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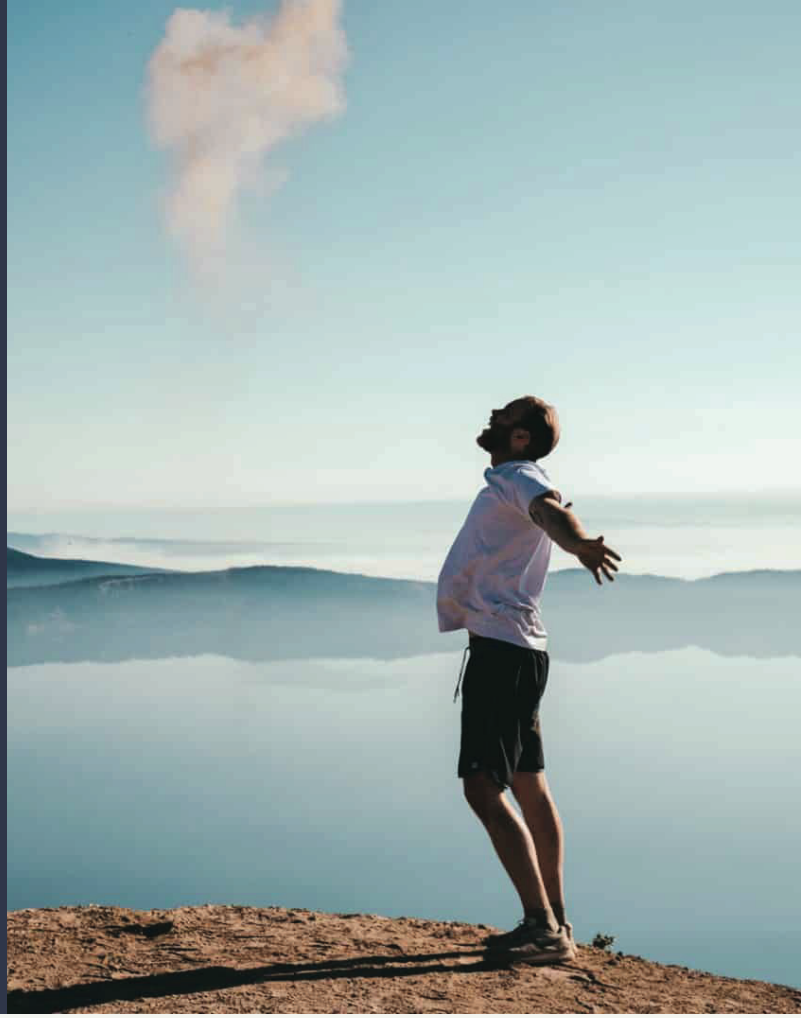

Quarterly Investment Update

APRIL 2022

Ukraine war amplifies global inflation risks

Early quarter confidence that the world was in a recovery phase, as Covid risk abated, turned to investor angst with developments in Ukraine. The eventual Russian invasion of Ukraine has only amplified inflation risk in the global economy. Central bankers are clearly more concerned about the need to tackle the inflation threat than they have been for two decades. The increases in central bank policy rates put at risk global growth, indeed economists have been busy downgrading growth forecasts for much of the quarter.

Sadly the Ukraine war has overshadowed positive news on Covid. Many parts of the world have significantly eased travel restrictions. Government restrictions on daily life within countries have also eased considerably in many parts of the world. Global travel is up substantially from the early days of 2021.

The shock to the system for investors was to see the correlation of negative returns for both bonds and equities during the quarter.

Equity markets were weak across the board in the first quarter as the market absorbed the impact of the Ukraine war. At one stage, the markets fell precipitously as analysts tried to frame the impact of the war on global inflation and growth. However, there was some stabilisation by the end of the quarter, and equities rebounded well off their lows. Global equities returned -5.2% in US$, -3.1% in GBP. Bond markets were far weaker than equities in risk-adjusted terms. Global bond indices fell 5.2%, UK bonds were down 10%, and international corporate debt down between 7 -10%.

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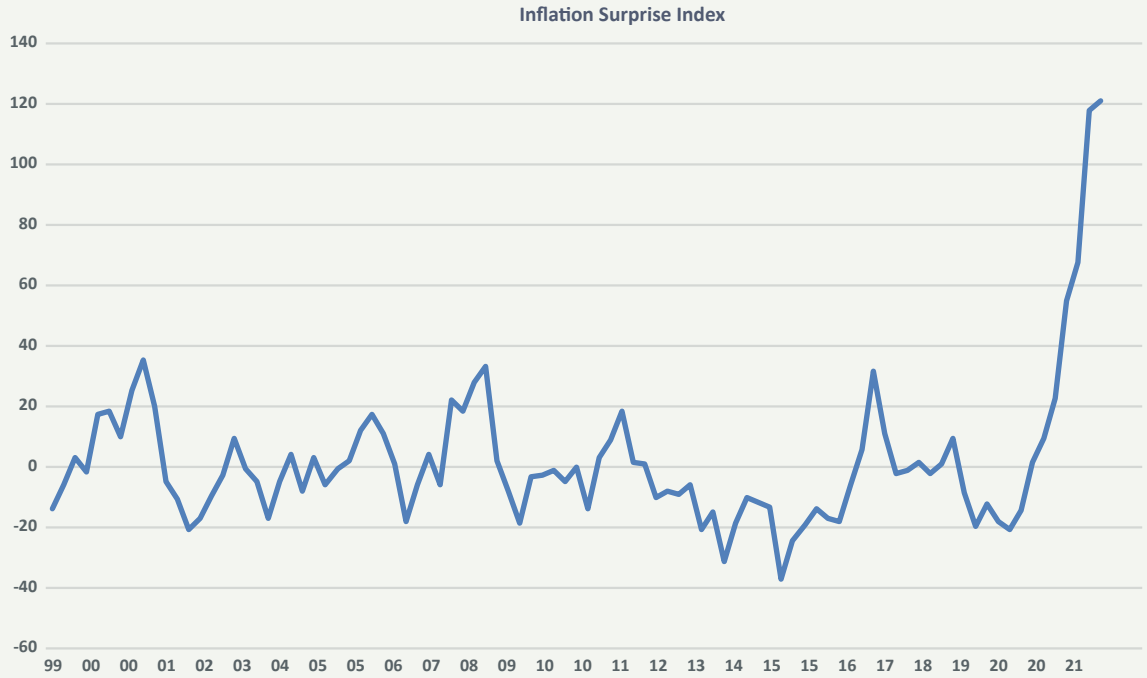


Source: Bloomberg

Market Focus

Global fixed income

We remarked at the turn of the year that in the fourth quarter, the Fed shifted its tone from describing inflation as "transitory" to one of recognising that it would persist. By the end of the first quarter, Fed officials were signalling that they had a fight on their hands with bringing inflation expectations down. Remember that the Fed has a dual mandate to ensure full employment and inflation to average around 2%. On unemployment, it is a job done; the rate of unemployment has fallen to 3.8%. However, on inflation, there is much for them to worry about. Hence the Fed has had to significantly adjust its stance on monetary policy and has signalled that interest rates could have to rise in 50 basis points increments to around 2.5% by the end of the year.

Monetary tightening will also come in the form of quantitative tightening. So instead of buying bonds and supporting the bond market, the Fed will completely reverse its strategy and start to dump bonds back onto the market, pressuring yields higher. The US 10-year Treasury yield increased from 1.51% to 2.35%, with the 2-year yield rising from 0.73% to 2.33%.

The change of strategy by the Fed, closely followed by many of the major central banks of the world, has led to a sharp sell-off of bonds leading to higher bond yields. The US Treasury markets are in the midst of one of the worst sell-offs in history. The sell-off of bonds in Europe was less pronounced given that Europe is at the epicentre of the Ukraine crisis and possibly faces a sharp setback in growth over the short-term, which tends to dampen any rise in bond yields.

The UK 10-year government bond yield rose from 0.97% to 1.61%. The Bank of England's monetary policy committee raised interest rates for the second time in this cycle in February. Credit markets were somewhat weaker than government bonds. With a risk-off environment in markets, investors were more aggressive sellers of higher risk bonds. High yield bond spreads widened more than investment grade. Emerging market debt fell, led by Asia credit, where the woes of the China high yield debt market weighed on Asia credit

markets. Brazil was a standout better place for investment, with the asset markets benefitting from the rise in commodity markets, helpful to the Brazilian economy.

US

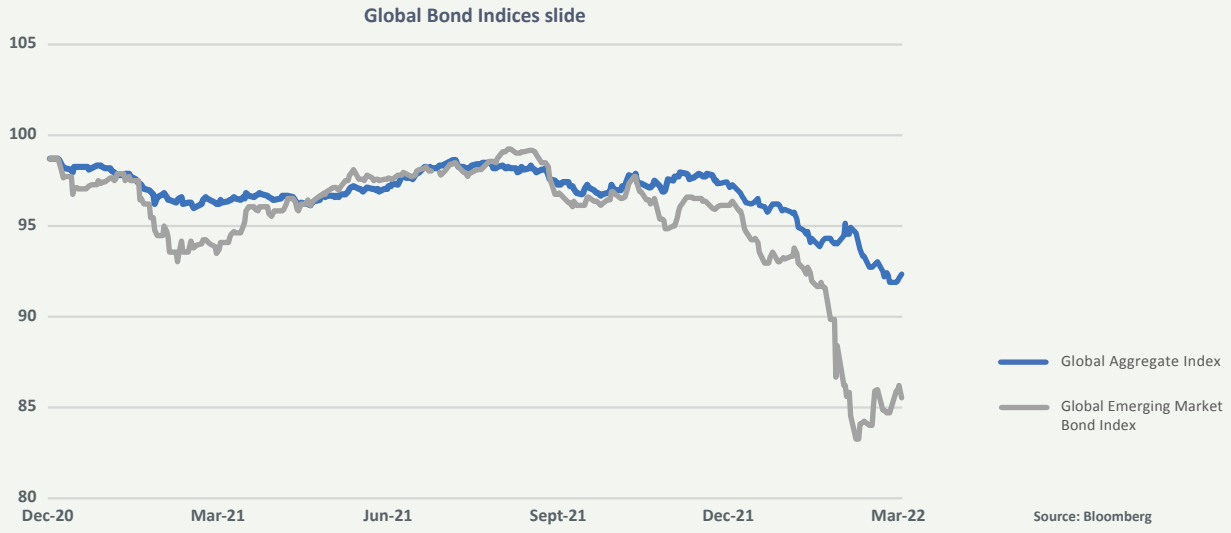
The US equity market fell 4.6% in Q1. The performance of the market was erratic, with the market down as much as 10% at one stage. The market managed to rally back 8.7% in the last three weeks of March. The weakest sector was small caps which were down 7.5%, and by style, growth stocks were down 9%, whereas value stocks were down a modest 0.7%. The market's performance was underpinned by a 39% return from the energy sector. Conversely, consumer discretionary was down 9% and communications services down 12%.

UK

The UK equity market put in a much more resilient performance than most major markets, eking out a positive return. The index performance was helped by the heavy weighting of energy stocks, up over 30%. Mining, healthcare, and banking sectors all contributed to the positive return. The Bank of England increased the official interest rate by a combined 50 basis points, with a further two consecutive 25 basis point increases coming on top of December's 0.15%. Consumer related stocks, as a consequence, didn't perform as well.

Europe (excluding UK)

As might be expected, Eurozone shares fell very sharply in the quarter. The Ukraine situation is clearly putting much pressure on Eurozone economies. The most significant stress area is the region's reliance on Russian oil and gas. The invasion led to a significant spike in energy prices and led to concerns about the security of the future energy supply. Consumer discretionary and information technology sectors performed poorly, offset to some degree by the rally in energy stocks. Due to the higher inflation levels, the European Central Bank has laid out plans to end bond purchases by the end of September, whilst it has also indicated that it could potentially raise interest rates in 2022. To date, there are only moderate signs of a slip in economic activity, although we do expect that to worsen.



Japan

Japanese equities had a weak January and February but managed to rally in March to end the quarter relatively flat to the end of 2021 levels. The Japanese equity markets reaction is mainly around the perception of the impact of the Ukraine war on global growth. Russia accounts for a fraction of Japan's trade with the world. The Bank of Japan's actions also underpinned the market by reining any significant increase in bond yields.

Asia ex-Japan

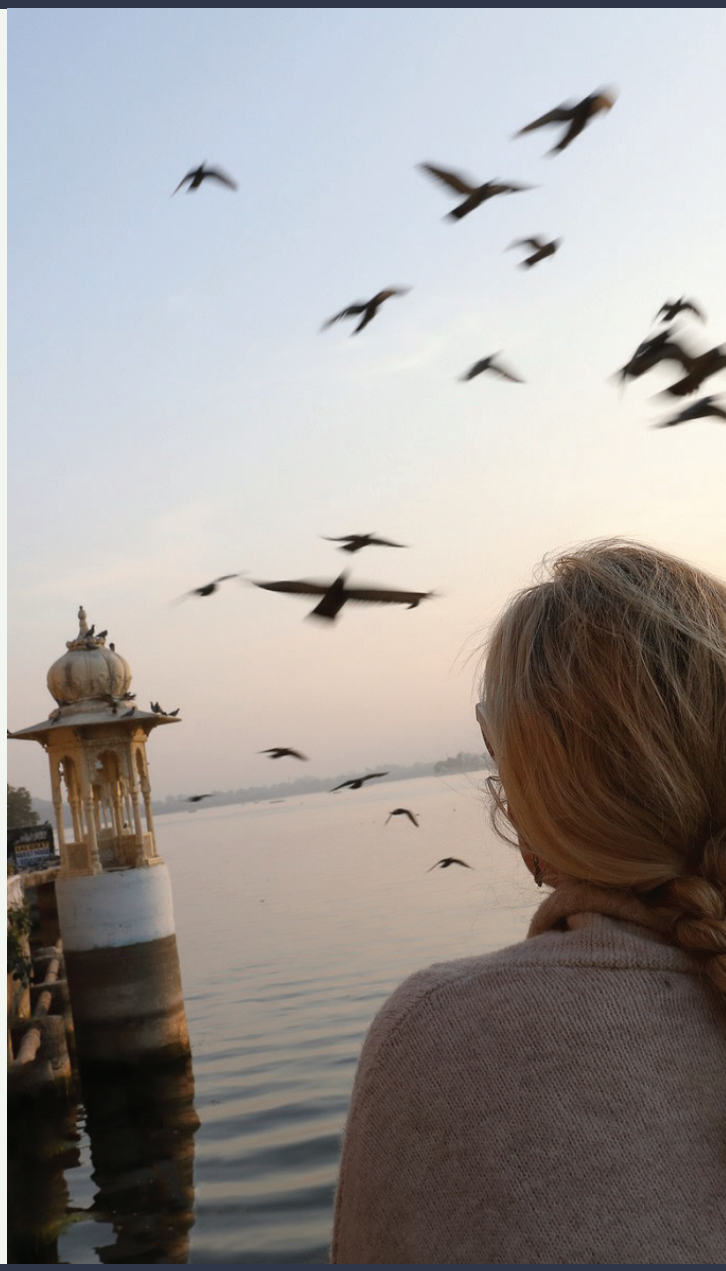
Asia ex-Japan's index performance was dominated by the weakness of Chinese equities. The ongoing lockdowns in China and limited easing of policy by the government or central bank kept the stock market weak, with the poor performance of China also dragging down Hong Kong and Taiwanese markets. The markets of Southeast Asia were in a more positive mood. The reopening of a number of the economies as they dealt more effectively with Covid led to positive returns, particularly from the Indonesian market and Thailand, Singapore, Malaysia and the Philippines.

Other emerging markets

Emerging markets had a poor time in the first quarter, down by 7.1%. The Ukraine war led to particular weakness in European emerging countries. China's problems tended to dominate the index's returns. However, there were some brighter spots. Latin American markets all generated good returns, helped by the strong performance of Brazil. Markets in the Middle East were also strong, understandably due to the higher oil price. Kuwait, Qatar, UAE, and Saudi Arabia all generated good returns. South Africa delivered positive returns off the back of higher commodity prices.

Currency

Given investor risk aversion, the US Dollar was again in the ascendancy making gains against most other currencies. The trade-weighted index rose 2.8%. The Japanese Yen was particularly weak (-5.8%), which is somewhat unexpected, as it is usually a currency that does well at times of global stress. Like the Swiss Franc, it is typically seen as a safe haven. Sterling fell 2.8% against the Dollar over the month, although down 4.4% from the peak of late January.



Commodities

The S&P GSCI Index rose sharply over the quarter (+29%). The Ukraine war led to sharp increases in energy prices and agricultural products. Ukraine provides a substantial percentage of global wheat supply, and sanctions on Russia and Belarus have significantly impaired the supply of fertilisers to the world market. Metal prices, particularly aluminium and zinc, were significantly ahead.

Conclusion

Financial markets face some significant challenges at present. Covid and the Ukraine war have reinforced inflation trends that have badly caught out central banks and left them scrambling to tighten monetary policy. Less growth and higher interest rates are not a combination that is helpful to risk assets such as equities. Investors also face a challenging environment when bonds and equities become positively correlated, and hence typically well-diversified portfolios end up with losses from both their bonds and equities.

However, it is not all bad news. The general relief that the worst of Covid is behind is helping economies to get back on their feet, leading to a burst of consumer spending that will be helpful support for economies.

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