CS INVESTMENT MANAGERS

VIEW FROM THE SQUARE

February 2022

Spiking the Punch Bowl

January 2022 has not started where 2021 left off. The all-time highs across various equity markets last year have receded on the back of concerns surrounding inflation, which has caused central bankers across the globe to consider raising interest rates and reducing asset purchases. The US Federal Reserve (the Fed) has indicated that several rate hikes over the course of the year are planned, in addition to "rolling off" the Fed balance sheet, by no longer providing the same degree of ongoing purchases of low-risk assets (such as government bonds) from the US banking system. A reduction in banking system liquidity, in conjunction with a rising interest rate outlook, has not been taken well by investors this month, with equity indices falling across the board.

Asset prices across various investment markets, including key equity and bond markets, are being impacted by a rising cost of capital as a result of the US base rate rising. This is because asset valuations are calculated with consideration of the level of interest rates, with additional discounting in price considered for any rise in this key measure, as well as inflation and/or perceived asset-specific risk.

The base case now is for 5 rate rises this year of 25 basis points, which would raise the US target base rate to 1.25-1.5%. At the turn of the year, the market was braced for one rate hike by the May meeting. Now it has fully priced in two, which many believe will come in the form of a blunderbuss 50 basis points hike at the next Federal Open Market Committee meeting in March. Within 12 months five hikes are now priced as a certainty. That's a radical shift in expectations and investors now appear to fear that the Fed may be spiking the proverbial market's punch bowl.

The effect the Fed is hoping for is a reduction in the rate of inflation, which is now running at an uncomfortably high figure of 7%. While an element of this is no doubt due to the one-off substantial rise in several input costs because of a recovery in post-pandemic economic activity, there is a fear that some of this may prove to be "sticky" or even prove to be self-reinforcing. We expect the headline figure of 7% to fall over the coming period, but we do however expect it to remain relatively higher than it has been in recent years.

This issue is not isolated to the US, with the Bank of England also poised to raise interest rates later this week from 0.25% to 0.5%, with the market anticipating gradual rises to eventually reach 1.2% by year end. We expect that some of this hawkish interest rate outlook is already priced into markets, however we do expect some volatility over the year ahead as expectations wax and wane upon consideration of unpredictable inflation prints over the course of the coming year.

There will always be risks, but how one responds is always what really matters. Fortunately, the world is constantly changing and evolving. There will be many weeks and months - and sometimes even years - when financial markets perform in a dull or disappointing fashion, but such movements can also provide opportunities.

At present, we continue to focus on quality companies in the equity space, which can pass on rising input costs to consumers and trade at reasonable valuations. The highly priced growth stocks, such as US large cap technology stocks which we do not generally hold, have suffered the most over the last month and we expect where valuations remain stretched, this trend will continue. There are however, "recovery" theme stocks which are set to benefit from the reduced impact of Covid restrictions this coming year, in areas such as industrials, travel and leisure sectors which look attractive.

In the Fixed Income space, we remain invested in shorter duration bonds to minimise the impact of rising rates. We will, however, continue to review this space and if bearish sentiment feels overdone, we will look to make tactical investments where mispriced opportunities present themselves.

Real assets continue to be our favoured area of investment for the year ahead. Property and Infrastructure assets continue to trade on reasonable valuations and still present good opportunity for upside, while providing some form of inflation protection from the underlying cashflows. If high levels of inflation continue to persist this year, these holdings should not only provide a relative degree of stability in portfolios when bonds prove to be more volatile than before, they also present the scope for capital upside. The latter point is particularly the case where a selective approach is taken and a mispriced opportunity can be identified, which is something we will continue to look for and capitalise on.

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