CS INVESTMENT MANAGERS

VIEW FROM THE SQUARE

March 2022

Keep Calm and Carry On

The events of recent weeks in Eastern Europe have dominated TV, radio, newspapers and online news. These events have also seen market sentiment deteriorate as investors increasingly price in the prospect of damage to the global trade environment. Meanwhile, the prospect of a greater inflationary burden than was anticipated at the beginning of the year has also led to a repricing of risk, as the supply of key energy sources has come into question, pushing the price of oil to a 7 year high.

There is no doubt, that certainly in the short-term at least, the global growth outlook has deteriorated because of the war between Russia and Ukraine. Western powers have responded swiftly with sanctions which will hurt the Russian economy. Even the historically neutral geographies such as Switzerland and Monaco have joined in this, which is unprecedented relative to previous wars.

As with many matters in life, the most important element is how you respond to challenges, uncertainties and sources of volatility. To this end, it has been noteworthy over recent days that the economic restrictions on Russia have been applied more quickly and more thoroughly than in other historic geopolitical crises. Unfortunately, it has not yet stopped the invasion of Ukraine, but it has significantly heightened the rationale for a return to peace.

Markets are priced for a medium-term disruption in certain sectors, but not priced for a broader disaster. You can see this in “safe haven” assets (such as government bonds, the Japanese Yen etc), where the flight to safety has, so far, been measured. The big issue going forward, as far as we see it, is the potential for a further rise in inflation and, in particular, key commodity prices. It is already looking as if central banks have moved too slowly to combat this issue.

The invasion of Ukraine may now make rises in interest rates less likely in the short term but also more necessary in the medium term as inflationary pressures grow. Unfortunately, events also make it likely that the post-Covid economic recovery we have been looking forward to will be weaker, especially in Europe. Raising interest rates to control inflation when economies lack resilience can lead to stagflation (high level of inflation, accompanied by a low degree of economic growth) and unhappy times for equity investors.

The conventional investing wisdom is to ride out market storms, particularly if you are investing for the long term. Historically, the best outcomes have been for those investors who have been diversified. Equity investors have seen relative outperformance during periods of heightened uncertainty and inflation via allocations to a combination of defensive "value" equity sectors (such as consumer staples and utilities) and inflation beneficiaries (such as energy and basic materials). We are currently overweight these areas of the market in our strategies.

In addition, other asset classes which thrive on inflation and see their underlying cashflows grow from rental or contractual payments linked to the rate of inflation, include property and infrastructure holdings. We have also been overweight these areas going into 2022. Other Alternative asset classes are also likely to be beneficiaries of this trend, such as Gold which remains a key theme in some shape or form across our portfolios. Gold has a strong inverse correlation with geopolitical, inflationary and monetary uncertainty. With this in mind, many portfolios have seen an increase in their allocation to this area in recent days, as the current trend continues.

Looking ahead, from an investment perspective, we believe it is key to watch the interplay of energy prices and inflation expectations. We dialled down risk-taking as we entered this year, because we saw a risk of confusion amid a confluence of unique events: the economic restart, spiking energy prices and new central bank frameworks. This confusion has played out: Market expectations of rate hikes have become overly hawkish, in our view, particularly as a result of events in recent weeks.

We remain tactically prepared to take advantage of market opportunities as and when they arise, both to help preserve the value of our investment strategies, but also enhance them when clear areas of mispricing emerge. We remain calm and prepared to act should market conditions deteriorate. Typically, however, a year on from the point of the invasion, financial markets most often demonstrate broadly positive returns following localised wars. In this case, we have the additional concern of broader inflationary forces, but we have positioned to either directly benefit or reduce the impact of this dynamic in underlying holdings, should this trend persist.

Finally, we would note that the point of maximum "pain" in markets often accompanies that of the greatest uncertainty. Right now, we are seeing this uncertainty in energy markets and geopolitics. Historical returns following periods of heightened uncertainty demonstrate that patient investors should be rewarded in due course, provided they are willing to "keep calm and carry on". This is the approach we are continuing to take, but with the added protective approach to tactical positioning in assets best suited to weather future storms which may lie ahead.

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