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Markets refocus on inflation and policy tightening

« The second quarter of the year is upon us: originally the quarter in which it was assumed inflation would peak as pandemic-related supply chain issues cleared up. It is clear that inflation isn't going anywhere anytime soon, with the conflict in Ukraine exacerbating price pressures. Despite new economic risks stemming from geopolitics, key central banks remain committed to reining in inflation, which is running far faster than their common 2% benchmark. »

Lieven De Witte *Head of Fixed Income Strategy, BIL*

Fundamentally speaking, the economy is still in decent shape and growth is expected to remain positive in the major regions through 2022. The corporate sector has thus far fared well, with services and industrial production showing resilience, only really hampered by supply constraints against a backdrop of still-robust demand. To date, the inflationary spike has not had a material impact on margins, and looking ahead, positive relative revisions suggest earnings will continue to run at a healthy pace this year.

With that said, the ongoing crisis in Ukraine increases downside risk for the economy by denting confidence, amplifying inflation and increasing the likelihood of "butterfly effects" (i.e., non-linear impacts that a difficult to forecast a priori). If there is one region more susceptible to these risks, or economic fallout from the war, it is Europe, due to its sheer proximity and dependence on Russian energy. A prolonged conflict that would curtail growth, but boost inflation would increase the prospect of stagflation on the continent.

Inflation is the overarching issue, no matter which side of the Atlantic you stand on. US CPI is at a 40-year high, causing Treasury Secretary Janet Yellen to comment that it "is of tremendous concern" and "hits Americans hard [making them] worry about basic pocketbook issues." While federal action languishes, blue and red states alike have begun suspending gas taxes to alleviate some of the burden on households. In Europe, inflation is at the highest level it has ever been and is projected to rise further in March to around 7%. National governments are seen intervening to protect consumers from a cost-of-living crisis (particularly with regard to energy costs).

Central banks are now under pressure to put the cat back in the bag and stop inflation escaping beyond their control. In the US, the Fed has initiated its rate hiking cycle and stepped up its hawkish rhetoric with a procession of Fed members (including the more dovishly inclined) calling for more aggressive action to tackle inflation. Markets expect a hike at every remaining meeting in 2022 (for a total of 200 bps of hikes this year), a 50 bp hike in May, and details of quantitative tightening in the next set of FOMC minutes (due 6 April).

While in a slower lane, the European Central Bank is headed in the same direction and has made it clear that it will act to stop surging inflation, even if there is a war playing out on the EU's doorstep. It ended its Pandemic Emergency Purchase Programme and has pledged to wind down its Asset Purchase Programme by summer, laying the groundwork for possible interest rate increases later this year. The market is pricing the ECB deposit rate (today at -0.5%) to be around zero or even slightly positive by year-end, thereby closing the chapter of 8 years of negative rates in Europe.

The global tightening campaign on its own would have created a tricky investment environment. Now, investors also have to contend with heightened geopolitical risk and renewed supply chain tensions. While in the past such a scenario might have made it tempting to hunker down in cash or the safest corners of the fixed income market, corrosive inflation makes both unpalatable. As professional investors, such an environment gives us the opportunity to flex our abilities, and we are energised for a challenging year ahead in which agility, problem-solving skills, innovation and a deep-seated knowledge of different asset classes will become ever more crucial.

As of today, our portfolios are positioned to benefit from continued growth, rising rates and still-strong earnings, keeping in mind that for now, higher rates are a headwind and not a cliff for economic momentum and stock market returns.

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We also place renewed emphasis on investment themes that we have been tracking for some time. The energy crisis brings the issue of energy security to the forefront. A stronger resolve within Europe to accelerate clean energy adoption and reduce its dependence on fossil fuels further supports our investment themes focused on the energy transition. Overall, what is required is a broad energy transition – not just in terms of energy supply (renewables), but also in transport, construction, and industry – this will involve the use of a whole new wave of manufacturing, automation, AI and IoT, as well as different approaches to energy storage. The secular trend behind these segments remains strongly supported by fundamental drivers. We are also focused on cyber security, something that is becoming increasingly relevant.

Equities

With regard to our equity overweight, this is concentrated in the US where companies are more insulated from the crisis in Ukraine. We are underweight on Europe, with the war, sanctions and the energy crunch weighing more heavily on its economic prospects. We are neutral on China (despite attractive long-term opportunities and a new wave of supportive policies, the epidemiological situation prevents us from acting with haste) and Japan (where valuations are attractive but rising input costs are weighing on earnings expectations). We are negative on emerging markets, a region that typically suffers under a more hawkish Fed regime and a stronger dollar.

Given current volatility and sharp rotations, we are neutral on style and have a diversified sectoral allocation giving preference to: **Energy** (a key beneficiary of higher oil and gas prices and a sector with strong revisions), **Materials** (a natural inflation hedge, benefitting from higher commodity prices and which boasts good revisions), **Healthcare** (a sector that has a long history of generating stable profits in all economic environments, which is forecast to have strong earnings and which has less exposure to current risks in markets), **Technology** (strong earnings season and still a key growth engine), **US Financials** (benefits from rising inflation expectations and interest rates) and **European Utilities** (as a defensive hedge against current uncertainty in Europe).

Fixed Income

Price pressures show no signs of abating and after the flight-to-safety at the beginning of the Russia-Ukraine conflict, inflation angst is taking centre stage again causing a spike in long-term yields (and a brutal sell-off in bond markets with few places to hide; even Japanese government bonds declined, even though the BoJ is bucking the global tightening trend). At the same time, the short end of the US curve is being pushed up on expectations for policy tightening causing the curve to flatten (and even invert in some places). In Europe, the end of the PEPP combined with a sharp rise in inflation expectations, pushed the longer end sharply higher. With the first-rate hike by the ECB getting closer and more likely, the curve should flatten going forward.

This makes for a complex investment terrain, which we approach being neutral on credit risk and underweight on duration. We give preference to instruments with a short duration or those with a high buffer protecting against rising rates (namely high yield). Long-dated quality investment grade corporates are also interesting – so long as they are hedged for duration.

We are neutral on gold, believing that rising real rates might limit the upside over the medium to long term.

Conclusion

While growth is slowing, financial markets are still basking in the afterglow of a spectacular economic and earnings recovery that followed the pandemic. How long this phase lasts largely depends on geopolitical developments and the success of central banks in removing their support without causing economic tumult.

While researching ahead of our asset allocation committee from my home office next to Luxembourg Gare, I was disturbed by a commotion outside. The entire train station was evacuated and the bomb squad swooped in as construction workers had uncovered a WW2-era explosive. From afar, I could just witness the process and I had one thought: though Jerome Powell refers to episodes in 1965, 1984 and 1994 when the Fed slowed an overheated economy without prompting a sharp contraction, looking at the current mix of factors central banks have to contend with (high debt, geopolitical tensions, shortages, renewed supply chain tensions, etc.), they are going to need as much precision and delicacy as the team I was spectating.

Investment Strategy

28/03/2022

Global Allocation	+	N	-
Equities	•		
Fixed Income			•
Gold			•
Oil		•	
USD	•		

Equities	+	N	-
US	•		
Eurozone			•
China		•	
Japan		•	
Emerging Markets Ex-China			•

Fixed Income	+	N	-
Government Bonds - Developed			•
Emerging Market Debt			•
Corporate - Investment Grade	•		
Corporate - High Yield	•		

Stance: Indicates whether we are positive (+), neutral (N) or reluctant (-) on the asset class.
Change: Indicates the change in our exposure since the previous month's asset allocation committee: increase, decrease or no change.

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