LIONTRUST

MULTI-ASSET PROCESS

Market review: April 2022

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- **Central banks face a balancing act between controlling inflation and tipping economies into recession**
- **Covid outbreak in China spooks markets already concerned about frozen supply chains**
- **Ongoing volatility supports our central case for lower returns from US equities this year and beyond**

April was another difficult month for markets and while the direction of fundamentals remains as it was, the magnitude has changed and we face a backdrop where inflation will be higher and growth will slow quicker than expected until very recently. This has left central banks struggling to maintain a balancing act between tighter policy to curb spiralling inflation and not tipping economies into recession, and the key question, beyond geopolitical concerns, is when we might ultimately see peak hawkishness.

Highlighting the level of volatility, the S&P registered its second correction – a drop of 10% or more – so far in 2022 over the month, just 22 days after it left the previous one, the fastest re-entry since the height of the Global Financial Crisis (GFC) in November 2008.

As always, we stress that we see little to be gained by aggressive trading in such an environment. There will ultimately be opportunities for patient investors from this volatility, particularly in heavily sold-down growth companies, for example, but we continue to resist any temptation to fall into the busy fool trap. While current newsflow is broadly negative, the best antidote to short-term volatility is focusing on long-term outcomes and, post-corrections, equity markets may look even more attractively valued.

Turning back to immediate issues for now, Covid did its best to nudge war in Ukraine off the chief source of volatility perch over the month, with fears around a worsening outbreak in China enough to panic a market already concerned about frozen supply chains and their impact on inflation. Chinese stocks on the CSI 300 dropped to their lowest level in two years as the government locked down areas of Beijing and ordered mandatory Covid testing in one district.

This came after the country's central bank unveiled a suite of 23 measures designed to support the economy after data highlighted the impact of a wave of lockdowns on consumer activity. Many of these encourage financial institutions to support infrastructure projects and the country's struggling property sector, as well as providing financial services to industries hit by the pandemic. The People's Bank of China also cut the reserve requirement ratio for banks by 25 basis points (bps), injecting more liquidity into the financial system as part of a gradual easing cycle, and billions in yuan wiped off stock prices over the month was clearly not in the script.

Rising inflation is proving toxic for markets and causing asset class correlations to increase, with equities, bonds and currencies all taking their cue from a price spike that is proving anything but transitory. Meanwhile, events in Ukraine are beginning to weigh on economic predictions, with the IMF drastically reducing its global growth forecasts for 2022 from 4.4% to 3.6% and citing concerns that Russia's invasion could lead to the fragmentation of the world into rival blocs. The Fund said every member of the G7 would grow less rapidly than expected this year and there is a strong risk of even worse outcomes. The UK could be facing a particularly perilous period, for example, with a rapidly deteriorating outlook in 2023 as GDP is expected to fall to 1.2%, leaving it with the weakest growth and highest inflation in the Group.

This combination has commentators whispering the dreaded stagflation word and the world appears to be in economic territory not seen for a generation or more. Given the fact we are still in the teeth of a pandemic and have war in Europe, this is hardly surprising, with Covid simultaneously damaging global demand and driving a supply-side shock via shrinking workforces and clogged up production in many parts of the world. Huge bouts of quantitative easing and ultra-low interest rates, alongside other policies, were designed to boost demand and where this ran into limited supply, the inevitable result was inflation, which Russia's invasion of Ukraine, sparking energy price volatility, has clearly intensified.

Looking to the rest of the year and beyond, there seem to be two paths out of this situation: the first is a lurch into recession under pressure from falling real incomes, and the second the considerably less painful inflation falling back of its own accord as supply difficulties are resolved. For our part, we continue to believe the latter will begin to happen as Covid base effects work their way through the system and bring inflation back to more manageable levels: the UK's Office for Budget Responsibility, for example, expects inflation will be back below 4% in a little over 12 months' time and below 2% by the end of next year. Whether that is enough to avoid recession, on the other hand, is another matter.

We always build our portfolios from the perspective of preparation rather than reaction and while we maintain the view that inflation will drop, we added index-linked bonds back in 2020, remain underweight duration on our bond allocation (as central banks continue to debate rate hikes and tightening), and recently added the Liontrust Diversified Real Assets Fund (DRAF) across several portfolios. We believe real assets should provide a differentiated return and income profile and, importantly given the backdrop, an element of inflation hedging.

Markets continued to digest inflation data over the month, with US figures coming in at 8.5% for the headline number, the highest in four decades, but better-than-expected at the core level that excludes volatile food and energy prices. This initially prompted traders to pare back expectations on how aggressive the Federal Reserve might be but an early sign of what to expect came as New Zealand implemented a half-point hike, its biggest in 22 years, highlighting the trend of sharp tightening across economies grappling with price pressures. Fed chair Jay Powell gave a strong indication he was on board with a 50bps rise in May and we saw exactly that in the early days of the month, with markets now pricing in half-point hikes for the next two meetings up to July and 0.25% increases after that.

Shortly afterwards, the Bank of England also pushed ahead with another 0.25% increase (the fourth since December) but while its focus remains firmly on inflation control, it does seem more concerned about slowing growth than some other central banks. From one of the most hawkish at the start of 2021, the BoE has become a more hesitant hiker.

In contrast, the Fed appears to have abandoned its implied asset volatility management as it looks to bring inflation expectations back under control, even if it means risking an equity sell off. Along those lines, we saw Fed official James Bullard test waters around a possible 0.75% hike this year as part of moving 'expeditiously to neutral' and reaching a 3.5% rate by the end of 2022. He highlighted a similar 1994 move by Fed chair Alan Greenspan in response to a fairly modest rise in inflation, which led to one of the strongest macro periods in US history over the latter half of the 1990s. Somewhat reassuringly, Powell appeared to push back on a 75bps hike the market was already starting to price in, managing – for now – to square the circle by implementing the largest rate rise since 2000 whlie still surprising market expectations on the dovish side.

A more troubling look at recent history can be found in the narrative – trumpeted on the front page of the 23 April *Economist*, no less – of the Fed that failed and pressure on Powell and colleagues to attack inflation and, in macro parlance, 'do a Volcker'. In the early 1980s, Fed chair Paul Volcker hiked rates from 11.2% to the highest ever level of 20% by June 1981, often in 2% increments and at unscheduled meetings. To put this in context, he was fighting record-high inflation, touching 14.6% in 1980, and no one is suggesting we will see anything like that this time on either front. The stark truth, however, is that evidence shows raising rates high enough will ultimately bring inflation down and we are approaching a point where evasive action may be needed.

Worryingly for investors, Volker's hiking caused a bear market for equities: from a peak in November 1980, the S&P fell for the best part of two years and finally bottomed out in August 1982, down more than 27%, before proving the definition of V-shaped by getting back to that previous high 83 days later in November. During this period, the US inevitably fell into recession, with a national unemployment rate climbing above 10%.

Bringing things forward to today, Deutsche Bank was first to raise its head above the parapet and predict the Fed will trigger a US recession by hiking rates above 5% by the end of 2023. Whether or not this proves overly pessimistic, we are clearly only in the foothills of tightening: analysis of 13 Fed rate hiking cycles since 1955 (by

Deutsche Bank again) show these have lasted an average of just under two years and recession has typically followed around three years after the first hike.

All this uncertainty continues to support our view that returns from stock markets, particularly the US, will be lower this year, which would put pressure on the many Multi-Asset funds with passive equity exposure, where the American weighting has crept upwards over recent years.

Given the huge impact of technology names on overall performance, Netflix's precipitous decline could also provide an interesting indicator. Shares have tumbled as the streaming company revealed its subscriber numbers have fallen for the first time in more than a decade over the last quarter and more are expected to drop off, with growing competition and the worsening cost of living crisis starting to bite.

As a counterpoint, however, Apple recently registered its best fiscal first-quarter results in half a decade so anyone predicting the death of the FAANGs may be very early to that wake.