LIONTRUST

MULTI-ASSET PROCESS

Market review: March 2022

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- **A volatile month for Mr Market as war in Europe continues**
- **Central banks follow through on expected rate rises despite uncertainty**
- **Liontrust Diversified Real Assets Fund added across some portfolios as inflation keeps rising**

The least favourite word for investment markets is uncertainty and it feels like we have not witnessed such a continuously high level for generations. The return of combat in Europe, with the worst conflict since the Second World War and the spectre of a new form of global cold war, follows a global pandemic that refuses to disappear.

Any believers in the rule of three will be nervously wondering what the world might face next (although depending on political persuasion, some might suggest Brexit was the first harbinger of this extreme uncertainty).

Given such a backdrop, it is little surprise to see markets behaving like Ben Graham and David Dodd's allegorical Mr Market character, who circles through bouts of euphoria and dejection. We saw a short spell of the former in mid-March, with equities recouping much of the losses triggered by Russia's invasion only to fall again before rising towards the month end. China's efforts to address a range of concerns, including the ailing property sector, overseas listings and a clampdown on internet firms, was a factor behind the uptick, while underperformance from energy companies as the US and EU agreed to wean European countries off Russian supplies tilted the seesaw back again.

As we continue to stress, the best suggestion for Mr Market is to look through the short term as far as possible and focus on long-term goals; very few investors can trade this kind of volatility successfully and as multi-asset investors, that is not what clients are paying us to do. More corrections are likely this year, particularly if recessionary risk picks up, and well-balanced portfolios remain the best way to steer through this.

As always, however, we keep a close eye on downside risk and recently added the Liontrust Diversified Real Assets Fund (DRAF) across some of our portfolios. Real assets should hold up well against a backdrop of higher inflation and this Fund provides diversified exposure across this space without facing potential liquidity issues. This exposure includes more specialist parts of the property market enjoying structural growth such as healthcare, logistics and digital infrastructure.

We could comment on the war in Ukraine, especially the oil price, but there is little to say with certainty about how this situation may impact our Multi-Asset funds and portfolios. History shows geopolitical upheaval tends to have a limited effect on long-term investment performance and however distressing the Ukraine situation may be, it is hard to envisage the conflict derailing the global economy and the prospects for long-term investors. Beyond that, everything is basically guesswork and this is where a robust, repeatable investment process provides the discipline to look through short-term noise.

Despite uncertainty, central banks followed through on well-trailed plans to raise interest rates over March, with the Federal Reserve announcing its first hike since 2018 and the Bank of England confirming a third increase since December. Consensus seems to be moving towards the view that the US Federal Reserve is behind the curve on this, particularly as inflation edges towards the 8% level, and the dot plot chart shows at least another six hikes to come in 2022. As would be expected given such a hawkish scenario, the Bank confirmed it believes inflation concerns materially outweigh the downside risks to growth from tightening policy and the median forecast is now for a 1.875% Fed funds rate at the end of 2022 (versus 0.875% forecast in December) and 2.750% at the end of 2023 (versus 1.625% previously).

Recognising inflation may take longer to dissipate, particularly in the face of a burgeoning energy crisis, the Fed is also predicting the level will still be above the 2% target in 2024; the transitory label that persisted for so long is well and truly consigned to history.

In contrast, the Bank of England's (BoE) rate hike came with more dovish rhetoric, perhaps reflecting the fact it was first off the tightening blocks and is already three rises through the cycle. While eight of nine Monetary Policy Committee members voted for the 25 basis point hike, the lone dissenter called for no change, and expectations had been that at least a few members would have pushed for a 50bps uplift after four did so in February. In one of those changes of nuance so loved by central bank watchers, the BoE also shifted to saying that tightening policy 'might be appropriate' from February's 'likely to be appropriate'.

While inflation is expected to hit 8% in the second quarter, the Bank said it should fall 'materially and possibly to a greater extent than had been expected in February, as energy prices stop rising and the squeeze on real incomes and demand puts significant downward pressure on domestically generated inflation'. In a speech later in the month, BoE Governor Andrew Bailey delivered the sobering message that soaring energy prices are set to deliver a historic shock to real incomes in the UK, with the biggest fall in living standards in a single year since the 1950s. Bailey warned that resilience in financial markets cannot be taken for granted and authorities continue to watch the situation closely.

Coming finally to the European Central Bank, president Christine Lagarde quoted Bertrand Russell in a speech in explaining that we must learn 'how to live without certainty, and yet without being paralysed by hesitation' and said the role of monetary policy in today's circumstances is to provide clear guideposts regarding how the Bank will react under uncertainty. According to Lagarde, inflation dynamics over the medium term will not return to the pattern seen before the pandemic and the ECB needs to manage a shock that, in the short term, has pushed inflation above target levels and reduced growth. Echoing BoE dovishness, the ECB said it will act 'gradually and flexibly' to deliver its price stability mandate, outlining a conditional path towards policy normalisation if 'necessary conditions are satisfied'.

Given the increased chance of recession, it would be reasonable to expect additional short-term volatility in equity markets. Key parts of the US Treasury yield curve continue to flatten or are inverted, stirring debate on whether the bond market is flagging a steep economic slowdown or even recession to come. With accurate forecasting nigh on impossible, however, we continue to build our solutions from the perspective of preparation over prediction.

As always, we want to retain a broad array of return drivers and a recessionary environment is one where we would typically expect to see interest rates falling and gains from fixed income to mitigate losses from riskier asset classes. With interest rates still low, however, and expected to rise for the next few years, scope for capital gains from bonds could be modest. The 10-year gilt yield today is a relatively meagre 1.6% and US 10-year Treasury yields are around 2.4%, with the latter suffering one of their worst quarterly routs since at least the early 1970s in the first quarter of 2022. Bonds remain an important part of our portfolios but we remain cautious on beta in this area and remain both underweight duration and focused on areas with more alpha, such as index-linked bonds and high yield.

Elsewhere, cash rates are also low and offer no prospect of a real return at present but the cash holdings in our portfolios should provide a short-term safe harbour from additional equity volatility. We recently increased cash's ranking in our quarterly target tactical asset allocation review from one to two (where one is the most bearish and five the most bullish).

Stock markets remain the most crucial asset class when considering long-term wealth creation: the risk they bring has historically given ample reward for patient investors but with the *quid pro quo* of volatility along the way. Although it can be difficult to believe during periods in which Mr Market is manic, stock markets are fairly regularly positive even for the most sedentary buy and hold strategy. It may seem a strange assertion at a time like this when the temptation is to be seen to be doing something, but making rash changes to Multi-Asset funds and portfolios during times of duress is rarely a sensible strategy.

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