Santander Asset Management

State of Play

13 January 2022

As markets begin the new year full of nerves, investors focus their microscope on US data following more cautious comments from the Federal Reserve. Our Investment Specialist, Simon Durling, shares his thoughts on why the data may shift momentum as the expansion phase of the economic cycle slows.

Federal Reserve warns on further rate rises

Last week the minutes from the December meeting of the Federal Open Market Committee were released, articulating plans to accelerate the withdrawal of financial support sooner than originally planned and signposting that rate rises may have to come sooner and rise further than previously forecast. Investment markets took their cue as share prices fell sharply with the technology heavy NASDAQ Index closing 3.3% lower (last Wednesday), one of the worst single trading days since the pandemic began (closing 10% below the record high recorded in November). The start of this week continued in a similar vein with all major indices falling initially - sparked by the reality of inflation data which was due a few days later and the consequences for asset valuations of a steeper path for rate rises. Investors remain concerned that sharp rises in interest rates, as central banks respond to sustained above target inflation, leads to more expensive borrowing costs hitting future earnings and forcing markets to revalue company share prices.

As expected on Wednesday (12 January) the latest inflation data showed a year-on-year increase of 7% (the fastest pace in nearly 40 years), in line with market forecasts, although the month-on month and core inflation were slightly above predictions. Some market participants had been concerned that the figures could have been higher than forecast prompting a re-evaluation of asset values and the path for interest rates. According to the so-called dot plot of individual interest rate projections published by the Federal Reserve (the Fed) following its December meeting, officials expect to raise interest rates three times in 2022, with another three moves pencilled in for 2023 and two more in 2024. If this normalisation of interest rates were to transpire markets are likely to readjust their valuations for all asset classes significantly. Another important aspect of the path of interest rates is the effect rate rises will have on the value of the dollar against other international currencies. In the event that rate rises in the US are faster, further and more significant than other central banks around the world, the likely outcome is a much stronger dollar impacting the value of goods and the balance sheets of companies relying on international supply chains.

As recently as autumn last year most central banks tried to calm markets by explaining that inflation pressures were temporary and their intention to tolerate inflation was above target to ensure the recovery from the pandemic was assured. What central banks hadn't factored in was supply chain breakdowns, additional COVID-19 infection waves and sharp rises in energy costs caused by several complex factors. Even after the Fed moved the goal posts somewhat on the target inflation figure, moving from a specific target to a rolling average rate, the pressures on prices started to take hold rapidly increasing month-on-month since. The biggest losers from this sharp rise, apart from consumers, has been bond assets. Yields (earnings generated over a particular period of time) have risen sharply in the last four weeks, especially in the UK where the 10-year Government bond yield has risen from 0.7% just four weeks ago to 1.2%, an increase of over 70%. As State of Play explained last week, bond values and yields are inverse, so when yields rise bond values fall.

US employment slows

The US economic recovery showed signs of slowing when employment data released last week registered non-farm payrolls as having risen by 199,000 in December, according to the US Bureau of Labor Statistics, finishing a record year of workforce expansion but falling short of market forecasts. The official monthly non-farm payrolls release is widely regarded as the most important indicator of how the US economy is performing. It shows how many staff were hired or fired by private employers other than farms, which are excluded from the figures because of seasonal variations. The latest jobs data comes after growth of 249,000 in November and 648,000 in October. Despite the slowing of recruitment, the headline unemployment rate fell to 3.9%

from 4.2% the previous month, its lowest level since the onset of the pandemic. Hiring slowed amid concern over the emergence of the Omicron variant and fears about inflation led rate rises.

The influence of the world's largest economy on the wider global stock market has grown following years of superior investment returns when compared to many other international markets. US shares now represent 69% of the market value of global shares according to the MSCI Index vs 51% in 2015. Largely this can be attributed to the success of the FAANG shares like Apple and Amazon, especially since the start of the pandemic. Apple recently breached a market capitalisation valuation of $3tr before the shares fell in recent trading, whilst others like Microsoft have benefited from the rise of cloud computing services and usage of applications like Microsoft Teams for online meetings. These companies have delivered exceptional returns for investors not only with the rise in their share price but also the huge cash revenues distributed via dividends. Some market commentators are starting to question the sustainability of the rise in their share prices which, for those who follow investment markets, is hardly new news.

There are countless examples over the last few years of commentators predicting sharp corrections only to watch as the price momentum continued. Apple reached a market valuation of $1tr in August 2018. It took just two years to reach $2tr in August 2020 and 16 months to reach $3tr on the opening trading day of 2022. The attraction of a cash rich business is hard to ignore, as demonstrated by the data for the fiscal year which ended 25 September 2021 as revenues increased 33% to $365bn and net income increased 65% to $94bn. Apple and many other large companies benefit from wide ownership as tracker funds which replicate indices hold the shares in proportion to the weighting to mirror the index for investors, whether this be individuals or fund managers. This does however create concentration risk meaning that only a small number of companies can affect the rise or fall of an index. Remember, the US is over two thirds of the world's market and the top 10 companies in the US accounts for over one fifth of the value in America, and Apple is now just shy of 5% of the value of all global stock markets on its own! This is why so many investment managers closely follow the press releases, data and news on the top companies in case the momentum shifts driving share values in a different direction. We wait to see what the next chapter brings.

Find out more!

Click **here** to read our latest A Month in the Markets, where our Head of Multi-Asset Solutions, Stefano Amato, looks at how key themes impacted markets in December.

Note: Data as at 11 January 2022.

Asset Management