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Economic Newsletter

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Into the Twilight Zone

In a recent article by Thomas Becket, the Chief Investment Officer of Punter Southall Wealth, he aptly referred to the current investment environment as the 'twilight zone'; a term which refers to a situation characterized by being undefined, intermediate, or mysterious in nature.

There are few definitions which could better describe global economic markets at present. In his article, Thomas went on to say, "Despite our long-term expectations for positive investment returns, which have strengthened after the turbulent start to 2022, it is fair to say that the immediate outlook for a range of global macroeconomic, market and corporate factors is particularly cloudy. This is not a case of us trying to express extreme caution but rather an admission that it is impossible to have certainty in a time when "the only certainty is uncertainty"."

When speaking from a wealth management angle, Thomas went on to say, "I have always believed that a wealth manager's role is to take the most extreme negative and positive outcomes (which are always fashionable in our industry) on a range of key factors and weigh up a sensible balance of probabilities. This helps us to shape our asset allocations and allows us to invest with conviction in specific investments and themes and show what that means for our investment strategy."

5 Factors shaping current Investment Strategies

There were five key factors highlighted in Thomas' article from which he has drawn his investment views for the future. Importantly, each of the five views mentioned are based on economic and investment valuation, and steer well clear of sensationalist and highly emotive topics which often receive far more coverage from the media. Not once does Thomas mention the state of the dollar, or even the current losses of Global Markets. His five factors are summarised below:

Factor #1 – The Global Economy
Investment decisions are influenced most strongly by the current broad economic outlook. The market weakness of 2022 reflects the deteriorating economic expectations of market participants, driven largely by recession fears and the war in Ukraine. Thomas states that, "It is too early to say whether we will endure a mild recession or a severe slowdown from previously healthy rates of economic growth", however he went on to say that at this stage they are not concerned about a terrible economic outcome, and as a result are looking for investments that can deliver growth in uncertain market conditions.

Factor #2 – Inflation
"To evaluate the prospects of economic growth, we must try to forecast what will happen to inflation, as this is currently the preeminent driver of consumer spending and corporate confidence", writes Thomas. Whilst most global economies expect inflation to moderate into next year, a key factor to watch will be the rate at which inflation moderates. The sooner inflationary pressures abates, managers will have increased confidence to increase their risk exposure in discretionary portfolios.

Factor #3 – Interest Rates
Due to Central Banks' failure to recognise how sticky the current levels of inflation would be, they now find themselves well behind the curve and having to aggressively increase interest rates in order to catch up with the rampant levels of inflation. Furthermore, central banks also didn't acknowledge the effects their stimulative policies during the pandemic would have further down the road.

Thomas went on to state, “central bankers have no special insight into what may happen next, and there is a real danger that they will go too far at a time when the economy is in danger of a massive slowdown. We believe asset markets have become too blasé in the last two months about the potential risks of significantly higher rates in the period ahead. This view also means we are sceptical about holding too great an exposure to assets with significant interest rate risk, such as government bonds.”

Factor #4 – Corporate Earnings

Another key factor from which to seek guidance regarding the direction of markets is that of corporate earnings. When the forward earnings of the US Stock Market (or indeed any stock market) begin to fall, it typically heralds an imminent drop in prices. So far corporate earnings in the US have been fairly resilient and haven’t come under severe pressure in 2022; a positive sign for asset returns.

On the recent announcement of corporate earnings, Thomas stated “while they were enough to encourage a recovery in prices in the last few weeks, they were not strong enough to justify an increase in risk in our strategy or warrant the extreme valuations seen in certain sectors at the end of last year.”

Factor #5 – Market Valuations and Investor Positioning

Thomas described his final factor by stating, “The two crucial observations within financial markets since the end of last year are the step change in the valuations of certain asset markets, most notably corporate bonds, and a reduction in the unbridled optimism that investors had at the end of 2021.”

“Given the impediments to constructing a concrete short-term view, we are relying more on what we think might happen over the medium term, probably best defined as one to three years out from today. Equities, at a broad level, look to us to be about the right price as we look forward a few years, but for active managers there are plenty of dependable sectors worthy of our focus, and certain other themes and markets that are good value, in our opinion.”

Where to from here?

The five factors described above provide a good framework for investors to navigate the current uncertainty and volatility. It is also worth noting that at this stage in the market cycle many investors ask their advisers questions around cutting their losses and selling out of equities completely to avoid further declines. In another recent note we quoted Michel Perera, Chief Investment Officer of global asset manager Canaccord Genuity, who stated “we must be careful not to embrace kneejerk reactions that dreadful markets often provoke.”

While Michel conceded that no-one can forecast the market with any degree of certainty, selling equities out of panic is likely to be a poor decision and one that investors would regret over a longer time horizon.

In periods of market turmoil such as these, investors face increased pressure to sell out of their equity holdings in order to avoid incurring further capital losses. Consequently, having a sound and reliable investment process in these times is of critical importance to protect investors against making emotionally driven investment decisions. In all decisions investors should be guided by their Advisers to navigate the markets and to assist in staying the course.

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