Capital Markets Update

Spring 2022

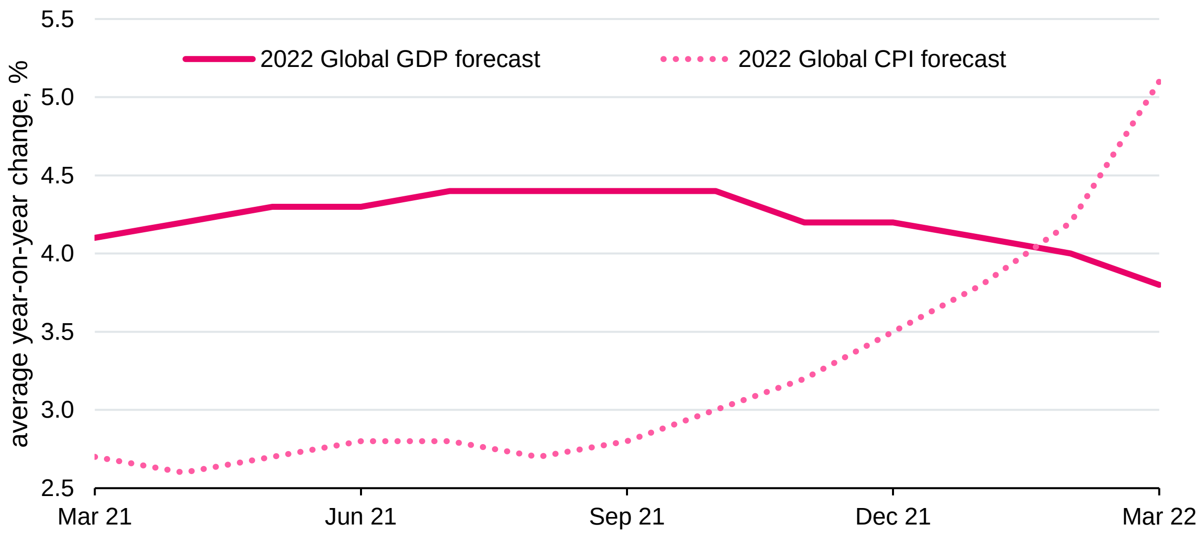
The Russia-Ukraine conflict, and its impact on commodity prices, has exacerbated existing inflationary pressures, weighing on the growth outlook as input and living costs rise, and central banks turn less accommodative.

Sovereign bond yields rose significantly as interest-rate expectations increased, equity prices fell, and credit spreads widened as the outlook dimmed.

Global themes

Consensus forecasts for global growth have been revised downwards whilst global CPI forecasts have reached new highs as the Russia-Ukraine conflict has reinforced and intensified existing trends (Chart 1). Russia and Ukraine represent a small share of global GDP and trade but produce a disproportionate share of key global commodity exports. Physical disruptions and sanctions have triggered broad commodity price rises which, alongside existing inflationary pressures, are increasing input costs and weighing on real consumer incomes. The rapid spread of Omicron in China, which has led to large-scale lockdowns, has also been a factor, weighing on Chinese domestic demand and compounding existing supply chain issues.

Chart 1: War in Ukraine upends global growth and inflation forecasts[1]

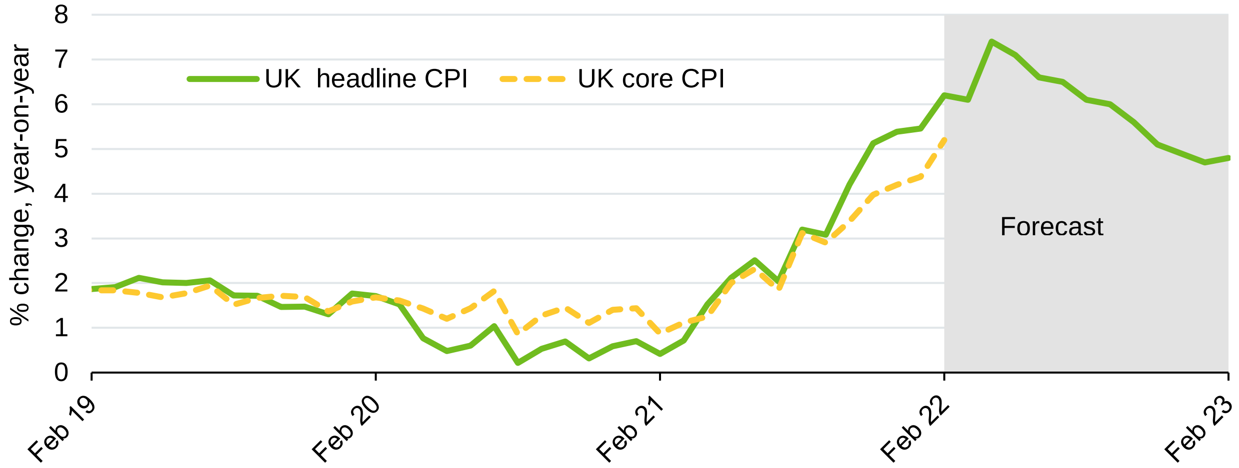


Global growth has been revised down from a relatively robust pace, but forecasts still point to relatively strong growth over the next couple of years, by the standards we've seen since the global financial crisis. Indeed, flash composite purchasing managers' indices for March remain consistent with economic expansion in both the service and manufacturing sectors in the major advanced economies. However, surveys continue to highlight severe labour and materials shortages and input and output prices rising at survey-record highs.

We anticipate inflation peaking at higher levels in the near term and falling back more slowly than previously expected. UK CPI inflation in February once again exceeded expectations, with further rises expected over the coming months (Chart 2). Part of this is attributable to soaring energy costs, but policymakers will be more concerned that core inflation, which excludes volatile energy and food costs, is also running at 30-year highs.

[1] Consensus Economics

Chart 2: CPI inflation reached a near 30-year high in February[2]



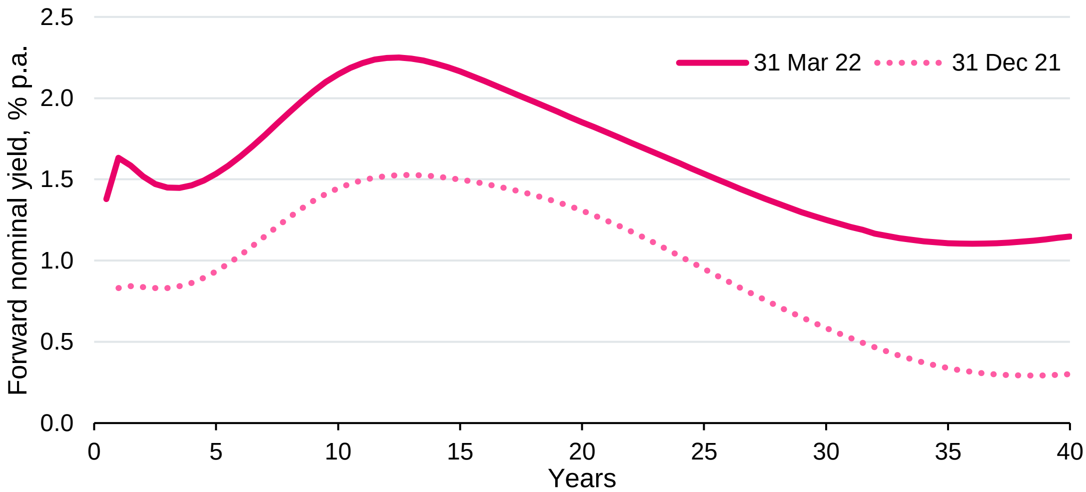
We expect the Bank of England and the Federal Reserve will feel that high current inflation and tight labour markets justify further interest-rate increases. However, the picture has become more complicated for central bankers: interest rates can do little to combat supply disruptions, while high energy prices can eventually help to suppress inflation pressure by weighing on demand. As a result, policymakers could slow down the pace of hikes if energy prices lead to further deterioration in the consumer outlook.

We still expect above-trend growth in the near term, but the balance of risks to both growth and inflation has shifted in the wrong direction. Although we expect interest rates to rise at a pace that does not necessarily disrupt the economic recovery, upside inflation risks leave scope for a much larger negative impact on growth and add substantial risk to the corporate earnings and default outlook.

Government bonds

In the UK, market-implied expectations of interest rates have risen at all durations (Chart 3). The current path out to 10 years or so does not, in our view, look unreasonable. Any new-found enthusiasm the Bank of England has for raising rates may be tempered by its own forecasts, which show a sharp fall in GDP growth, an excess of supply over demand, and below-target inflation in 2024. Longer-term yields, which imply that interest rates will begin to fall in 12 years' time, offer less compensation for inflation risks and the uncertain impact a reversal of central bank asset purchases could have on yields.

Chart 3: Front-end of the forward nominal curve continues to offer better value than long-end



Implied inflation has also risen at all durations. The rise at shorter terms has fundamental support from the expectation that near-term inflation will stay higher for longer and the premium reflects the risk of further

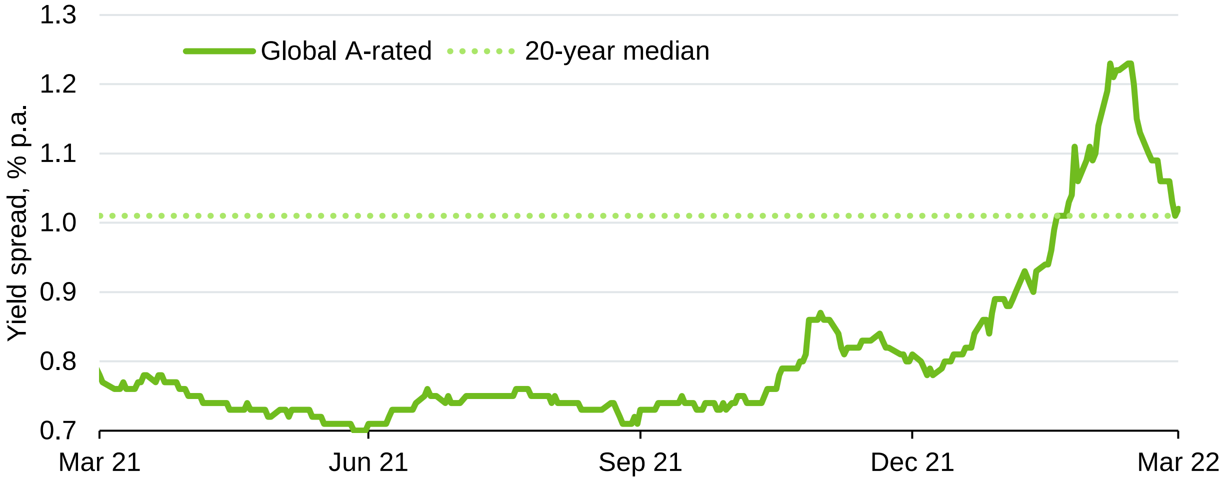
[2] Datastream

increases in inflation. If a de-anchoring of longer-term inflation expectations is a concern, there is little evidence of this in longer-term forward implied inflation, where inflation risk premia are only slightly elevated relative to neutral expectations. However, should inflation moderate as forecast, and move back towards target over the next three to five years, medium-term implied inflation looks more vulnerable to a re-pricing of inflation risk.

Credit

Despite snapping back sharply from levels reached in mid-March, credit spreads have risen significantly this year. Investment-grade spreads have returned to long-term median levels (Chart 4), but speculative-grade spreads remain below long-term averages. Geographic dispersion increased as spreads in continental European markets rose more significantly than their US counterparts, consistent with the suggestion that the economic impact of the conflict will be more keenly felt in Europe.

Chart 4: Recent spread widening has restored a degree of value to credit markets

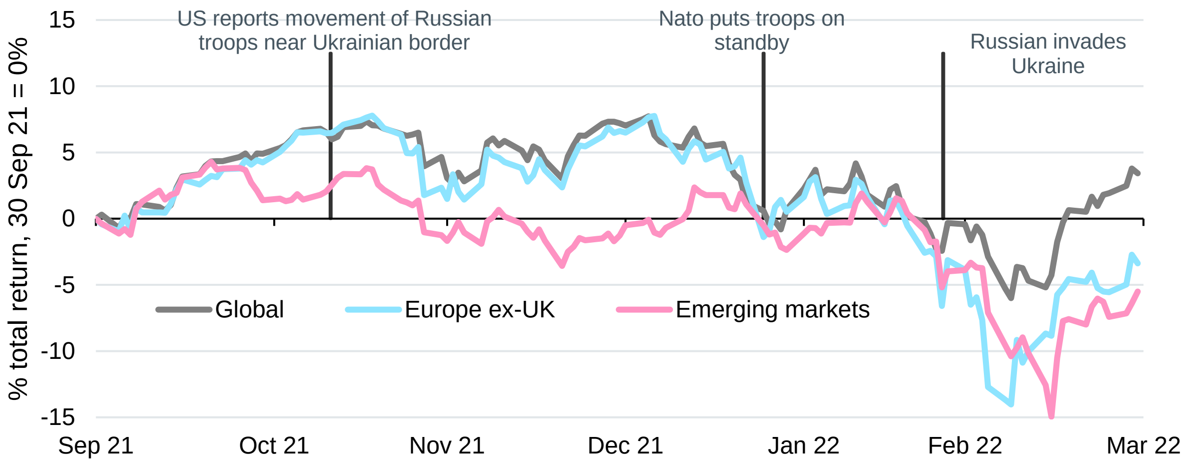


Slowing economic growth raises the risk of default and downgrades, but cash balances, income and capital leverage metrics are in robust shape, bolstered by the scale of refinancing in recent years at extremely low rates and a recovery in earnings. Because of our view on implied interest rates, we prefer shorter-dated and floating-rate credit. However, we retain a degree of caution: high current and forecast inflation, and its corrosive effect on nominal coupons, dims the appeal of fixed-income assets; and speculative-grade credit spreads, trading well below long-term medians, may not adequately compensate for the increased downside risks.

Equities

Global equities have largely rebounded from the initial sell-off following Russia’s invasion of Ukraine, but high inflation, expectations of monetary tightening, geopolitical tensions, and slowing earnings momentum have all contributed to a -4.6% year-to-date global equity return (Chart 5). This, coupled with ongoing earnings growth, has taken a little heat out of valuations, but they are still stretched by historic levels.

Chart 5: Equities have largely rebounded from the initial Russia-Ukraine sell-off while European and emerging markets have underperformed.

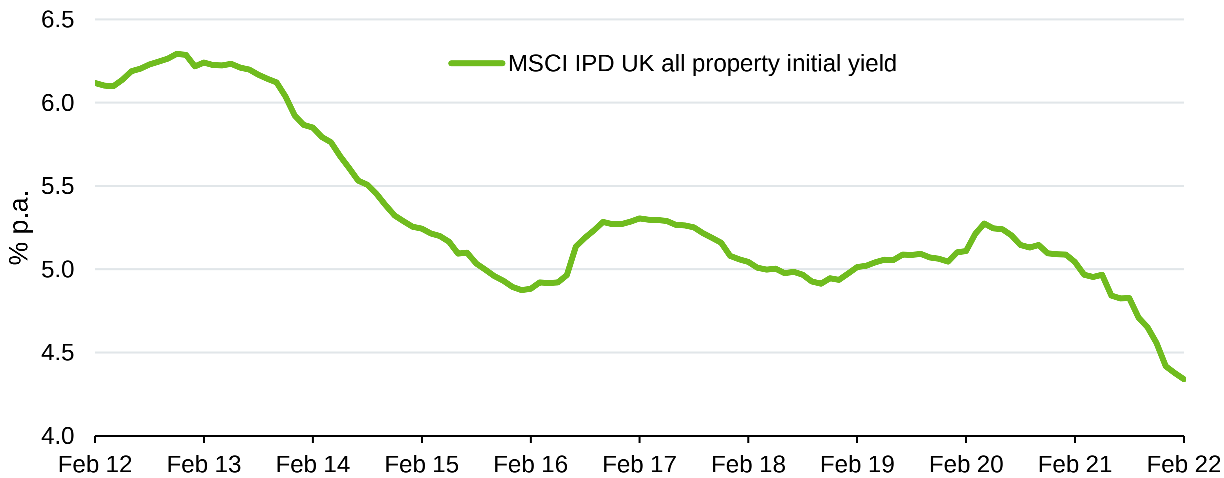


Earnings growth in 2022 will inevitably slow sharply from an expected 54% in 2021. But demand and revenue growth remain strong and there is evidence that businesses expect to be able to pass on most of their higher costs. Business surveys highlight the share of firms raising, or planning to raise, average selling prices at record highs[3]. Consensus forecasts show earnings growing by almost 10% this year, reflecting only a modest margin squeeze. Nevertheless, there are risks, and the inflationary backdrop may favour sectors that benefit from more inelastic demand and greater industry concentration, both of which are key in maintaining pricing power and margins.

Property

The property market appears to have reasonably strong fundamental and technical foundations to support further recovery. Nominal property rents, in aggregate, have been rising for the past year, though rental growth continues to fall short of inflation. The most recent RICS Commercial Property Survey showed that respondents expect further rent increases as availability reduces. The investment market is in good health, supported by overseas demand and a resurgence in the number of domestic buyers – transaction volumes reached their highest quarterly volume since 2015 at the end of 2021. Within the market, there is still significant sectoral divergence, with strong industrial fundamentals masking weaker sectors, such as retail.

Chart 6: UK property yields are low, even relative to more recent history



Initial (current) and reversionary (full) rental yields have continued to trend downwards and are very low versus their long- and even short-term history (Chart 6). However, as with equities, demanding valuations are offset, at least to some extent, by the current and projected low level of real government bond yields. The prospect of

[3] NFIB Small Business Optimism Survey

some inflation protection from rental growth over the medium term, particularly within the long-lease market, is also attractive in current circumstances.

Conclusion

We still expect above-trend growth and though inflation is still not expected to be a long-term problem, even if exacerbated by the Russia-Ukraine conflict, it will be higher for longer. Nevertheless, central banks are likely to continue raising rates. The potential impact of inflation and energy prices on real consumer incomes increases the downside risks for growth.

Sovereign bond yields have risen to reflect a faster path of interest-rate rises, and we think the risk of higher inflation is increasingly balanced by the risk that a faster-than-expected slowdown eases current price pressures. This makes us more comfortable than we were previously with the path of future interest rates (implied by nominal gilts). Uncertainty and risk to the inflation outlook provide near-term support to index-linked gilts, but the very low level of real yields undermines their relative appeal on a longer-term view.

Spreads have also risen across credit markets and, given our views on yields, we are more agnostic between short-duration fixed- and floating-rate credit. Within credit markets, we see better value in investment-grade than in speculative-grade markets, where spreads may still not adequately reflect increased downside risk. Despite improved valuations in bond and credit markets, the potential impact of high and more persistent inflation on real returns means we retain a degree of caution.

Nevertheless, the combination of improved valuations and the view that markets have already moved to price in a lot of near-term inflation risk calls for a more neutral position between income and growth assets, given that equity and property valuations still look extremely stretched versus history. However, the prospect of inflation-linkage in earnings and rental growth, set against the high inflation backdrop, prevents us from taking an underweight position in growth assets, despite high valuations and increased downside risks.

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