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Objects in the Mirror are Closer than they Appear

2022 didn't exactly start with the bang that many were hoping for - initially. Instead of turning the page, it seemed that the only things turning were stomachs – as sharp stock market volatility took hold early in the year and has not yet subsided at the time of writing. It was definitely the case that "**omicron killed certitude**" as a headline screamed early in the year, and with that certitude went much of the enthusiasm for tech stocks and high growth names.

Inflation concerns moved to top of mind globally, with levels hit not seen in decades, and many dusting off the Stagflation playbook of the 1970s, when high oil prices combined with rising unemployment to choke off growth. Interest rates were on the move too – with two back-to-back hikes by the Bank of England and up to 5 hikes being forecast for 2022 in the US, the first one (or two) expected in March. Supply chain stresses have been erratic, with certain components (e.g. for cars, or new house extensions) in short supply while most staples are still well stocked despite longer shipping times.

Stock markets have been disappointing year to date, with the UK stock market (FTSE 100) a notable exception – until recently in positive territory and the best performing stock market globally (see detailed chart below on page 6). This may be due to its strong defensive and "old economy" orientation – with a heavier emphasis on financial stocks and energy companies than, say, the US NASDAQ.

As we write markets remain on a geo-political knife-edge. The Beijing winter Olympics passed with more than a whiff of scandal around doping, while Russia's invasion of the Ukraine in late February sparked a wave of unprecedented economic sanctions and isolation amid recriminations and a united front against Russian aggression. The might of NATO might well be unified at this juncture, but markets indicated little appetite to shrug off a ruinous confrontation in the region, especially with its impact on already high energy prices. It will likely be a fractious quarter and we will be watching closely.

Highlights since the last quarterly update:

- **Inflation speculation and indicators finally "crossed over" beyond what policy makers could tolerate and with a shift in rhetoric a new "assertive" stance was telegraphed. The Bank of England initiated back-to-back rate rises in January and February, the first time that it has done so since 2004. UK rates now sit at 0.5%.**
- **Gilt yields fell sharply in the middle of February (indicating strong demand) suggesting that the rise of inflation (and interest rates to match) might be short-lived.**
- **This "flat yield curve" phenomenon is also present in the US, and suggests a mediocre medium term and long term outlook for the economy, with inflation expected to level off out of the initial shock levels currently being experienced.**
- **Supply chain issues and labour shortages are persisting, and inflation levels are at at multi-decade highs 7.5% in the US (a 40 year high) and 5.5% in the UK – a 30 year high. Energy prices and anomalies such as used car prices are driving much of the increase, while house prices are also continuing to soar,**
- **Markets closed out the year of 2021 with record highs in the US and lack lustre performance from emerging markets. While new highs were touched in the month of December, there was already a harbinger of volatility ahead as markets lurched away from high tech stocks intermittently during the month. This volatility continued throughout January, with January representing the worst January since 2008 for the tech-heavy NASDAQ and the worst month since 2020 for the Dow and the S&P. The FTSE 100 bucked the global trend by returning 1% for the month after a decent 14% return in 2021.**
- **Geopolitical concerns mounted over the quarter as Covid concerns both kept most of Asia locked down and locked out of international travel and led to a standoff between truckers and authorities in the Canadian city of Ottawa. As Covid restrictions started to fall globally, the "certitude" mentioned above still remains out of reach. The war between Russian and Ukraine remains firmly at the forefront as we write.**
- **In the UK the Prime Minister remained in place despite scandals and cabinet-level departures, and the balancing act of emerging from Covid disruptions was revealed. AN investigation into fraudulent Covid loans revealed that up to £5bn of loans made as part of the government's bounce back loan scheme (which provided 1.1mn small companies with borrowing worth more than a total of £47bn) could have been fraudulently obtained, and the Governor of the Bank of England advised that pay rises might place undue strain on companies that are struggling.**

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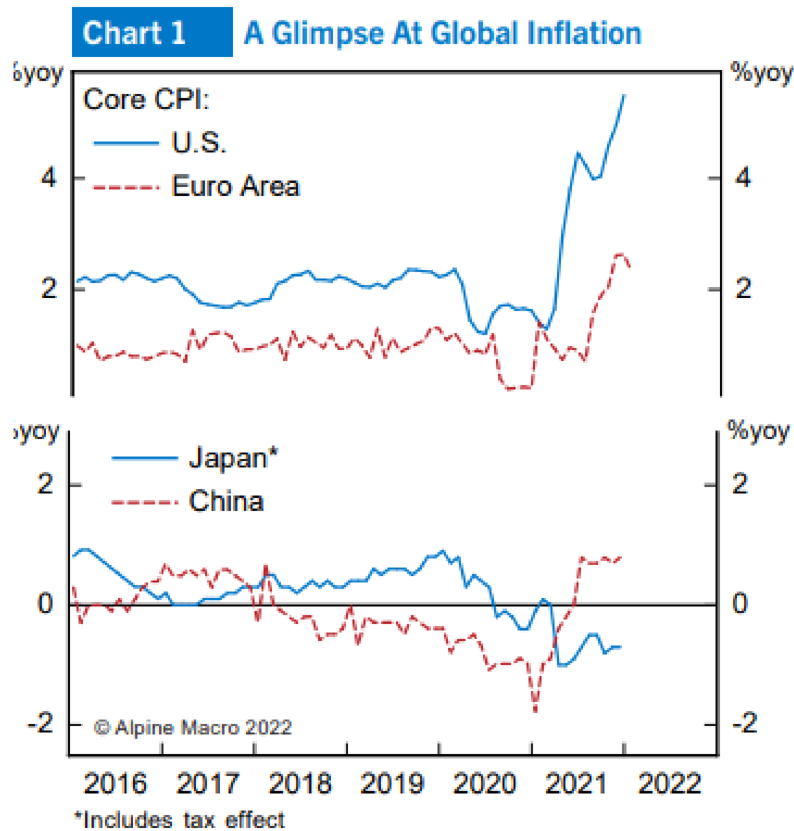
Current Macro Snapshot

Inflation Takes the Reins

While inflation is often considered something that can be "reined in" or tamed, or controlled, it seemed this quarter that it had the reins. As the chart below shows inflation is a global phenomenon, but by no means uniform. While regions such as Japan and China have also seen rising energy costs, the overall inflation levels remain much below the US the European area – suggesting that a large part of the current surge is due to consumer spending (and the aftereffects of massive stimulus).



Central banks shifted from their "inflation is transitory" rhetoric to taking a far sterner approach and signalled sharper and faster interest rate rises in order to curb spending. While inflation at multi-decade highs did spark fears of the 1970-s style hyper-inflation there was a counter-narrative that the current price spikes would be short-lived. Evidence for this included the flat yield curve, the fact that supply chain shortages could be short-lived and a reaction to an exogenous event – Covid-19 – so similar to the shortages that occur after a war. Interestingly the US dollar remained strong, which would typically be unusual in times of high inflation – see below:

U.S. Dollar Index (DXY)

CLOSED

96.12

▲0.07 0.08%

Last Updated: Feb 20, 2022 at 6:28 p.m. EST
- Delayed quote

PREVIOUS CLOSE

96.04

96.08 DAY RANGE 96.13

Equally unusually, gold remained lack-lustre in terms of performance, whereas it would typically rise in an inflationary environment. See below:

Gold Continuous Contract

OPEN

$1,907.20

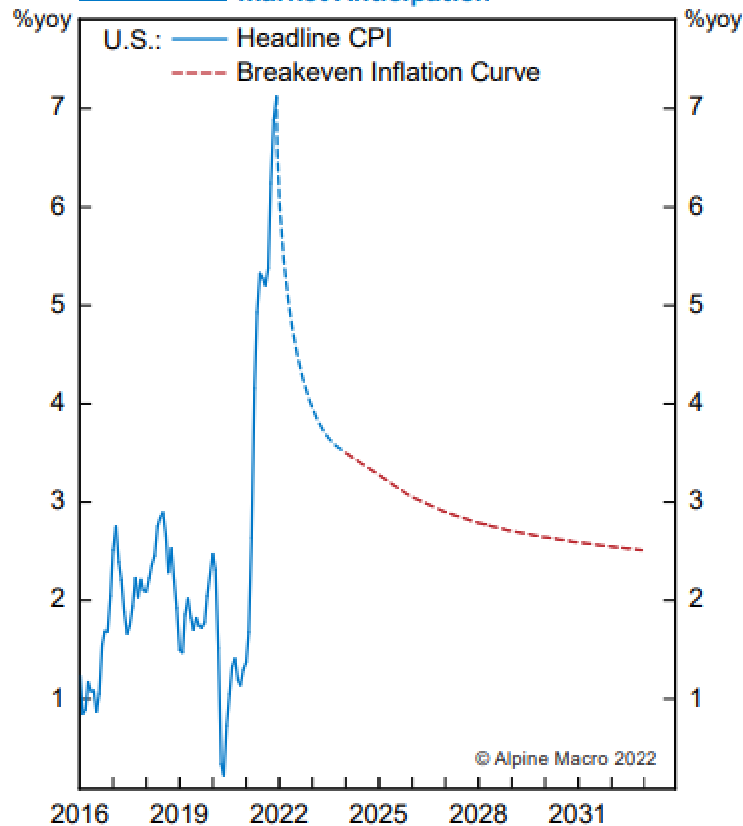
▲7.40 0.39%

Last Updated: Feb 20, 2022 at 6:29 p.m. EST
- Delayed quote

SETTLEMENT PRICE 02/18/2022

$1,899.80

Finally, the expectations for inflation are quite muted in the medium term, as shown by the chart below:



Interest Rates:

Interest rates are on the march upwards with up to five hikes now expected in the US in 2022 and a further rate hike expected in the UK in March. European rates have stayed stable although now Christine Lagarde has refused to rule out a 2022 rate hike, which some interpreted as a hawkish pivot. It is clear that Europe will remain behind other central banks in raising rates, due to concerns about the sluggish post-Covid recovery and a fear that it could be jeopardized. It is also worth watching whether the ongoing geo-political strife will impact the pace of rate hikes globally.

Brexit Update:

Most news regarding Brexit was focused on individual trading arrangements and protocols relating to matters such as medicine moving from GB to Northern Ireland (where two sets of regulatory regimes apply) as well as arrangements regarding data transfer. The focus has now shifted to the wellbeing of the overall economy as it emerges from Covid restrictions and we have discussed this above.

Individual Asset Class Performance.

- Equities
- Fixed income
- Other asset classes

Equities: A Change of Tune

Equity Index	Year to date (March 3)	1 year
FTSE 100	-0.23%	10.78%
S&P 500	-7.35%	15.88%
Nasdaq	-12.02%	14.27%
Dax (Europe)	-11.9%	-0.44%
Hang Seng	-4%	-23%
Shanghai Comp	-4.3%	-0.64%

Equity markets had a very mixed start to the year with pronounced weakness among the higher growth names and tech "darlings" that had run up the most in 2021. The older economy indices such as the FTSE and the DAX saw some renewed interest, as did emerging markets, in particular Asia, in recent weeks.

While recent volatility can be unsettling, it is worth returning to the chart below as a reminder as to how frequently markets can actually decline by 5% or more, and what's more how relatively short the time to recovery can be. For now we sit at the top of the chart below. If challenging conditions persist and the drawdown deepens, only then should we start to consider it more than typical market volatility.

Declines in the S&P 500 since 1946

Decline	# Occurrences	Approximate Frequency	Average Time to Recover (in months)
5%-10%	84	~ 1x per year	1
10%-20%	29	~ Every 2.5 years	4
20%-40%	9	~ Every 8.5 years	14
40%+	3	~ Every 25 years	58

Source: Guggenheim

Fixed Income/Credit: the hike we had been waiting for

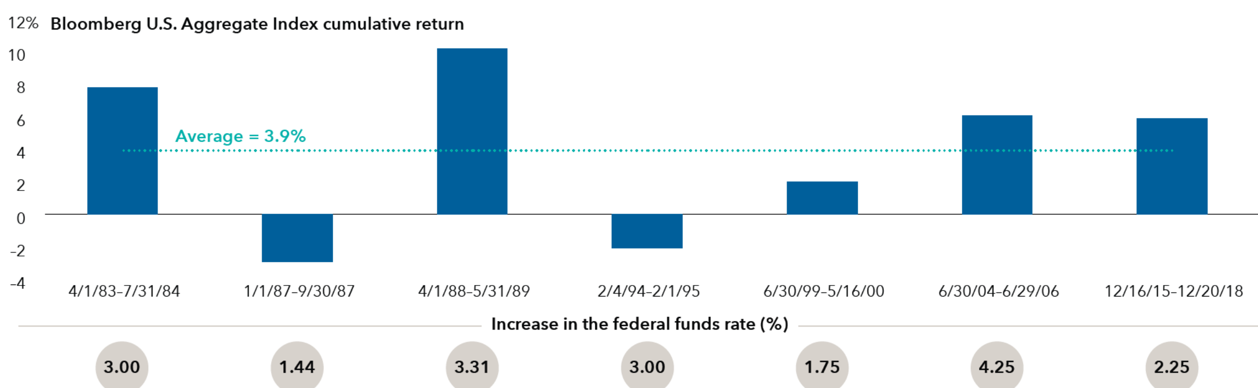
While last quarter we noted that expectations of a rate hike had “missed the mark” those rate hikes came in the past quarter and look poised to continue as noted above. Performance throughout the fixed income complex has been lacklustre over recent months, with the exception of private credit which has seen returns in line with expectation.

There is some demand for government bonds as equity markets wobble, and the drop in the Gilt yield in recent days in the UK suggests that there is a belief that Bank of England hikes will level out sooner than had previously been thought. The drop in the Gilt yield indicates renewed demand for government debt suggesting both a desire to hold “safe” assets, and a “risk off” mentality as well as a belief that future interest rate hikes will not be too large.

The US 10-year bond has recently seen its yield adjust to 2%, which is the highest it has been in some time, indicating some expectation of interest rate hikes. The fact that it has been fairly range bound also indicate a ceiling on rate rise expectations into the future.

A rising rate environment is often thought of as being poor for bonds, but as the chart below shows (US based) it has been possible to generate decent if not spectacular returns from bonds even in a rising rate environment. This confirms the importance of the role of fixed income in a diversified portfolio.

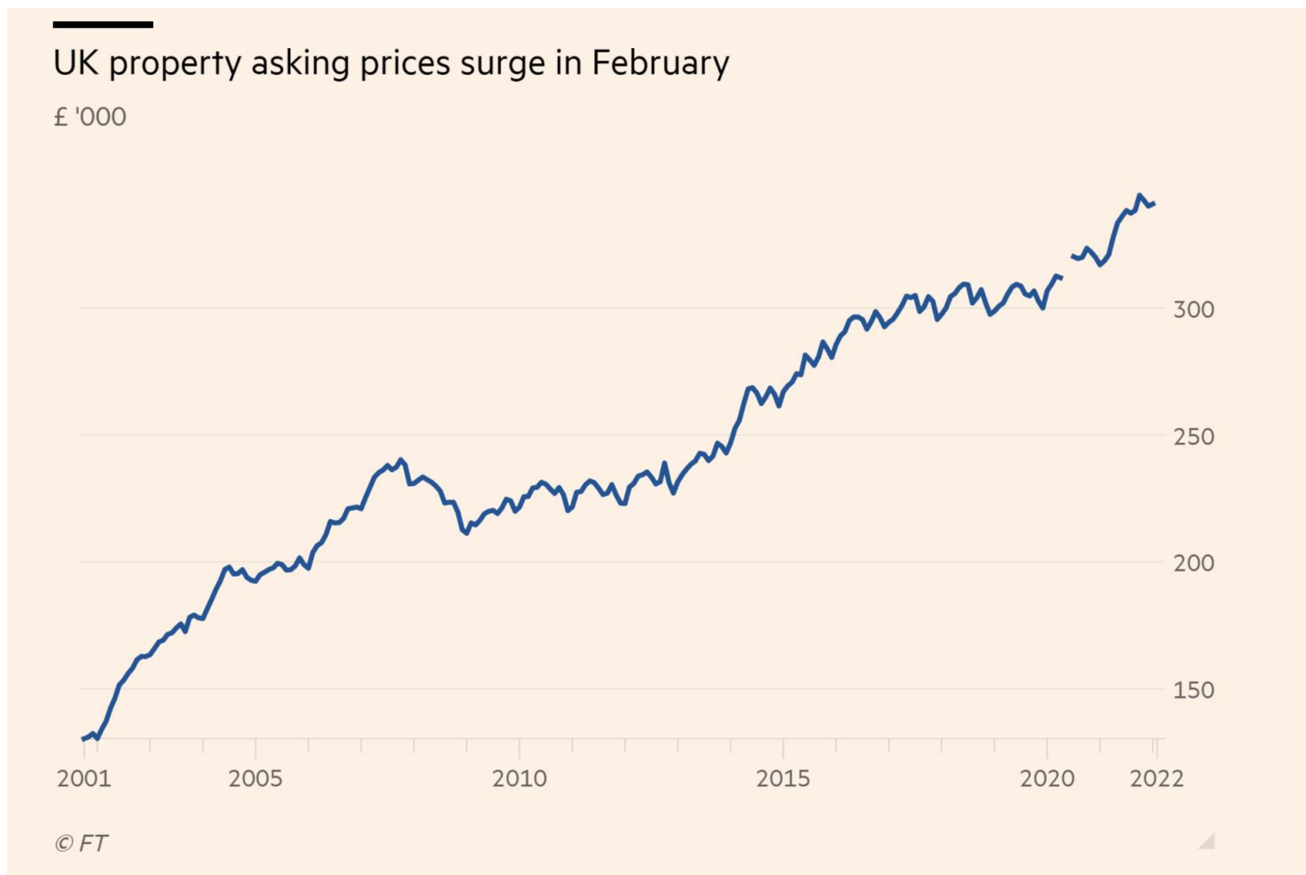
Bonds can still do well in rising rate environments



Other asset classes

Oil prices remained strong (up 22% year to date), as did natural gas, supported in the near term by tensions between Russia and the Ukraine and potential uncertainty around gas prices.

Housing prices remain robust in the UK with asking prices “surging” in February and following an increase of over 10% in 2021, the fastest level in 15 years.



Private equity activity remains robust as does infrastructure and private debt investing.

Spotlight: Levelling Up and What May Lie Ahead

In early February the UK government released its Levelling Up white paper, and some of the highlights are contained below.

The White Paper is focused on ways to transform places and boost local growth, and plans to publish plans for working with local government pension funds to increase local investment, including setting an ambition of up to 5% of assets invested in projects which support local areas. These investments may include investments in housing, transportation systems, urban infrastructure and sustainable energy production, among other areas.

In a recent LGPS forum though the following refinements were noted:
1.‘Local’ investment is in the context of the UK only, not necessarily a local county or region.
2. It will be mandatory only to have a plan, not to invest in a certain way.
3. 5% is not a ceiling so more would obviously be permitted and desirable.
4. The government is looking for ‘new’ investment - i.e. existing LGPS investments that meet the “Levelling up in UK” description don’t count in the 5%
5. A further extensive consultation can be expected in the - which will cover not just the 5%, but also climate change and pooling guidance.

This suggests that infrastructure investing, particularly within the UK, will obtain ongoing support and will be encouraged. It is imperative, however, that such investments are compatible with good portfolio diversification and reaching the overall return objective. This is particularly of concern now that infrastructure investments continue to attract crowding and compressed returns are expected as a result.

We will continue to watch as more detail for the levelling up agenda is published and report on the implications and opportunities for the Fund.

Outlook

We are echoing again our prediction of two past quarters now: **VUCA** - volatility, uncertainty, complexity, and ambiguity. As geo-political tensions mount and markets continue to churn with a volatility that feels somewhat unfamiliar it is clear that emerging from Covid restrictions and their effect on economies will be a marathon and not a sprint. While the disease may become endemic, the initial shocks will take longer to settle. Interestingly despite the chatter in the aftermath of COP26 and the flurry of directional change that seemed to come out of that, the last quarter has had a decidedly old economy feel:

A focus on energy prices, a lookback to the high inflation levels of previous decades, a surge of interest in the “old economy” indices such as the FTSE 100 and a rising rate environment that favours financial stocks – all of this has drowned out much of the post COP26 newsflow.

In coming months we will be watching in particular:

- **Inflation – to the moon or back to earth?** At some stage the “base effect” will start to work with the current inflation figures, in that the already high prices will start to become the base

number (the opposite occurred in 2020 when the “base” number was artificially low due to lock-downs). This is simple mathematics – price rises off a higher base won’t look as eye-popping in terms of percentage changes and that may cool the media headlines somewhat. It will be critical to watch how energy prices impact the levels and how supply chain issues get resolved, and no small portion of this may depend on the outcome of the war in Ukraine.

- **All Eyes on Russia/Ukraine.** As the stand-offs, the skirmishes, the diplomatic posturing and the economic threats evolved into full-blown war this situation will be critical in coming days and weeks ahead in what has become the only genuine geo-political news item to move markets in many months.

- **Investment “starts at home”.** As normal operations return and Covid restrictions are lifted we will return to policies and objectives which will receive a renewed energetic push following months (if not years) “on ice”. Some of this attention on LGPS schemes may be unwelcome and may vary from oversight of local investments and the requirement of a plan to increase them, to heightened scrutiny on the high funding levels currently in effect across many underlying Funds. With more consultation also likely on pooling, it is to be hoped that none of these planned policy changes will stymie progress currently underway.

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March 3, 2022