Commentary on Responsible Futures MAP Performance

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Market Update

The recent increase in tensions between Russia and Ukraine has added volatility to markets which were already hit by concerns about skyrocketing inflation and interest rate hikes from the various central banks (predominantly the US Federal Reserve (Fed). As usual, when there are geopolitical issues, many investors want to run for the hills, acknowledging their lack of understanding of the situation and assuming it can get much worse.

What impact do political events have on markets?

Political events do not tend to derail the course of economic trends and fundamental facts. With the exception of world wars, most geopolitical events have created short-term volatility in markets which was ultimately reversed a few months later. In fact, the 3-month, 6-month and 12-month equity returns following such events are overwhelmingly positive. There are some cases where there were strongly negative returns over these periods, but this occurred against the backdrops of existing recessions or bear markets (such as post 9/11, after the Israel-Arab War and the oil embargo of 1973).

How should investors view the political situation in Ukraine?

There is a large industry of political analysts and commentators, who are doubtless better placed than we are to explain the current Ukraine situation and how it could develop over time. We do not claim to have that expertise, but we can say that events such as the one that is unfurling in the region should generally be seen as opportunities rather than threats for investors.

Will energy prices be affected?

It is true that energy prices have been rising as a result, further adding to the misery experienced by many consumers who have to overpay for petrol and heating. The reality is that such energy costs have been rising for a long time before the Ukraine crisis, and the additional pressure is unlikely to change the fundamentals for US, UK or European consumers. One noteworthy fact is that our economies are much less vulnerable to energy cost increases today than they were in the 1970s, whereas today we are overwhelmingly more dependent on semiconductors, which is why the chip bottlenecks have damaged our supply chains and contributed to sharply higher inflation.

Are there factors which could affect market volatility?

The current market correction has been triggered by the expectation of interest rate hikes in the US and elsewhere in the developed world. Until the Fed (and the Bank of England and other main central banks) is in a position to map out future rate increases with some clarity, markets could well be buffeted by conflicting expectations. The next meeting of the Fed takes place next month and could make a difference to investor sentiment. At the end of the day, the path of future inflation will determine how far central banks raise rates and there is still some uncertainty about where the peak price rises will be, how soon and how fast inflation could come down afterwards, and where it will settle late this year and next year. This may make this year more volatile than previous ones, but we should not forget that there are two components to a share price: interest rates and future earnings. Nothing indicates a drop in future earnings at this stage and indeed, companies have been able to maintain their profit margins in spite of cost increases. Historically, the pattern has been that when rates go up due to high growth and high inflation (which is the existing set-up), the initial market reaction is negative, but eventually, it is replaced by a more constructive backdrop as earnings come through. We see nothing today that tells us otherwise.

What is the outlook for inflation?

Inflation took markets by surprise last year and has reached unexpected highs with no current let-up, so it's easy to feel gloomy about prospects for prices and interest rates. While nobody can forecast inflation with any degree of accuracy, we can suggest that soaring prices have been caused by a one-off COVID-19-related phenomenon due to massive spending on goods during lockdowns. It may be too early to see the unwinding of this trend, but professional-driven markets (like bond swaps, for instance), as opposed to those that have more private investor influence (like equities) are telling us that long-term inflation is likely to be more subdued than what we are experiencing now.

In conclusion

One thing we have said and will reiterate, is that the worst asset class to sit on during a period of rising inflation is cash, whereas well-selected equities have an opportunity to eke out a gain after going through the market turmoil. The Russia-Ukraine situation is unlikely to change that statement, even if the military and political crisis lingers on for longer than is currently anticipated.