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Market updates

Investment team updates | 4 March 2022

Fixed income

Markets

- **February update** It was not a great month for financial markets, with only really commodity prices rising – which by 2 March were up around 25% year-to-date (with wheat, of which Ukraine and Russia are major producers, up 57% year-to-date) – as well as oil with WTI (West Texas Intermediate) trading at $111, which is up 47% year-to-date. Credit spreads were very much wider on the month, as well as year-to-date. European credit – both investment grade and high yield – has underperformed in the sell-off in spread terms, with Euro IG spreads now 50% wider year-to-date, but now 0.3 standard deviations cheap to long-term averages. In total return terms, the Euro index is down around 4%, the US and UK are down around 5% (with longer duration), while Euro HY is -6% and EM -8%. The month began with fears of interest rates rises globally, on the back of high inflation and therefore an expected policy response. But the second half of February was all about the ongoing Russia/Ukraine conflict, which remains a very fluid situation. The week started with Russia saying it had put its nuclear arsenal on high alert and peace talks held later in the week yielded little. Most Russian banks are now excluded from the SWIFT (Society for Worldwide Interbank Financial Telecommunication) system, the main secure messaging system used by banks to make rapid and secure cross-border payments. Emerging Market spreads moved wider, around 80bps year-to-date, and Russian debt is trading much lower (about 30 cents) and the ruble has collapsed. In macro markets, US yields rose and yield curves flattened, though rising real yields were reversed and ended the month lower.
- This week was tricky for core government bonds. The week's starting position (28 February) was US 10-year =1.86% (which meant it was 40bps lower in just a couple of weeks), Germany = 0.13% and UK = 1.41%. A fairly difficult Tuesday (1 March) saw yields plummet further, and in the case of the UK the most since Brexit vote: US 10-year = 1.72%, Germany = -0.07% (back into negative territory) and UK = 1.13%. They ended the week (3 March) having risen slightly from this position to: US 10-year = 1.80%), Germany = -0.01% and UK = 1.3%. The yield curve is flatter with 2-10s now less than 30bps.
- Credit markets, based on BofA Merrill Lynch Bond Indices, were less volatile and saw Global IG start the week (28 February) at 132bps and Global HY at 458bps, before ending the week (3 March) at 137bps and 460bps respectively.
- Meanwhile, interest rate rises are being priced out in all markets with only 5bps in Europe from 50bps a few weeks ago. Market volatility is up to levels last seen in January 2021. So higher risks to inflation and to growth combine in an unpalatable mix for risk markets.

News

- In non-Russia/Ukraine news, the US saw jobless claims fall to a two-month low of 215,000 in the last week of February, as Omicron waned, while in the euro area the unemployment rate fell to 6.8%, a record low.
- Also in the US February's ISM service sector fell surprisingly for the third month in a row. The ISM Manufacturing index for February however was at 58.6 – stronger than expected and led by robust new orders. PCE inflation for January rose to 5.2% year-on-year – the highest level since the early 1980s.
- In Germany, inflation came in higher than anticipated at 5.5% year-on-year, while Christine Lagarde, president of the European Central Bank, said the conflict may drive inflation temporarily higher in the eurozone.
- Germany also announced it would increase military spending to 2% of GDP from a normal 1%-1.5%.

US equities

- The conflict has materially increased the tail risks in the global economy, resulting in a higher probability of a slowdown in growth. Moreover, it is clear there is heightened volatility in markets which, while resulting in noise and disturbance, creates opportunities for active managers.
- The vast majority of the US equity market is not directly impacted by exposure to Russia or Ukraine, and the combined revenue exposure of the entirety of the S&P 500 is estimated to be about 1%. So although the US is part of the coordinated global effort in terms of sanctions, the stock market impacts for now are relatively benign. Corporate earnings are not expected to be materially affected by the crisis. Indeed, we still expect to see earnings growth of around 8%-12% through 2022.
- The main impacts, therefore, will be felt through second-order effects such as energy prices and supply chain disruptions. Higher energy prices are likely to persist, which will squeeze consumer wallets and feed through to higher input costs for some companies, while inflation risks remain to the upside. The risk of further disruption to a supply chain already hit by the Covid-19 crisis remains elevated as the conflict makes supply chain problems more acute at the margin. This will give further impetus to the trend of supply chain diversification and domestication.
- This heightened risk environment means interest rate increases could be less steep this year, but we do expect the Federal Reserve to follow through on its intention to start hiking rates in March. The potential for less severe rate increases is to the benefit of long-duration growth stocks, which have already gained from the "flight to safety" and accompanying fall in the 10-year Treasury yield, which has declined from 2% to 1.7%.
- The flight to safety is centred on the US dollar and we are modelling what the impacts of a much longer dollar will be on holdings. Contagion from crisis-hit European banks is a risk, given the nature of the global banking system, but we have already reduced weightings in this area.
- Due to the distance of the US from Russia, on a number of levels, the direct portfolio impact is likely to be limited to the factors outlined above and so we have not made any changes as a direct result of the conflict. We are, however, diligently seeking to better understand and anticipate the second and third order effects. Our edge is in harnessing our research intensity to uncover those companies we believe will continue to grow earnings, which will be key in a year marked by rising interest rates and reduced support for the economy and asset prices more broadly.

European equities

- Market reaction in Europe to the Ukraine crisis has been strong but justified – European banks and other stocks with exposure to Russia have fallen by more than 30%. We do not believe there is systemic risk for the larger European institutions, but there may be further loan losses across the continent. European banks have significant excess capital – enough to prompt share buybacks – so while banks could lose equity, it should not represent a solvency risk.
- Europe was expecting the first European Central Bank (ECB) rate hike later in 2022, but that will likely now be pushed back. We will monitor the inflation outlook and factor in any impact on longer-term interest rates to our decision-making. Interest rates are a key issue: the US Federal Reserve is on track to deliver well-signalled hikes, but the ECB is less keen, for two reasons: first, higher interest rates will not cure higher energy prices; second, higher interest rates compounded with higher energy costs would be unpalatable for consumers, who also happen to be voters, and would threaten recession.
- However, if interest rates were to move to higher levels it would impact the overall market valuations. However, our base case is this is unlikely.

Responsible investment

- In November, 80% of people lived in countries that are net importers of fossil fuels[1] – this is likely to be a driver of renewable energy adoption in order to gain energy independence. The Ukraine/Russia conflict has accentuated this, with renewable energy companies rallying significantly. UK business and energy minister, Kwasi Kwarteng, has been very clear around the UK's plans for additional nuclear and the acceleration of renewable auctions.
- Indeed, the conflict underlines the importance of focusing attention on the source of capital invested, as much as where it is invested and at what rate of return, taking environmental and social impacts into consideration. Indeed, it strengthens the case for a holistic, RI-integrated investment approach in which all stakeholders are scrutinised, from those who provide capital to those who choose to do business with less reputable clientele or facilitate the inequitable extraction of wealth and resources.

Note: all data as at 3 March 2022, unless otherwise specified. Source: Bloomberg.

[1] https://carbontracker.org/the-iea-calls-time-on-the-fossil-fuel-era/