The World has changed

An unexpected start to the year.

The new year began very much to que, with the global economy reflating. The main concern for markets being how fast and hard Central Banks were going to tighten monetary policy with interest rate hikes and tapering. Whilst the economic recovery appeared text book; the extent of growing supply chain issues with essential goods, transportation bottlenecks, and labour shortages were not. Each of these were adding fuel to the already blazing inflation fire, and in the first half of the quarter interest rate expectations rapidly heated up. This in turn hit both bond markets and growth focussed equities hard, with many equity indices falling around 10% by the middle of the quarter.

The only exception in equities were sectors that underperformed during the covid crisis, including banks, mining, and oil & gas companies. Sectors with a stronger ESG and Impact profile, which had a higher growth exposure, tended to suffer more in the first part of the quarter. This was visible when looking at an array of market indices, which showed very different performance numbers. It was also a frustrating start to the quarter, as the reflation trend of 2021 continued with momentum rather than abate as anticipated.

In early February, events in Central Europe began to cause concern. The build-up of Russian forces on the Ukrainian border was alarming, but the tragedy that soon unfolded was even more of a concern, and not just for financial markets. Putting aside the appalling human cost of war, it is often said the first casualty is truth. Whilst this is true on one level, at a deeper level, war reveals longer-running truths and fault lines in society.

Most notable is Europe's over dependence on Russian oil and gas. Being the cheapest in financial terms, this overreliance now has high social costs for millions, which come on top of the environmental costs that are well documented already. There are other areas with an immediate economic impact. The European car sector's dependence on Ukrainian components, the UK's financial and legal involvement with Russian Oligarchs, and the world's exposure to Russian copper and nickel will all add to supply chain worries and costs.

Of even greater significance from a social perspective is the possible loss of exports of Ukrainian and Russian wheat. It will be felt in most developed economies with price rises, but the adverse impact will be felt much harder in the developing world where it is a staple rather than a discretionary commodity. Whilst we knew the pandemic would change the world, the events over the last six weeks have added to this tension.

The New Shape of the World.

Anyone old enough to remember the cold war will also remember the peace dividend that followed. Defence spending fell sharply and state finances were diverted to other areas. We have already seen Germany double its defence spending, and in what were already difficult times, this will have ramifications as funds are diverted from other areas.

At around the same time, the Japanese art of “Just in Time” manufacturing became fashionable. Globalisation of supply chains made them tighter and leaner, so business and consumers became used to ever cheaper goods being just a click away. Before the pandemic we saw some questioning of this, and the post-pandemic world, followed by conflict, has tested this to destruction. Nearshoring, local production, and sources of energy are now being considered in a broader context. There are some positive social and environmental benefits to this, but it will be inflationary in both the short and long-term.

Whilst fossil fuels enjoyed a boom as both a beneficiary of global reflation, and then further more from the sanctions placed on Russia, it has also sped up the desire for renewable energy on a global scale. The wider benefits of independence and localised production of renewable energy are increasingly apparent. In the short-term, this will be inflationary, but going back to the past is no longer an option. (We cover how portfolios are positioned for the future economy in our ESG and Impact review: Available via our website.)

Looking ahead, this may lead to more imbedded mid- and long-term inflation, (on top of the short-term higher cost push inflation we are already seeing), at a time when economic growth is threatened. Interest rates may still rise a little, as are taxes in many leading economies, and whilst this will reduce demand pull inflation, we expect the cost push inflation to persist. Whilst the ideal is that it pulls back and settles at 2-3%, there remain many risks and we do not see this scenario in the short term.

Fixed income fell in the quarter, and as an asset class, we have been negative on it for a number of years. In our view, we are reaching the point where we are close to over pricing future interest rates. As a result, this sector has become more interesting and over the quarter we added to fixed income exposure. The near-term risks with fixed income are still around tapering, and increasingly, credit quality as things become more strained, so our focus has been on quality of the debt and the underlying business.

In property, our exposure has been stable and is more defensive in nature, which led to no major changes in the quarter. We remain exclusively focussed on investment with a strong social impact. Social housing has seen a little pressure as some terms for new agreements have become a little more onerous, something that was expected.

The more defensive infrastructure focussed equities performed well in the quarter; higher wholesale prices for electricity helped sentiment, even though much of the business is on long-term contracts. As interest rate expectations began to fall back, and sectors such as renewable energy returned to favour, we have seen a recovery from mid-quarter lows. High risk investments which were hardest hit have also recovered from their lows.

Global equity markets finished about 5% lower for the quarter, but this number hides a diverse range of returns depending on sectors and prospects. We did anticipate volatility in our last report, but not quite the extremes we have seen.

Within model portfolios, the more impact focussed equities suffered due to their longer duration cash flows, although they bounced back as rate hike expectations eased in the face of the Ukraine and Russia conflict. The heightened volatility did create a number of investment opportunities, and in bespoke portfolios, we added exposure in areas such as clean mobility. We will be updating on any changes to model portfolios in the coming weeks with an investment committee imminently scheduled.

The interest rate outlook is still for further rises, the UK economy has just seen a tax increase for working adults and energy prices are beginning to impact households. The next three months contain a great deal of uncertainty and the rate of economic growth is less certain. Social, as well as physical infrastructure, needs to change for the new world and this favours many sectors we invest, and balancing this with wider macro-economic concerns will be our focus in the next quarter.

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