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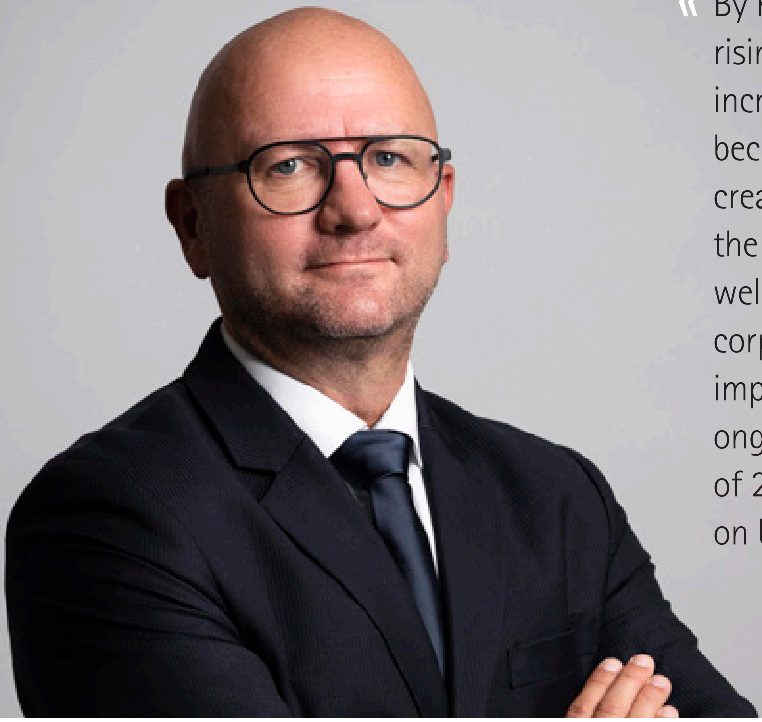
A bumpy ride but with some shock absorbers still intact



« By now the majority of us have felt the sting of rising prices first-hand. Central banks are under increasing pressure to prevent inflation from becoming entrenched in expectations and the creation of a self-fulfilling feedback loop. Despite the inflationary environment (which was prevalent well before the conflict in Ukraine) and rising rates, corporate margins are yet to be meaningfully impacted. In fact, analysts currently expect that the ongoing Q1 earnings season should be the weakest of 2022, and insofar, it has exceeded expectations on both sides of the Atlantic. »

Lars Naur Mogeltoft *Head of Equity Strategy*

By the estimations of many economists, 2022 was to be a year of strong economic growth. Supply chain disruptions would ameliorate, allowing companies to get busy satisfying the pent-up demand of consumers who had accumulated unusually high amounts of savings. The sheer prospect of it had stock markets clocking new highs and the abundance of liquidity created by stimulus had investors crowding into all manner of assets (think meme stocks, NFTs and SPACs). Clearly, the theme of the recent Met Gala in New York was imagined in light of this context: Gilded Glamour – a homage to the period of wealth, industrialisation and growth from 1870 to 1890.

While corporate margins still portray general prosperity, a rowdy guest is threatening to ruin the growth party: inflation. Already, consumer confidence has plummeted as households start to watch their pennies. In a sign of the times, the Met Gala is under fire for its choice of theme, accused of insensitivity to the worsening inflation households now face.

The doormen (central bankers) assumed inflation would linger a bit and then take his leave, but he has proven to be a stubborn presence, and they are now trying to strong-arm him out the door. This is especially so in the US, where inflation has bled into structural areas of the economy such as housing and wages, compounded by an exceedingly strong labour market – there were a record 11.5 million job openings in March, meaning two job openings for every unemployed person. As such, the urgency for central bank intervention to contain inflation is more acute. For the Fed, 50 is the new 25. After a 25 bp increase announced at the March meeting, the Fed enacted its first 50 bp rate hike in May and stated that further increases of same size should be "on the table" at next two meetings. The market expects that the Fed funds rate will be around 2.8% by year-end.

In Europe, and as Lagarde herself has put it, the ECB is grappling with "a different beast", with roughly 50% of overall inflation driven by higher energy costs (which the central bank has little power over). Given the importance of Russia to the energy supply, deficits are likely to persist in the near-term, and while inflation has definitely still has some wind in its sails, early signs of peaking are starting to show. As such, the ECB is proceeding more cautiously, confirming the end of bond purchases in Q3 followed by rate hikes "some time after" to bring the deposit rate to zero or even into positive territory by year-end. Markets are pricing in almost nine hikes by the end of 2023 (to 1.5%). This is quite aggressive, and generally we believe that the market is extrapolating the sense of urgency from the Fed to other central banks' reaction function.

Moving forward, we may be reaching the peak in terms of aggressive pricing of hawkish central bank action, and domestic factors should start to become more relevant for developed market central banks, bringing an idiosyncratic normalisation of policy.

The million-dollar question is whether central banks can get inflation to leave (or at least calm down and take a seat) without having to end the party (i.e. tighten policy so aggressively that it chokes off growth).

Investment Implications

The impending task of central banks undoubtedly complicates the investment landscape. For decades, the markets have thrived on the one-way bet that when conditions deteriorate, the Fed would prop up asset prices with rate cuts and bond purchases. It thus always made sense for investors to "buy the dip". In 2022, a small saving grace could be that this so-called "Fed put" might – to some extent – be replaced with a "CFO put".

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That is to say that a planned wave of buybacks and dividend payouts from cash-rich companies might offer some support to valuations, even as central banks start to step out.

As evidenced in the ongoing reporting season, corporate earnings remain strong, and have thus far been minimally impacted by rising rates and inflation, with companies exhibiting strong pricing power. Analysts predict that the current earnings season will be the least fruitful of the year, with an acceleration expected from here, allowing margins to reach peak levels once more in Q3. Even though it is a common view that inflation should peak somewhere around the middle of the year, these estimates seem quite aggressive (especially in Europe given the ongoing conflict on its doorstep) and some downgrades might be expected. However, equity markets can still perform as long as an earnings recession is avoided – which is our base case.

Despite rising risks to growth, we continue to see scope for positive market performance over the next 12 months and maintain our equity overweight. We have not adjusted our allocation therein, believing that regionally the US is still best poised. In terms of sectors, we remain exposed to late-cycle beneficiaries such as Energy and Materials. As the cycle continues to age, defensives are likely to pick-up, and there we already have exposure via Healthcare/European Utilities. We are maintaining an overweight on US Financials – with the Fed really cracking its knuckles and getting ready to take on inflation, the zenith of ultra-low rates that has dogged bank balance sheets for years is nearing its end. We have made no changes to our IT overweight: while the sector has been hit hard in an environment of rising interest rates, we believe that the bulk of rate hikes are now priced in. IT, on aggregate, boasts quality names, strong cash flows, resilient earnings growth and healthy balance sheets.

The fixed income market is undergoing its worst sell-off in over thirty years, driven by continued upwards surprises in inflation prints and fears surrounding earlier and faster monetary policy normalisation. The starting point of ultra-low yields meant that when rates shot up and credit spreads widened, the buffer offered by coupons was wafer thin or non-existent. For euro investors, this has led to a situation where "safer" government bonds have performed worse than Investment Grade bonds, which in turn have performed worse than High Yield bonds. Moreover, in a once-in-a-blue-moon episode, the sell-off in bonds happened at the same time as an equity market sell-off, meaning that even portfolio diversification was unable to offset the blow.

While the decline has been brutal, the silver lining is that, looking forward, fixed income investors can finally start to earn a better yield on their investments, as corporate bonds with negative yields are history (for now). Taking EUR Investment Grade bonds as an example, the average yield is now 2.1% versus a meagre 0.5% at the beginning of the year.

We remain overweight on High-Yield and Investment Grade bonds. The Committee added to the latter position, switching out of Emerging Market Corporates and into US short-term fixed, rate investment grade credit. Emerging Markets are feeling the impact of the conflict in Ukraine through rising prices for both hard and soft commodities and typically, when US real yields are increasing while the Fed has its foot on the brake, this hampers the performance of EMD. In switching to short-term, fixed rate US IG credit, we can reduce potential volatility while keeping an attractive yield (currently around 3.3%). This segment again benefits from the fact that most central bank action is now already priced in, and as Moody's comments: "A gradual rate hike will increase corporate borrowing costs but will not necessarily hamper credit fundamentals significantly without economic shocks".

High inflation levels and more restrictive Fed policy are expected to drive weaker gold investment demand in the medium-term. Nonetheless, gold remains attractive as a diversifier and store of value.

Conclusion

With the invisible hand of central banks retracting and inflation still running high, we obviously face a bumpier road ahead and returns will probably be more humdrum than they were previously. However, resilient demand, healthy consumer and corporate balance sheets and rising earnings should act as shock absorbers. In times of turbulence it also pays to remember that time in the market is more important than timing the market when it comes to long-term capital appreciation. Though the current market would test the patience of a saint, as we noted in a previous article, keeping cash is a guaranteed way to lose purchasing power, without any upside risk.

Investment Strategy

28/04/2022

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 reluctant (-), neutral (N) or positive (+) 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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