website). Inflation and the all-important central bank response is the principal driver for markets currently.

With CPI inflation in the United States standing at 8.5%, created by the Covid-19 supply shock and exacerbated by mountains of central bank liquidity, the vampire-like effect of spiralling price rises across the board is a serious headwind to progress. A possible summer of discontent at home takes us back to images of the 1970s. Labour supply remains tight, giving bargaining power to employees who will demand higher pay and more relaxed working practices. Stagflation or "slowflation" as the ECB christened it has become real. Central banks face a tough challenge of slaying the inflation vampire whilst manoeuvring delicately to avoid a recession. Raising rates multiple times and removing excess liquidity by a new tool called quantitative tightening will slow economic growth. However, economies are simultaneously slowing down quite naturally following the turbo charged recovery from the worst effects of the pandemic. So, the distinct possibility of central bank policy error must be calculated and factored into our forthcoming asset allocation decisions. The chart, courtesy of Bloomberg shows bond yields rising in the United States.

Source: Bloomberg
As at 3 May 2022

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US 10-year treasury yields hit 3%, the highest level since 2018. The world's supply of negative yielding bonds has evaporated before our eyes as the bond bubble steadily deflates. Higher bond yields prove a disruptor for equity valuations, particularly for those levered firms and those whose stock prices have risen perhaps too high. The likes of Meta Platforms (Face Book) are down around 47% from their peak and Netflix down similarly, along with multiple others who have struggled to post strong ongoing growth numbers during the quarter one earnings season. We flagged this as being distinctly likely in previous updates.

China is undeniably witnessing a slowdown following intervention by politicians in the excesses of its technology firms and a resurgence in Covid-19 cases set against a zero-tolerance policy. The emerging world which typically borrows in dollars will be dampened by tighter US interest rates. Europe's manufacturing base and its over dependency on Russian hydrocarbons has similarly taken its toll on equity markets. Meanwhile in Japan the yen has sunk to a 20-year low as the Bank of Japan maintains the cost of borrowing at ultra-low levels through so-called yield curve control. Consequently, Japanese exporters are afforded a strong competitive platform by the ultra-competitive currency. Our investment memories are short - we should recall the very strong financial results of the recent past and look forwards as we grind through the slowdown. Remember equity markets are a hugely efficient discounting mechanism and always look ahead. Despite the gloom, forecasters maintain a positive view for US equity markets by the year end.

We expect to see inflation headlines moderating as we travel through the year and as rate rises come into play. Markets have factored in a Federal Reserve 0.5% hike during early May with a series of further rises throughout the year. Economic data will determine the exact speed and magnitude of policy. We would expect to undertake some further rebalancing of portfolios to moderate risk in the near term. As rate rises near the peak, we anticipate equity values firming and longer duration bond yields beginning to fall back. We will aim to move portfolios into position as events unfold.

Academic studies underpin the importance of asset allocation and the relevance of prudent risk management – we are amongst the strongest advocates, bringing forward looking institutional grade methodologies to bear. Portfolio performance remains strong relative to peer group averages across the board, and we retain a vivid focus on risks and opportunities as this great normalisation plays out.

As ever we would like to thank you for your ongoing support. If you have questions or feedback, please do get in touch.

Written by the Alpha Beta Investment Team

All data as at 3 May 2022

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