Current Position

In the latter part of 2021, one of the greatest mysteries to investors was how bond yields could remain largely unchanged in the face of an ever-growing upturn in inflation. That mystery finally unravelled in the last four weeks, as the US 10-year treasury yield has moved aggressively higher from around 1.4 to around 1.8%. The catalyst has been the minutes from the latest Federal Reserve meeting, which suggest a much more hawkish tone than previously understood and the prospect that there may be several interest rate hikes in 2022. This derailed equity market indices that had begun the year setting new highs and 'growth stocks' bore the brunt of the sell-off.

Inflation in the US hit a nearly 40 year high this week with the December CPI report coming in at 7%. Jerome Powell testified before Congress, and as expected the Federal Reserve will continue the increase in monetary tightening.

Interestingly at least one data point, however, hints that the battle against inflation may have turned. The ISM supply managers surveys have consistently shown elevated worries about inflation and were the first significant indicators to signal a reason for alarm early last year. So the "prices paid" index reported by manufacturers was remarkably healthy. It dropped from 82.4 to 68.4, for the biggest one-month decline in more than a decade. It also fell below the average forecast reported to Bloomberg by the most since the survey started 20 years ago. This was a very surprising big improvement, which suggested that supply constraints must have eased significantly.

Perhaps the surprise later this year might be the reverse of 2021 with inflation becoming subdued much faster than people expect. For this reason and the fact that growth stocks have already taken a pounding, the investment committee decided to not fully rotate out of growth stocks as the fear of rising inflation may start to plateau. That said, we have implemented several fund changes to increase diversification and this has typically meant an increase in the 'value' tilt in the portfolios, typically by replacing funds with a long term growth bias with those with a more cyclical stance. Steps have also been taken to reduce the costs of the portfolio.

Earnings season is about to commence in the US and we will get a micro view of how businesses are coping in this inflationary environment and whether they have been able to pass rising input costs through to consumers. Expectations are modest from analysts, suggesting high single-digit increases and our hunch is that companies may yet again surprise on the upside and underpin equity valuations. There is also the fact that the attractiveness of both cash and bonds is underwhelming and money has to find a home, so despite headwinds, equities look the best place to provide gains above inflation this year.

UK equities, which have performed well over the last 6 months, are still cheap relative to other global markets and especially versus their US counterparts. The UK market is also more value-orientated having an above-average exposure to Financials and Energy stocks, a sweet spot for investors at the moment. The UK also seems to have navigated the Omicron wave extremely efficiently by focussing on vaccinations over lockdown which seems to be the best long term strategy and this fills us with confidence that economic growth could be higher than many of our G7 counterparts. Rising costs of living, notably fuel bills will however put the consumer under pressure this year and is perhaps the main reason that we haven't moved fully overweight in our domestic market.

Looking Forward

With a degree of nervousness, we will open with the bold and optimistic statement, that the COVID-19 pandemic is likely to recede in importance next year. The effect of the recently discovered Omicron strain looks to be much milder in terms of death and morbidity and it has rapidly overtaken the more deadly Delta virus as the dominant strain. Whilst a far greater number of infections will inevitably occur, the effects will be milder and could potentially help build global immunity levels and in time consign Covid to a similar status as flu or the common cold. As such, we expect any negative economic impact that occurs, to be limited to the first half of the year largely as a result of workforce absentee levels. A receding pandemic will lay the groundwork for a more normal labour market, improved supply chains and in time more price stability.

If our optimism on the health front proves accurate, then economic growth in advanced economies will be above-trend and we expect the US, UK and Euro area output gaps to close in 2022 as activity normalises. Above-trend growth will still be supported by easy monetary policy, a shift in spending from goods to services, and a sizeable amount of excess savings that will support overall consumer spending.

A reacceleration in Chinese economic activity is also becoming more likely as the state begins to introduce stimulatory measures.

That being the case, then the scene is set for equities to outperform bonds yet again in 2022, but we believe that equity market returns are likely to be much more modest this year and our best guess would be in the single-digit territory – the net result - of robust revenue growth and some return compression from profit margins and equity multiples. Equity market volatility may rise in the lead-up to US monetary policy tightening at the end of the year. However, after a potential spike higher in the first half of the year, we expect long-maturity bond yields to settle down, probably a little bit higher than current levels but this should not threaten economic activity or cause a major decline in equity multiples.

Given this backdrop, we will maintain our strategy of diversifying across all asset classes including cash and fixed income which offered such an important buffer against equity market volatility in 2020 as one never knows what events might unfold in the coming year.

Full details of the portfolio asset allocation can be found on the enclosed factsheet.