

## State of Play

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5 May 2022

As the US records an unexpected economic contraction in the first quarter of 2022, will the Federal Reserve (Fed) press ahead with more rate rises beyond the biggest rise in 22 years? Or is inflation already effective in slowing down overheating economies? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

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### US rates rise 0.5%

As expected, the Fed increased interest rates by 0.5% yesterday, the largest increase in 22 years, in response to rising prices.<sup>1</sup> Jerome Powell, Chair of the Fed, tried to reassure markets that whilst tackling inflation was the priority, he did not anticipate that any rate rises throughout the remainder of this year would be more than 0.5%, seemingly calming fear that the central bank would hike rates too high or too quickly, potentially triggering a recession.<sup>1</sup>

Critically, investment markets now face the task of assessing how central banks will react as the global economy starts to slow in the face of rising inflation. The latest reaction from investors is clear as US 10-year bond yields have now reached 3% for the first time since 2018.<sup>2</sup> Inflation casts a shadow over market sentiment which has seen increased volatility since the start of the year.<sup>2</sup> Macroeconomic data has always been crucially important for investors to assess future expectations, but it's not surprising that markets at present appear to be sensitive to new data releases.

## US surprise economic contraction

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The US commerce department reported on Thursday last week that the American economy contracted by 1.4% in the first quarter of 2022 on an annualised basis, following the data release which is in sharp contrast to previous market predictions of 1% growth.<sup>2</sup> This is a remarkable turnaround given the 6.9% rise recorded in the fourth quarter of 2021 which at a first glance provides some evidence that rising inflation may already be starting to cool the world's largest economy.<sup>3</sup> However, when you 'lift up the bonnet' to take a closer look at the underlying data, the picture looks somewhat different.

Firstly, when you apply the same measurement used by other major economies the contraction is just 0.4% when compared to the previous quarter.<sup>3</sup> The skew in the measure was heavily influenced by a growing trade deficit as exports fell 5.9% at the same time as imports increased 17.7%, creating approximately 3.2% drag on the economic numbers.<sup>3</sup> The data looks even more at odds with the reality given personal consumption grew 2.7%, up from 2.5% at the end of last year, and business investment rose sharply by 9.2%, a significant increase from 2.9% from the previous quarter.<sup>3</sup>

President Joe Biden is likely to be mindful that this latest report, coupled with the highest inflation for 40 years, presents challenges as we approach the mid-term elections in November.<sup>3</sup> In response he said, 'The American economy powered by working families continues to be resilient in the face of historic challenges. The US confronts the challenges of COVID-19 around the world, [President Vladimir] Putin's unprovoked invasion of Ukraine, and global inflation from a position of strength'.

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## UK dividend outlook improves

The latest quarterly dividend monitor report from Link Group, has revised the forecast for UK dividends for the remainder of this year.<sup>4</sup> Whilst the overall picture has improved, some adjustments have had to be made following the departure of the mining company BHP from the dual listing in London with it now only listed in Australia. Even though the UK share of its business is a relatively small share, it was still the fifth largest payer of dividends in 2021, so this income will clearly be missed.<sup>4</sup> Special dividends in the first quarter accounted for less than £1 billion, which was in sharp contrast to the first quarter of 2021 where special payments accounted for £6.2 billion.<sup>4</sup> This reflects the uncertain nature of these type of pay-outs, as often, they are one-off and cannot be relied upon in the future. The largest contribution to dividend payments in the first quarter came from the oil sector, which will come as little surprise given the sharp rise in oil prices especially after the Russian invasion of Ukraine started in late February.<sup>4</sup>

At the time of writing, BP announced their highest quarterly earnings in more than a decade.<sup>5</sup> Underlying profit on a replacement basis more than doubled from \$2.63bn to \$6.2bn compared with the same quarter a year earlier, well in excess of market expectations.<sup>5</sup> The consequences of the conflict have affected companies like BP where they had a strong presence in Russia, writing down this element of the business to near zero, taking a loss of \$24 billion after their decision to pull out of Russia and disposing of the stake in Rosneft leading to a

pre-tax loss of \$20.3 billion.<sup>6</sup>

Ian Stokes, the Managing Director for Corporate Markets, EMEA UK and Europe at Link Group commented in the outlook adjustments in the report; 'We now expect headline dividends to reach £92.2bn this year, a fall of 0.8% year-on-year reflecting lower one-off specials and BHP's departure from London. Underlying pay-outs of £85.8bn will be 11.1% higher than 2021, though if we adjust for the BHP effect (and one or two other companies leaving the index such as Morrisons), the true underlying growth rate this year will be an encouraging 15.2%. Without any mining stocks at all, the growth rate for the rest of the market would be around half this level'.<sup>4</sup>

## Market update

Focus this week has been on central banks, both the Federal Reserve decision taken yesterday (Wednesday), and the Bank of England decision today (Thursday) to increase interest rates from 0.75% to 1% which was in line with market expectations.<sup>7</sup> Inflation has dominated market activity since the beginning of the year, pushing up bond yields and forcing investors to reprice shares as their expectations for future earnings and profits are diluted by more expensive raw materials, higher wage demands from employees and more expensive borrowing as rates rise to combat surging inflation.<sup>2</sup> Whilst I believe market participants have already priced in the rate rises expected, much of the attention will be on the small print and the language used in the updates given by both central banks which are delivered alongside the rate decisions. At the time of writing market reactions have been positive across the board following Jerome Powell's reassurance on the size of future rate rises.<sup>2</sup> Market attention is likely to turn quickly to the inflation data, which is due over the next couple of weeks, to assess whether rising costs are above or below forecast and whether there are any trends or signals within the numbers that provide some light at the end of the tunnel.

**Find out more!**

Listen [here](#) to our latest Market Views from our Head of Systematic Research for TAA and Alpha, Stefano Amato, as he discusses whether controlling inflation is the priority.

Note: Data as at 3 May 2022.

<sup>1</sup> The Times, 4 May 2022

<sup>2</sup> Investing.com, 3 May 2022

<sup>3</sup> Financial Times, 28 April 2022

<sup>4</sup> Link Group, 31 March 2022

<sup>5</sup> Financial Times, 3 May 2022

<sup>6</sup> The Times, 3 May 2022

<sup>7</sup> The Guardian, 5 May 2022

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