State of Play

7 April 2022

The first quarter of 2022 was very eventful with investors experiencing high volatility and market uncertainty. So, what were the key drivers in the first quarter and how did they impact asset classes? Our Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Asset class performance

The first quarter was dominated by concerns about rising inflation, subsequent increases in central bank interest rates and the conflict in Ukraine. Even before Russia began the invasion in Ukraine, market volatility had increased dramatically (in January) with the Chicago Board of Options Exchange (CBOE) Volatility Index, known as the VIX,[1] (which is based on the implied volatility of S&P 500 Index options) doubling from the start of the year hitting a recent peak in early March.[2]

Shares

The UK top 100 companies by market value, as measured by the FTSE 100, delivered returns of just over 3%, beating all other major stock markets, with rising commodity prices driving strong returns from the energy sector.[3] More cyclical and technology shares, in indices like the NASDAQ, suffered as concerns about rising interest rates pushed many investors to reassess valuations which fell nearly 7% in the quarter. The ongoing concerns about central government intervention in China saw the FTSE China 200 Index fall over 10%.

Fixed Income

As State of Play explored throughout the first quarter, rising prices and the subsequent reaction of central banks raising interest rates created a challenging environment for bonds. As at recently as mid-December, the 10-year UK Government Bond yields were 0.7%, continuing to rise sharply and reaching just over 1.6% at the end of the quarter.[4] This saw the FTSE All Gilt Index fall 7% during the quarter, measuring total return which includes both capital and income.[5] There are expectations of further increase of interest rises in the months ahead which is likely to leave bonds with a steep hill to climb.

Commodities

The backdrop of rising consumer prices was largely led by sharp increases in commodity prices across the board. Virtually every major commodity increased in price since the start of the year, with natural gas leading the way with an increase of 60%, closely followed by Brent Crude oil at 40%.[6] At one point Brent Crude oil hit over $130 a barrel before easing back following President Joe Biden agreement to release some strategic reserves of at least 1 million barrels per day to increase supply.[7] The implications of both Ukraine and Russia providing a huge portion of the world's farming produce saw global prices soar. Even the insulated US wheat prices surge 40% in the first quarter, adding additional pressure to rising prices.

What key factors have influenced markets in the first quarter?

War in Ukraine

Ever since Russia moved troops to the Ukraine border in mid-February markets were fearful about the escalating conflict. Thus far a significant and to co-ordinated financial response and exclusion of Russia through sanctions and other bans have resulted in some peace talks but without any material progress or result so far. The outcome of the conflict remains unknown and it is impossible to say how long it will continue, but the shadow of uncertainty is likely to hang over financial markets for the foreseeable future.[8]

Cost of living crisis

Inflation for the last 30 years remained low by historical standards for many different reasons, as I explained in previous updates. However, following the latest inflation data released last month in the UK, US and Europe rising prices prompted central banks to respond and increase interest rates.[7] The Bank of England warned that in the next couple of months inflation will rise further, especially in the aftermath of the increase in the Energy Price Cap of 54% which came into force last Friday (1 April).[9] The Federal Reserve also warned markets that it intends to raise rates throughout 2022 to try to cool inflation.[10]

The key question that remains for investors is how many rate rises are already priced in or could central banks go beyond the measures they have already signposted. I often view ten-year government bond rates as a predictor of future interest rate levels as markets are more obsessed with the future than they are reflecting on the past. The reason why so much uncertainty remains around future interest rate levels is because as rates rise alongside inflation, the impact on economic growth and the time that this takes to cool demand is unknown. In some respects, because inflation is a rolling 12 months picture of prices, what is known as the 'base effect' will probably see inflation cooling down later this year. If current increases are not sustained because price comparisons are over a rolling 12 month period much of the current spike will begin to fall off the calculation.

In addition, as rate rises increase borrowing costs, and increases in consumer goods prices, energy, and petrol prices, for example, dent the spending power of consumers, naturally people spend less money. If collectively we all spend less money, demand falls and the rise in prices of the goods and service should then start to fall away. Assuming the current inflation levels do not translate into further wage pressures, whereby employees demand inflation level wage rises, then real incomes will fall impacting on the rate of economic growth. This all points to inflation starting to ease in time, but it doesn't remove the short-term pain for consumers and investors alike.

Market update

Depending on which financial organisation you follow, you may have seen a different mood about the outlook for investing for the remainder of this year. My own observations have seen various influential investment banks and fund houses expressing very different opinions about what to expect in the future providing strong evidence of ongoing market uncertainty. Often the question investors ask is whether this is the right time to invest. It is probably fair to say, market conditions remain challenging, but this is only likely to be short term. As uncertainty recedes investors will probably regain their confidence pushing up values in the process. The famous investor Warren Buffet once said; "Be fearful When Others Are Greedy and Greedy When Others Are Fearful".

Context and comparisons help to appreciate that there is no such thing as zero risk. Whether you choose to keep your savings in the bank and expose your capital to inflation erosion as low interest rates fail to keep pace with rising prices, or you decide to invest and face fluctuating capital value over time, you cannot avoid risk completely. One factor is the lack of alternatives. The market has a nickname for this – called 'TINA' – there is no alternative. It means that whilst a traditional portfolio made up of shares and bonds faces all of the challenges mentioned previously, with interest rates still very low and other alternative investment classes carrying other risks, in some respects investors can be forced to embrace risk, even when at times like these, they would prefer not to.

Importantly, as State of Play explained on previous updates, investing depends on several factors specific to the individual circumstances and investors attitudes. Trying to time the market is nearly impossible, even for professional investors. Being focussed on your time horizon, risk comfort and having an appropriate financial plan taking into account your financial needs now and in the future enables most people to decide how to address this key question. As always, if you are unsure you should seek professional advice to help guide any decisions you choose to take.

Find out more!

Listen **here** to our latest Market Views from our Head of Systematic Research for TAA and Alpha, Stefano Amato, as he shares his thoughts on recent volatility within investment markets.

Note: Data as at 5 April 2022.

[1] Investopedia, 5/04/2022
[2] Investing.com, 5/04/2022
[3] FE Analytics, 5/04/2022
[4] Investing.com, 5/04/2022
[5] FE Analytics, 5/04/2022
[6] Investing.com, 5/04/2022
[7,8] Financial Times, 5/04/2022
[9] Office of Gas and Electricity Markets (Ofgem), 5/04/2022
[10] BBC News, 5/04/2022