...Saltus

Investment review for quarter ending 31 March 2022

WAVERTON | WEALTH

"There is nothing permanent except change"

Heraclitus, Greek Philosopher

The first quarter of the new year began nervously. After two years of living with the consequences of Covid, investors could have been forgiven for expecting a reduction in the pace of change and market volatility, but it was not to be. The quarter was instead characterised by a violent repricing of inflation expectations, a war in Europe, a strong response from central banks and overall, a sense that profound changes were underway in both the real and financial worlds.

Initially, the price weakness was concentrated in global bond markets, which moved rapidly and simultaneously to price in an outlook of higher inflation and, as a consequence, higher interest rates. This repricing had been long overdue, as it had been clear from economic data for many months that the consequences of Covid lockdowns would be generally higher prices. However, perhaps lulled by a central bank narrative that had been describing inflationary pressures as 'transitory,' markets had put off assessing the issue until hurriedly catching up with economic reality in early 2022.

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This catchup period delivered one of the weakest bond market performances in over two decades, reflecting perhaps a high degree of complacency around the inflation topic and the rich valuations which bond markets entered the year with. That complacency has now completely evaporated over the last three months as bond market volatility first skyrocketed, and then spilt over into other asset classes.

Equity markets unsurprisingly also struggled during this reporting period, particularly in those sectors which are interest-rate sensitive. Small and mid-sized companies in nearly all developed markets sharply derated, as did many richly valued growth companies. There was a strong sense of speculative froth being blown away, as investors adjusted to an environment where the easy liquidity conditions which came along with lockdowns and low inflation disappeared in the rearview mirror.

In late February the invasion of Ukraine intruded brutally into this already volatile and complex mix of investment conditions. The market effects were as instantaneous as the human ones, with oil and agricultural commodities transmitting the impact to the rest of the world overnight. The large footprint of Russia and Ukraine in commodity markets meant the disruption caused by sanctions and fighting, would impart another shock to the global supply system, acting to exacerbate the existing trends of higher inflation and slowing growth. All eyes began to turn towards the central banks to see how they would react to this evolving situation, particularly as many were seen as being 'behind the curve' or dangerously slow to react to the reality of conditions on the ground.

Ultimately the Western central banks, led by the Federal Reserve, delivered a clear message that their stances had changed, interest rates were going up and inflation-fighting was their core focus. Forward guidance was stiffened to show that in order to steadily bring inflation rates down over the next two years, interest rates would need to be considerably higher than previously thought. Bond markets moved quickly to digest these messages and by the end of the quarter had effectively priced in an entire interest rate cycle in three turbulent months.

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With all the movement described above, it is perhaps a little surprising that equity markets recovered nearly half their losses in the final month of the quarter, as opposed to bond markets which remained very weak. Signals from closely watched, and widely, held key government bonds are not optimistic, with prices implying that central bank hawkishness could ultimately tip economies over into a recession. The chances of a 'growth scare' and war-related pressures on consumer spending are undoubtedly real and have worsened the outlook since we came into the year. We think this will merit some adjustments to existing positions. However, the pessimism that is now embedded in some asset prices, as well as investor mindsets, seems to us to point more to a nuanced set of changes, reflecting considerable offsets to the negative issues outlined above.

Given the shock of the war to us all and the shock to many investors from the adjustments in bond markets, it is very easy to understand why it may seem that the outlook is much bleaker than it was only a few short months ago. However, it is still the case that the global economy is in good health and absorbing these shocks from a strong footing, buoyed up by pent up demand and the strong balance sheets of corporations and households. Growth will likely slow from above trend rates to something closer to trend as higher oil prices and interest rates take effect, but this lower growth rate is more reflective of a maturing business cycle rather than one which is ending. Monetary authorities in Japan and China are acting in the opposite direction to those in the West, continuing to pump money into their markets and economies and helping somewhat to offset the tightening in liquidity elsewhere.

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Inflation is indeed high, but the rates of change in prices needs to be maintained at high levels for this to become firmly embedded into expectations. That is certainly possible, but it is not the central likelihood, underlining the point that the shifts to our positioning should be measured and nuanced rather than dramatic or reactionary. For example, if the base case scenario is one of a maturing business cycle, then the type of equity exposures should shift to hold more stable, higher-quality investments than before. Higher interest rates offer acceptable returns for some traditional safe-haven assets for the first time in many years, and higher volatility offers tactical opportunities in all assets on a regular basis.

> **"Investments based upon fundamental valuation work, diversification benefits and return prospects provide a stable foundation for building portfolios, however complex the external environment."**

Looking forward it seems to us that the investment outlook is characterised by the same business cycle risks that it always has been, only this time the amount of indebtedness in the financial system amplifies market volatility and compresses time horizons more than it has in the past. This requires nimbleness from your managers in assessing threats and opportunities, but it doesn't require any changes to the principles underpinning our decision taking process. Investments based upon fundamental valuation work, diversification benefits and return prospects provide a stable foundation for building portfolios, however complex the external environment. Change is indeed permanent and always has been. The investment process we have in place is built around this fact and provides your investment team with the stability needed to manage your portfolios with confidence in these turbulent times.

The Saltus Investment Team, April 2022

	UK Equities	US Equities	Europe (ex UK)	Japan	Asian	Other Equities	Property	Alternatives	Bonds	Cash
MAP 2	5.4%	22.8%	3.6%	4.3%	3.5%	0.7%	2.8%	33.1%	16.0%	7.8%
MAP 3	6.6%	34.0%	5.1%	6.6%	5.6%	0.8%	1.5%	24.9%	9.4%	5.5%
MAP 4	8.4%	45.7%	6.8%	9.0%	7.1%	1.0%	0.5%	15.7%	2.1%	3.8%

	Quarter	Benchmark Quarter	Year to Date	Benchmark Year to Date	Benchmark
MAP 2	-1.25%	2.24%	-1.25%	2.24%	CPI plus 2%
MAP 3	-1.58%	2.50%	-1.58%	2.50%	CPI plus 3%
MAP 4	-2.19%	2.75%	-2.19%	2.75%	CPI plus 4%