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## Russian Roulette and Stable Geniuses

The year was already fraught with uncertainty and unease, but it was until the second quarter that the "wheels really started to come off" in markets and investor sentiment. As supply chain problems persisted, notably within the energy complex, price inflation proved stubborn and central banks moved to action – suddenly it seemed that investors had nowhere to hide.

While most stocks were generally weak (with the notable exception of energy producers), technology stocks, with their eccentric leaders, disruptive governance and breathtaking valuations provided a steady stream of drama (e.g. Elon Musk and his offer for Twitter, Tesla, Cathie Wood and the Ark chronicles), while digital assets, the upstarts at the fringe of some asset allocations, saw sharp volatility to the downside.

The conversation around interest rate hikes and slowing growth inevitably returns to talk of Stagflation, but, notably, it is only the Bank of England that seems to dare speak the name of "recession ahead". Rate hikes are now in full train globally, with moves by the US Federal Reserve, the Bank of England, and the central banks of South Korea, Canada and Australia – all in response to rising inflation, while a rise by the European Central Bank is broadly expected this summer. A shutdown in parts of China have savaged economic growth numbers there as sales numbers completely stall in the cities affected, and the ongoing war in Ukraine is playing out on the European stage as NATO membership applications grow and access to energy (namely natural gas) is used as a weapon.

**Highlights since the last quarterly update:**

- **Inflation remains the core focus of central banks worldwide, and it appears that taming it and possibly stemming economic growth in the process is the priority. The Bank of England continued its streak of rate rises to bring its number to four, and UK rates now sit at 1%**
- **Fixed income had one of its worst starts to the year since recordkeeping began, with sharp falls in investment grade and high yield issues, as spread widening accompanied a climb in government bond rates, indicating broad expectations of further rate rises.**
- **Employment numbers remain positive, but GDP numbers are strained due to supply chain problems and a slowdown in exports as the global economy sputters.**
- **The de-globalization rallying cry remains a strong one – with some commentators expecting this to lead to more inflation, more local supply chains and ultimately more protectionism.**
- **The pressure on energy users remains severe and this has dialled up the pressure to locate alternative sources, avoid collapse (in the case of factories such as fertilizer factories highly dependent on energy as an input) and this is feeding through into food and commodity prices.**
- **Markets have experienced severe volatility globally and have touched technical bear markets and "corrections" with quite indiscriminate selling. This did turn more positive before trending more positively as the end of May approached.**

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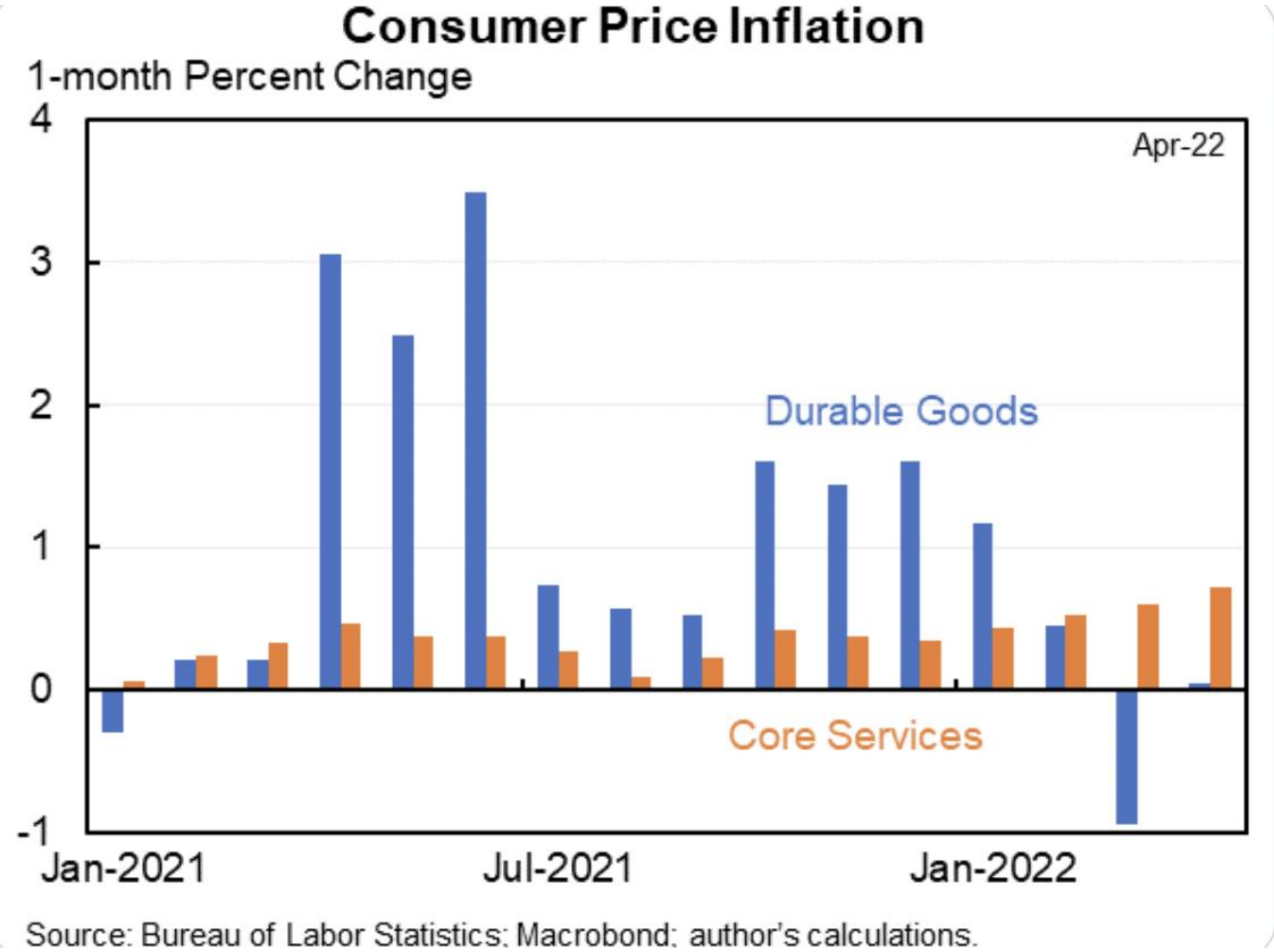
## Current Macro Snapshot

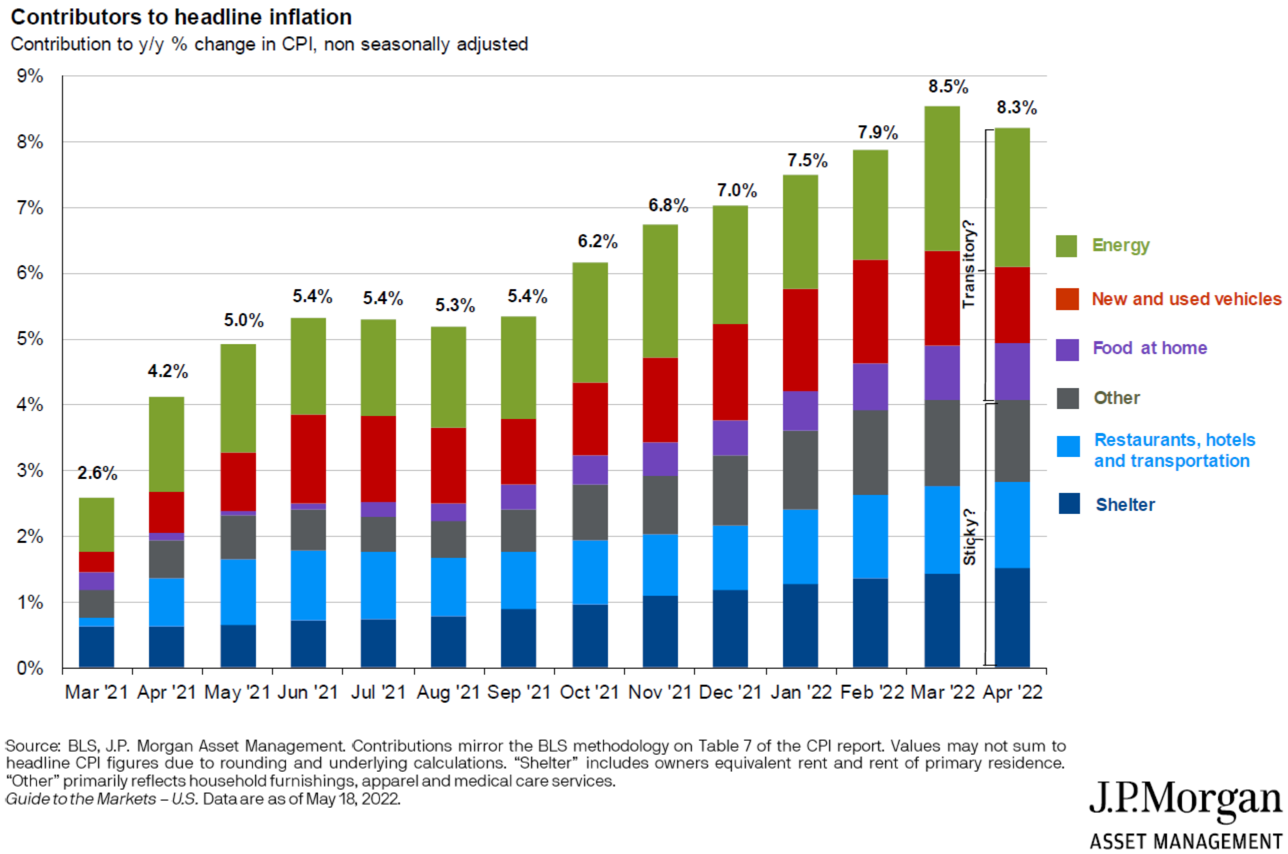
*Inflation and Interest Rate – "The Ayes have it"*

Inflation and interest rates (the two "Is") have been a recurring theme all year and remain at the forefront of macro concerns. Over the course of the quarter numbers hit 6.3% year on year in the US, remaining close to a 40 year high but slightly down on the previous month as goods prices fell although service pricing remained high in the face of strong demand.




In the UK monthly figures hit 9% in April, another 40-year high, due to "spiraling" food and energy prices in what was dubbed an "apocalyptic" environment for consumers.

Globally central banks have shifted from the "inflation is transitory" stance to one of growing concern, and much focus is now on what aspects of inflation are "sticky" – such as higher energy prices. As this interesting chart from JP Morgan shows, it is challenging to divide the components into what might be sticky or transitory, but they suggest that shelter and services are likely to be more persistent.

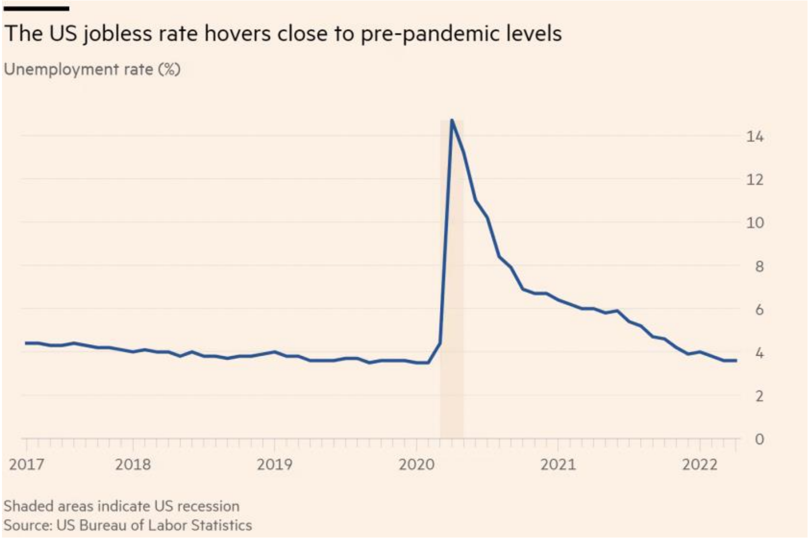



The other key "I" is interest rates, and currently a reasonably smooth upwards interest rate trajectory seems to be priced in by markets – with US bond investors expecting two consecutive 50 bps rate rises in June and July. Such has been the telegraphing of these rate rises that markets react in relief when the rise is "only" 50 bps, and not 75 bps, and when there is evident consensus in the decision making body, and not more aggressive, or hawkish, voice in the mix.

Only the European Central Bank has been sluggish in raising its rates, although the first rate rise in a decade is expected in June or July of this year. Their reluctance might be explained by the sagging growth numbers across the area as shown below:


Meanwhile in the UK (as shown below in the separate section) there are also signs of weakness.

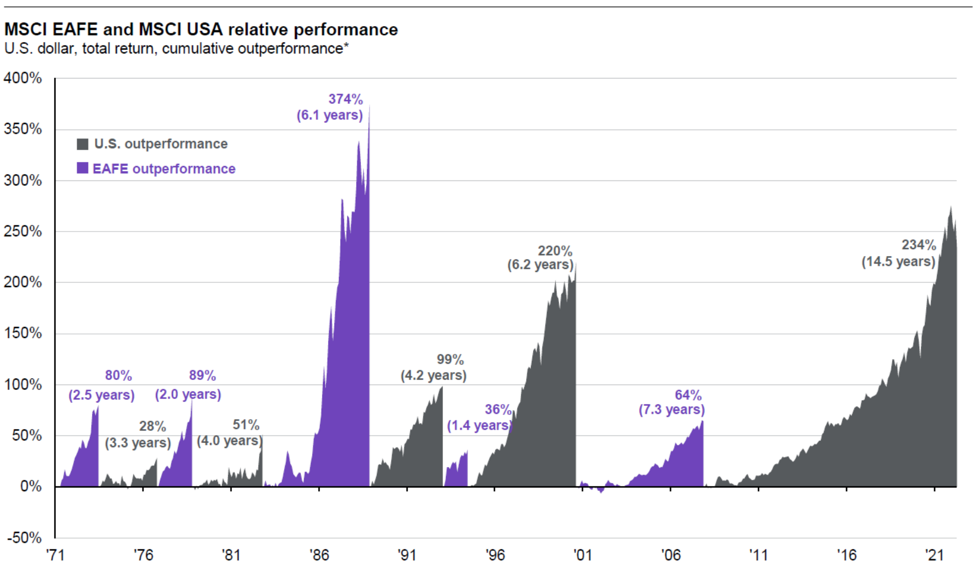
The only resilient bright spot in the current economic outlook is employment, and as the chart below shows and as numbers have repeatedly supported, the employment picture is generally strong. This chart is from the US, but the same skills shortage and low unemployment rate is a feature globally.




Commodity prices continue to drive higher, sparked by the contagion effect of energy, and this is seen as both underpinning inflation as well as threatening earnings and margins at companies.


*Fiddling While Rome Burns?*

As the equity performance chart below shows Europe's performance has been sluggish as its dependence on energy from Russia and its proximity to the Russia/Ukraine conflict has stymied growth projections and created more uncertainty. It is clear that US performance has strongly outpaced non-US markets now for well over a decade (see chart below), but surely from looking like a chart like this it would suggest that some form of a course correction is possible?




*Brexit Update and UK economy*

The outlook for the UK economy remains subdued as indicators such as that below show a reduction in consumer confidence and purchasing manager behaviour.


While discussions around Brexit continue, particularly as it relates to the Northern Ireland protocol, there are small wins on the trade side, such as signing deals with individual US states (e.g. Indiana). 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.**

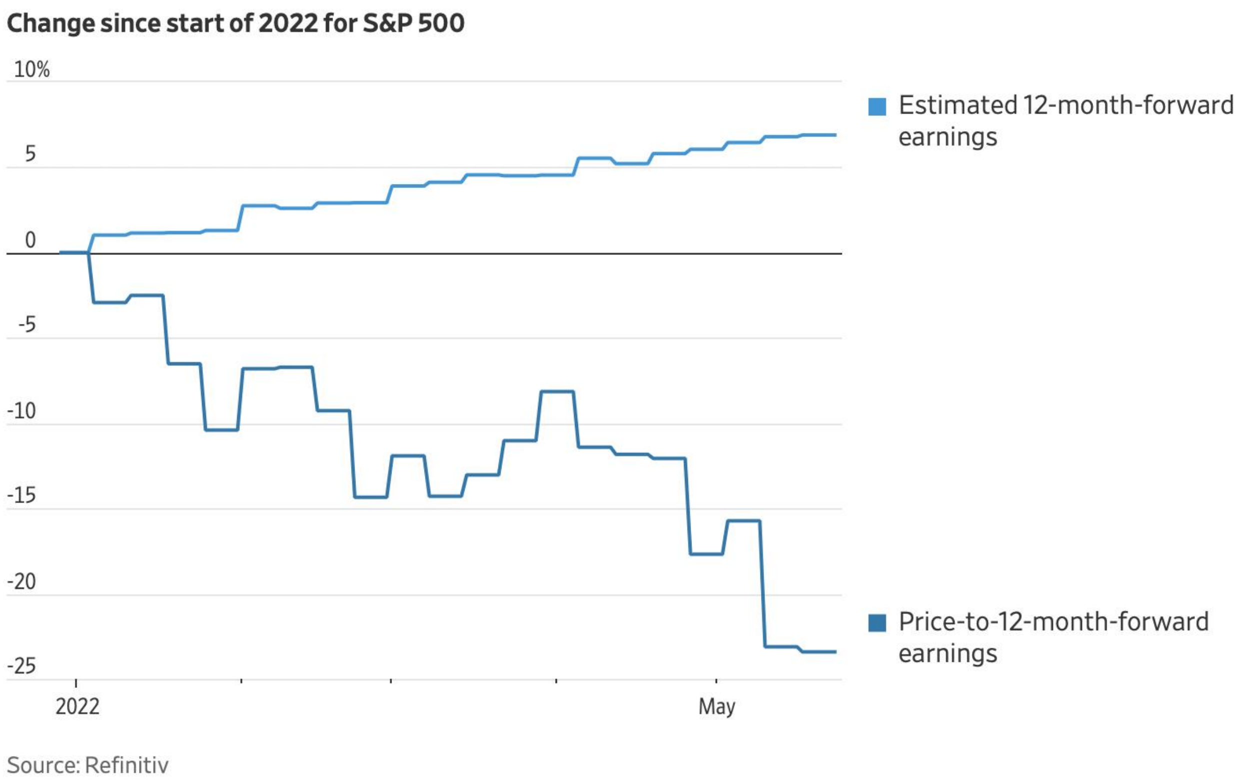
- Equities
- Fixed income
- Other asset classes

**Equities: A pattern of volatility becomes the norm**

| **Equity Index** | **Year to date (May 30)** | **1 year** |
|---|---|---|
| FTSE 100 | 2.7% | 7.99% |
| S&P 500 | -12.13% | -0.46% |
| Nasdaq | -22.46% | -11.77% |
| Dax (Europe) | -8.49% | -5.74% |
| Hang Seng | -9.72% | -27.54% |
| Shanghai Comp | -13.48% | -12.9% |

Equity market performance was particularly poor over the past quarter, although interestingly, whether due to the weak Sterling or the "old economy" nature of many of the FTSE stocks, the FTSE 100 bucked the trend by holding its own.

However, the monthly numbers, poor as they were, actually masked the volatility that was experienced intra-month. As the chart below shows, the correction in valuations – as expressed by P/E multiples has been swift, while earnings growth has actually been fairly steady, if unspectacular. This suggests that maybe markets have over-corrected and present good value today – it does not speak to massive valuation anomalies.




**Fixed Income/Credit: One for the History Books**

The most remarkable factor in the last quarter was the correlation of bond markets with equity markets and the fact that there was among the worst performance since records began for the year to date in this segment. The chart below shows the correlation between equity markets and bond markets year to date, and this double threat was particularly challenging for portfolios that may have resembled the traditional "balanced" style of 60% equity and 40% bonds. It is intriguing as to why bonds failed to provide their traditional "protection" function this cycle, although it may be due to the spectre of inflation, in which bonds typically provide poor protection, the unequivocal rising rate future – again – typically poor for bonds – and the likely end of the multi-decade bond bull market. It did underscore, though, why there was seemingly no place to hide this time around.

Finally, the sell-off in investment grade and high yield bonds raised the question as to whether any of it was justified in terms of likely default. The default rates during Covid famously came nowhere close to default rates hit during the financial crisis in 2008, and much debate centered on whether this was due to "extending, amending and pretending" by banks and credit institutions given the unprecedented "force majeure" which had intervened (Covid). Little would appear to have changed today, so it could well be that these sell-offs in bonds were overdone and unsupported by credit fundamentals. Time will tell, but certainly at the current levels returns look appealing in fixed income.


**Other asset classes – Untethered and Luna-cy itself**

Crypto currencies and other digital assets saw stark volatility in recent weeks, and while there are no such assets in the pension fund portfolio it is highly possible that digital "adjacent" assets – say those dependent on tokenisation or on the blockchain as infrastructure are creeping in at underlying portfolio company level in, say, private assets. What was remarkable about recent price action in these names is that it has sharped the discovery process as to how these assets behave. Many of the questions asked about digital assets are as follows:

*Are they inflation resilient – maybe because they rise in line with inflation like equities?* The answer to this would appear to be no, as the fears around inflation have caused a sell-off. On the other hand the assets that are traditionally inflation resilient like real estate, real assets and infrastructure have been supported. Gold, notably, has not done so well – perhaps as it was overlooked in favour of digital assets recently and it is only up 1% year to date.

*Are they hedges in a portfolio? Do they hold their value when risk assets sell off?* Again no, clearly they are more correlated with highly volatile tech stocks than with defensive stocks or assets, so they probably should be regarded to have the highest risk/reward profile of portfolio assets.

*Are they so widely held now that we can trust their infrastructure and so-called backing?* The answer to this would also be no – as the volatility in so called pegged coins such as Terra showed during the early month of main as well as the collapse of the Luna token. The complexity of these issues together with a poor understanding of the size and scope of the markets indicates that the infrastructure behind many digital assets is also still at thediscovery phase today.

Oil prices remained strong (up over 50% 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 although the pace of the price rises are slowing

Private equity activity remains robust as does infrastructure and private debt investing – although see the Spotlight below for more insights on this.

**Spotlight: Venture Capital and Private Market Valuations**

Private equity activity has soared in recent years and venture capital in particular is seen as the key portal to innovative investment minds as well as eye-popping investment returns. In 2021 venture capital deal activity reached record highs, at more than $150 bn capital allocated per year, and life-sciences and bio-tech remain the main areas of interest.

As before, this is an area where volume of activity (deals) matters as the hit rate can be low and the outcomes binary. On average, seven out of ten portfolio companies will not return even the money invested and the majority of this capital will need to be written off. Of the remaining three portfolio companies (out of ten), two are expected to return enough to cover all the losses; the third to provide the 20 to 30 percent internal rate of return (IRR) investors anticipate at the overall portfolio level – which could be a 10x or 20x multiple for that particular investment.

As the demand for diversification has grown, many investors have taken comfort from the lower volatility and mark to market experience in their private markets portfolio as these investments tend to be marked quarterly, so do not experience the same intra-month volatility. However, private market valuations are based on public market comparisons (or multiples) and as multiples have adjusted it can only be expected that private market valuations will follow suit – albeit at a later stage. We might therefore expect that in the quarters to come we will see an adjustment in private market investments that reflects some of the movement we have seen in equity markets in the first half of the year.

**Outlook**

The year so far has sparked talk of "regime change" and a new paradigm. I have dropped the term "VUCA[1]" for this quarter's letter as the uncertainty piece seems to be slowly resolving – and with it volatility. As the certainty about rate rises, and their magnitude, comes into focus, market volatility has become more subdued, and the initial revulsion around equities at their previous valuations has passed. Even the spectre of another world war seems to have fizzled out for now, as the might of the Russian army seems to have reached its limit. While other geopolitical shocks are possible, in 2022 the Russian/Ukraine situation did indeed "suck all of the air out of the situation room" and possibly tied up the "shock budget" for 2022.

In coming months we will be watching in particular:

- **Inflation – and bringing it to heel.** As was stated last quarter, at some stage the "base effect" will start to work with the current inflation figures, although the current prints are still persistently high. It will be interesting to watch inflation expectations evolve and how that affects consumer behaviour – i.e. whether consumers buy now to avoid higher prices later, or start to shift down to lower price point items or consume less (otherwise known as "demand destruction") and how that factors into company margins and their ability to stay the course.

- **The consumer unleashed.** As the summer unfolds before us, will we witness what has been called a wave of "revenge tourism" – a backlash to the travel restrictions enforced by Covid and a spending on services with some pent-up demand? Will this be supported by the strong job market? As Covid-induced restrictions seem to be receding (at least outside China, but now, importantly, within China with a "release" in Shanghai expected June 1), perhaps we are now getting to see the true shape of the economy, without artificial crutches and guardrails

[1] Volatility, Uncertainty, Complexity and Ambiguity

- **Central Bank conviction.** As central banks around the world dig into their toolkit to counter inflation, it will be fascinating to see how the messaging and telegraphing of moves differs, how some banks are more or less willing to stoke market upset, where the true boundaries of central bank independence lie.

- **Political and currency moves.** The strong dollar has correlated with the outperformance of the US equity markets on the global stage as well as the slightly higher forecasts for economic growth there, due in part to the lack of reliance on Russia for energy. The pending US mid-terms could bring a change of the composition of the legislative branch which could portend deadlock in Washington DC, more uncertainty and fewer tools to control the economic outcome. This is likely to erode the leadership position of the US in terms of market performance and we could see both the Eurozone and the UK start to see currency strengthening and their economies take the baton.

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**May 30, 2022**