Investment Update

January 2022

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A spectre in the form of inflation stalks developed economies and particularly in the largest economy, the United States, where 7% was recorded, the fastest prices increase in four decades. Recently reappointed Federal Reserve Chairman, Jerome Powell has unapologetically deleted the word "transient" from his commentaries and joined Bank of England Governor, Andrew Bailey using words and phrases that chime with our longstanding description for inflation – "higher for longer". This reappraisal has brought with it a U-turn in central bank policy which served up the worst start to a calendar year for the S&P 500 Index in 39 years.

The minutes and their hawkish tone resulting from the latest Federal Reserve meeting has marked inflation as "public enemy number one". We envisage a package of measures to tackle inflation – yes raising rates but also tapering back the extensive liquidity injections and ultimately instigating a relatively new central bank weapon, quantitative tightening, or "QT" if you prefer. QT is simply the inverse of QE (quantitative easing) and effectively sucks excess liquidity out of the economic system slowing growth ideally without harming the real economy. The risk is that raising rates too far, too fast into a slowing economy brings the potential for policy error and induced recession. Bond yields have risen as expected, 10-year yields moved up to 1.9% before stabilising and now sit a shade below 1.8%. As real yields finally turn positive there is scope for the 10-year Treasury to nudge 2.25% or so. Fortunately, the economy is strong, having grown at 6.9% during the final quarter 2021.

However, we also note that despite inflation sitting at elevated levels and likely to go higher, particularly at home in UK, we are beginning to observe indications of pressure starting to ease. In US 5 and 10-year breakeven inflation indicators sit around 2.8%. Supply bottlenecks have eased significantly, and base effects are likely to bring down headline inflation figures beginning in quarter two this year. A used Honda Civic cannot increase in value at 25% year-on-year, for example. Receding Omicron will open the employment markets and could reduce employee bargaining power. Nevertheless, a watchful eye remains trained on wage settlements at home and abroad. The Federal Reserve faces the challenge of gliding the economy to a safe landing whilst liquidity is withdrawn, rates are raised, and the economy slows back from previous turbo-charged velocity.

After the warmth of a 27% increase in 2021 US markets opened the year significantly weaker led by the prospects of higher rates and tapering liquidity. Credit spreads have begun to widen in anticipation of a possible US rate rise in March. The price to earnings ratio for the S&P 500 now sitting at around 20x earnings down from 27x in December. However, giant technology firms such as Microsoft and Apple continue posting strong earnings growth. Markets have rebounded higher from over-sold positions shown by our Momentum Indicator, and we expect normalisation at a higher level. The most exposed firms being those highly levered with weak balance sheets. Markets typically do not price-in geopolitical risk such as Russia/Ukraine, which has the potential to upset progress temporarily. A negotiated settlement allows dignity for all.

The below chart shows the price to earnings ratio for the S&P 500 Index.

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Chart as of 28th January, 2022
Source: Bloomberg

In the so-called emerging world, the People's Bank of China cut rates twice in consecutive months after GDP contraction resulting from the pandemic. We expect an upward rebound in growth and equity valuations as the economy reopens. A reopening China will help to pull back inflationary pressure in the West. In Europe, Germany has also seen recession looming and the ECB shows no sign of raising rates in the near term, despite high inflation, although liquidity will be tapered back. The UK market has performed well, aided by better prospects for banks and mining stocks benefitting from commodity inflation globally.

Portfolios have been buffered by January volatility which is now ebbing away. All portfolios remained inside their allocated risk corridors during the month. Equities protect the real value of money during an inflationary spell - Invest in price setters, not price takers whilst remaining vigilant. We anticipate markets moving higher before we contemplate our next move whilst retaining a clear and vivid focus on the risks in play.

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If you have any questions or feedback, please do not hesitate to get in touch.

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