CS INVESTMENT
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# VIEW FROM THE SQUARE

April 2022

## The Winds of Change...

Since our last publication of View from the Square, the wider market outlook has changed dramatically. While a humanitarian tragedy continues to unfold in Ukraine, markets have proved to be somewhat resilient in the face of mounting macro-economic concerns. To put it candidly – traders have been insensitive to both the humanitarian and macro-economic issues unfolding. We disagree with this viewpoint on a one to two year view, despite the “music still playing” and markets recovering in recent weeks from their earlier selloff. For now, we continue to benefit from these trends, but we are positioned more conservatively than previously given the longer-term implications at play.

Just yesterday, the US government bond yield curve started to invert - a signal whereby the yields on shorter dated bonds begin to exceed those of longer dated maturities (in this case, the US 2-year government bond yield has risen above that of the 10-year yield). This has historically proved to be a fairly reliable indicator of an impending recessionary environment. While several of our peers and a chorus of economists are suggesting that “this time is different” (a phrase we generally approach with extreme caution) as the inversion is being driven largely by shorter term expectations rather than a much longer-term decline in growth and/or inflation assumptions, the outlook is far from as healthy as it once was.

Consumers are being hit by a number of key inflation factors, ranging from energy prices to commonly purchased goods in their supermarket baskets. The fundamental driver of this is not just a rise in energy prices, but also weakened global supply chains. The latter is a combination of the Covid pandemic and the ongoing deglobalisation trend we are witnessing from the Russian war on Ukraine, in addition to geopolitics surrounding technology nationalism and the redrawing of supply chains. The recent announcement of Intel’s $88bn European expansion is just one such example of this, as large companies begin to “wise up” to these trends and look to protect their access to key markets – we suspect that others will be less prepared and caught out by this trend over the coming period, which would likely continue to erode consumer confidence.

While these trends indicate that the outlook is not as buoyant as it was for equity markets in recent years, there are still attractive areas of opportunity in particular areas. Credit conditions are still supportive. High yield bond spreads (i.e. the yields on lower grade bonds relative to government bonds) have contracted of late, indicating that the corporate environment from a balance sheet and cashflow perspective is still healthy.

Meanwhile, certain sectors of the market are benefitting from the trends at play, with commodity related companies in particular demonstrating superior future returns potential, as a result of enhanced profit margins. Our allocations to property and infrastructure holdings are directly benefitting from higher rental and cashflow expectations due to rising inflation rates. This has meant that the impact of the recent market volatility on these holdings has been negligible.

The key viewpoint we would suggest that readers take away from all of the above is that the global economy has seen a regime change relative to the recent past – namely, higher inflation expectations, accompanied by slowing economic activity. We are continuing to find opportunities in this environment where returns can be made, but the overall approach has had to adjust to a somewhat more cautious one. The expected returns seen in strong performers of recent years (such as mega-cap tech) are highly unlikely to repeat – this is where the bulk of market-cap weighted indices and other investment managers are biased towards at present. We don't believe this approach to be wise and, like a captain of a ship, we are moving with the "winds of change" to avoid the pitfalls that would otherwise present themselves from being rigid or static in our approach.

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