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Economic Newsletter

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Uncertainty Reigns Supreme

Arguably the biggest driver of global market volatility at present is the rampant inflation existing in the market, and, more importantly, the measures that central banks around the world are using to combat these multi-decade high levels.

During the Covid-19 pandemic, the market saw a significant shift in consumer demand away from services into goods, as citizens were forced into lockdown. This reallocation was triggered by the lack of production and movement of goods to consumers, coupled with the increase in discretionary cash levels of consumers brought about by the stimulus cheques offered in the United States. As economic activity restarted, this pent-up demand for services (e.g. travel, restaurants, delivery services, healthcare, salon services etc.) unleashed itself on the economy, creating a very tight labour market characterised by extremely low levels of unemployment. So tight, in fact, that there are currently two job openings for every one unemployed individual in the US. The subsequent war in Ukraine had the effect of injecting an additional commodity price shock into the market, ratcheting up prices from their already elevated base. These factors have culminated in the US inflation rate climbing to 8.6% in May 2022, its highest level in 40 years. Locally we have also seen our headline inflation rate climb, with the latest reading up to 6.5%.

In order to combat the unbridled inflation, Central Banks have stepped in and aggressively raised interest rates. At the US Federal Reserve's (the Fed's) latest meeting in mid-June, Federal Reserve Chairperson, Jerome Powell, increased the benchmark interest rate by 0.75%, the largest single rate hike since 1994. Commenting on the move, Powell stated that "Clearly, today's 75 basis point increase is an unusually large one, and I do not expect moves of this size to be common." He added, though, that he expects the July meeting to see an increase of 50 or 75 basis points. He said decisions will be made "meeting by meeting" and the Fed will "continue to communicate our intentions as clearly as we can."

The question now faced by investors is "where do markets go from here?" Global Equity markets, as measured by the MSCI AWCI, have fallen -20% in the first half of 2022 in US dollars. Likewise Global Bonds, as measured by the Bloomberg Global Bond Aggregate Index have fallen -14% over the last six months, also in dollar terms. Commodities have introduced further pressure into the system, with the price of crude oil currently trading around $115/barrel, nearly 50% higher than its level at the end of last year. These fundamental concerns, coupled with the political tensions rife between world leaders, all influence the investment decision and the positioning of portfolios.

With the culmination of all these factors, how then should investors react? The macroeconomic outlook remains of paramount importance and should not be ignored, with many economists anticipating a regime change to market cycles.

Fears of a Global Recession

The Nedgroup, Ninety One, and M&G (formerly Prudential) Global Investment Summits which took place in central London in late June 2022 hosted a wide panel of leading economists and portfolio managers from across the globe. When posed with the question, "where are markets going?", the responses were distinctly ununified in nature.

Andrew Headley, lead portfolio manager of the Nedgroup Global Equity Fund stated that the global economy is headed towards an earnings recession, and that an economic revival this year is fairly unlikely.

Likewise, Steven Romick, portfolio manager of the Nedgroup Global Flexible Fund predicts earnings to be challenged by the inflationary and rising interest rate environment. As a result, his fund currently holds a 30% cash allocation in order to reduce the exposure to market volatility.

Conversely, Gareth Witcomb, executive director and portfolio manager of Multi-Asset Solutions at JP Morgan, stated that a global recession is unlikely. While he conceded that growth is expected to slow, the house view at JP Morgan Asset Management is that inflation will cool in the second half of this year without the economy falling into recessionary territory. Also on the more optimistic side was Clyde Rossouw, co-head of quality at Ninety One Asset Management, and lead portfolio manager of the flagship Ninety One Opportunity and Ninety One Global Franchise Funds. Clyde stated that already we are beginning to see signs of the market turning and that the bottoming of the market will coincide with the peaking of the oil price. This could be as close as one month away, when the Fed hikes rates again at their next meeting (at which point Clyde expects to mark the end of the Fed hiking cycle).

The economic view taken on a macro level will, by nature, have a direct influence on the positioning of the respective funds managed by asset managers. Again, there was little consensus from the global portfolio managers as to how to position their portfolios given the heightened levels of volatility present in the market. Mike Bell, global market strategist at JP Morgan, stated that now is the time to be neutrally positioned in a Multi-Asset portfolio in order to minimize portfolio bias and reduce volatility. Conversely, Remi Olu-Pitan of Schroders stated that times such as these call for active tactical moves in order to take advantage of the volatility in the market, and that being neutrally positioned could result in the loss of potential alpha generation.

In short, uncertainty reigns supreme!

Amid this uncertainly, the markets will continue evolving and the threat of a global recession, described as a “significant decline in economic activity that is spread across the economy and lasts more than a few months”, will continue to dominate economic headlines. It is therefore paramount that the US Fed is able to walk the tightrope of carefully balancing the rampant inflation in the market whilst not choking the strong job market. Mohamed El-Erian, noted economist and president of Queens College, Cambridge, stated that “Good central bank policymaking calls for the Fed to lead markets rather than lag behind them, and for good reasons. A well-informed Fed with a credible vision for the future minimises the risk of disruptive financial market overshoots, strengthens the potency of forward guidance on policy and provides an anchor of stability that facilitates productive physical investment and improves the functioning of the real economy.”

As asset managers, aggregating and understanding the differing views in the market, as well as maintaining a current and well informed view of markets, is of critical importance as market conditions develop. We retain a well-diversified allocation across asset classes in our portfolios, whilst maintaining a high degree of agility should markets prove more bullish or bearish.

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