

Whither Markets?

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It is often said that “markets go up on an escalator and come down in a lift.” Unquestionably it has been a very poor first half for financial markets.

Some of the reasons are clear and obvious; others reflect a more subtle but rapidly changing economic environment, particularly with respect to inflation and a reversal of some of the economic policies that investors and markets have become used to. These are principally near zero interest rates and quantitative easing. Both policies are designed to boost the money supply but as the supply of goods has become impaired by war in Ukraine, too much money in the economy chasing too few goods has raised the risk of rampant inflation.

Whereas for much of the last twenty years global supply has outstripped demand leading to price deflation, we have very quickly entered a period where Covid-suppressed demand has been released into a supply-constrained world economy where fundamental food and energy markets are dislocated by war. Russia and Ukraine are responsible for up to one third of global energy and food supplies.

There have been few hiding places as central banks have moved to reduce the money supply to bring the flow of money into line with the supply of goods; they do this by raising the cost of money, by raising interest rates.

The safest asset on the planet, backed by the “full faith and credit of the United States”, is regarded to be the Treasury bond issued by the US government. From our perspective in the UK, the British Government gilt, backed by the taxpayer, is the safest investment you can hold.

Yet the returns on both assets this year have been dismal: the US Treasury Index has returned minus 8.63% and the British Gilt has done worse, returning minus 11.12% in the year to date (to Aug 1).

Equity markets, in the short run, typically follow the lead set by the fixed income markets, but in the longer run they are driven by entirely different dynamics.

World equity markets this year have declined on average by 11.74%. As you might expect, those markets closest to Russia/Ukraine have lost the most; the Emerging Eastern European index has lost some 83.9% of its value this year. Nevertheless, German, Italian, and Swedish markets have also declined between 15.1% and 18.1% year to date.

At the same time, the broader expectation for higher interest rates (in the jargon, higher discount rates) has driven down the valuations of some of the frothier parts of developed world equities. In the US, the Nasdaq index, which is home to the world's leading technology companies, the change in the discount rate has driven the market down by 20.8%, which is the definition of a bear market.

Ironically, due to the heavy weighting of low duration but low growth companies in the UK e.g., Oil, Mining and Banks, the FTSE 100 has proved unusually resilient and is essentially flat y.t.d. at -0.5%. By contrast the smaller and “growthier” midcap index, the FTSE 250 has declined by some 14.1%.

The shift in fixed income markets was within our strategic expectation as the world emerged from Covid lockdowns; we have for some time favoured index-linkers and short-duration issues, which are much less sensitive to rising inflation and interest rates. Nonetheless the surge in inflation and war in Europe was a deeply negative surprise.

There are two parallel themes running at present which have significant implications for markets.

First, in the short-run, Russian aggression will keep confidence low and uncertainty high. Both will tend to keep valuations lower than they otherwise would be.

Secondly, the interest rate outlook was already negative before Russian troops crossed the border. The “success” of QE was always going to send interest rates higher as we got back to a normally functioning economy that no longer required emergency stimulus. The economic impact of the financial crisis and of Covid was passing through the system.

It is also worth remembering that futures markets see interest rates in the US and the UK peaking at around 3% in 2023 and then falling modestly thereafter settling at 2.5% for the longer run.

Several things can be said about that: fixed income markets will not return to their previous highs since it is unlikely that we will see zero interest rates again in our lifetimes. Secondly, even at 3% interest rates will remain low by historic standards. The mean bank rate in the UK since 1794 to the present day is 4.85%.

Where does that leave equity markets?

Short-term volatility is the hallmark of share prices, which is the reason they should be regarded as long-term investments: they hedge inflation by matching rising input costs with higher prices, and they generate growth by delivering goods and services profitably over the cycle.

It is notable that in the month of July the average world stockmarket returned plus 4.4% led by those markets which had had the worst results year to date; the Nasdaq rose by some 12.4% in July.

None of us likes “downward volatility” but it is a price we pay for the longer-term gains accrued by compounding rising cashflows through the vicissitudes of the valuation cycle. In the near-term, it is also worth remembering that equity returns come in lumps; if either Russia eases its aggression or inflation numbers subside somewhat, markets are likely to celebrate.

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