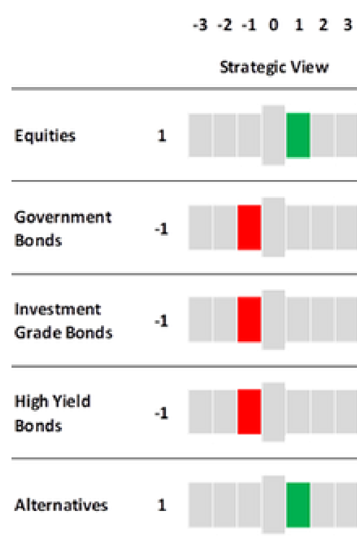
1H Strategy

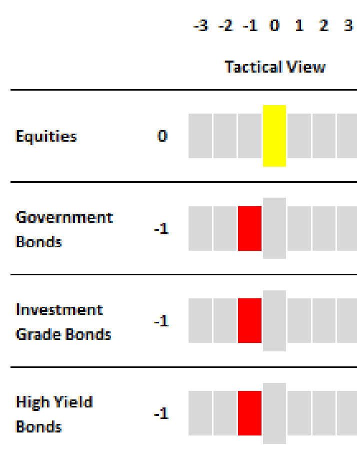
Monthly Portfolio Insights

May 2022 Edition

For important disclosures, please see Page 18

Portfolio Strategy





Inflation concerns are dominating portfolio strategy. We explore the causes of the surge in prices. While we expect inflation to moderate in the second half of the year and into 2023, we are mindful of the uncertainties to this forecast.

We remain moderately underweight fixed income but believe that the pace at which yields have been rising will ease up. Faced with rapidly rising prices, the Fed and other central banks have been slow to act. The bond market has been quite the opposite.

We maintain a strategic bias (time horizon greater than 12 months) towards equities. The wall of worry is higher than usual, but still surmountable. Valuations are fairly low in many equity markets. In the US, where valuations are somewhat elevated, robust economic growth coupled with above-average earnings growth should underpin stocks.

Tactically, however, we have a neutral positioning in equities as investors assess the implications of the rapid move higher in bond yields, quantitative tightening that may begin in May, and China's Covid lockdowns.

Hong Kong's Hang Seng Index still offers value on a medium-to-long-term basis, in our view, bouncing off an historically low valuation in March but coming under pressure again as China battles Covid with city-wide lockdowns.

We have a strategic overweight in alternative investments due in part to the heightened uncertainty around returns from traditional asset classes as well as the potential for price dislocations that may favour niche investment strategies.

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Key Thoughts

· **Inflation and inflation expectations will be pivotal to investment outcomes in 2022**. Should inflation moderate significantly, as central banks are forecasting for the second half of the year and into 2023, then the outlook for equities and bonds will become far more benign. This is also our base case. We expect supply chain issues to ease and year- on-year price comparisons to assist. **We are constructive on equities on a strategic basis (+12 months) and see plenty of investment opportunities** (See Page 15).

· **However, we are concerned that inflation may remain somewhat higher than forecast if inflation expectations rise among business and consumers, for example if higher wage inflation becomes embedded** (See Page 8). Moreover, if inflation remains particularly high and 'sticky', the investment landscape will look quite different to the past decade and portfolios will need to be repositioned accordingly. **This is currently not our base case, however**.

· **The Fed will likely be the most aggressive major central bank in 2022**. We expect the Fed Funds rate to increase by 2.5% or thereabouts to year-end. Recent comments from Fed officials have been increasingly hawkish. Fed policy is critical not least due to the outsized importance of the dollar in global bond issuance.

· **Markets posted a rocky start to 2022 after a year of strong returns in 2021**. The retreat in both equities and fixed income has been primarily due to the twin headwinds of rising bond yields – a trend that was already underway but accelerated in Q1 - and the war in the Ukraine beginning on February 24th leading to a spike in commodity prices.

· **Investors may continue to find fixed income markets tricky to navigate** as rate hikes proceed through the year. The declining value of global fixed income in fact began in June 2021. Since then, the total value of global bonds has declined by around $6.6 trillion, or 9.5%. Indeed, **bond markets had their worst quarter since 2008**. Investors have been pulling money from bond funds in 2022.

· **Global equities registered their first correction since Q1 2020**. Surging inflation and the consequent hawkish talk from central banks spooked equity investors at a time when a pullback was increasingly likely anyhow. And then the war started. Conversely, equity valuations have improved.

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· **In Asia, we are following Hong Kong's Hang Seng Index**. A confluence of factors, including local Covid policy, a weak domestic economy, poor investor sentiment, and then a new Covid outbreak in China, drove the index down to an historically low valuation. Following a strong bounce of +20% in March, weakness has resumed on the back of city-wide lockdowns in China. Thus, we once again find the index valuation compelling on a medium-to-long-term basis. (See Page 16).

· While the outbreak of war in Ukraine exerted further pressure on risk assets, **the initial panic in markets has somewhat subsided** as investors have digested its potential impact on portfolios. The human cost of the war is appalling. The situation in Ukraine remains complex and ugly. There is no clear path to the ending of the war at present. However, markets have a deeply cold-blooded way of assessing what is relevant to asset prices.

· **Chinese economic data could weaken substantially over the next several months** as the country continues with its lockdown strategies to control Covid. The city-wide, strictly enforced lockdown in Shanghai has received much attention. Additionally, there are lockdowns or restrictions in many other locations, all of which impact economic activity. It is quite possible that China will pursue its zero-Covid policy until Q4. However, the importance of the Party Congress at that time may prohibit the authorities from allowing excessive economic weakness in the preceding months. Consequently, we expect monetary and / or fiscal stimulus to be forthcoming.

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Inflation: Monster or Myth?

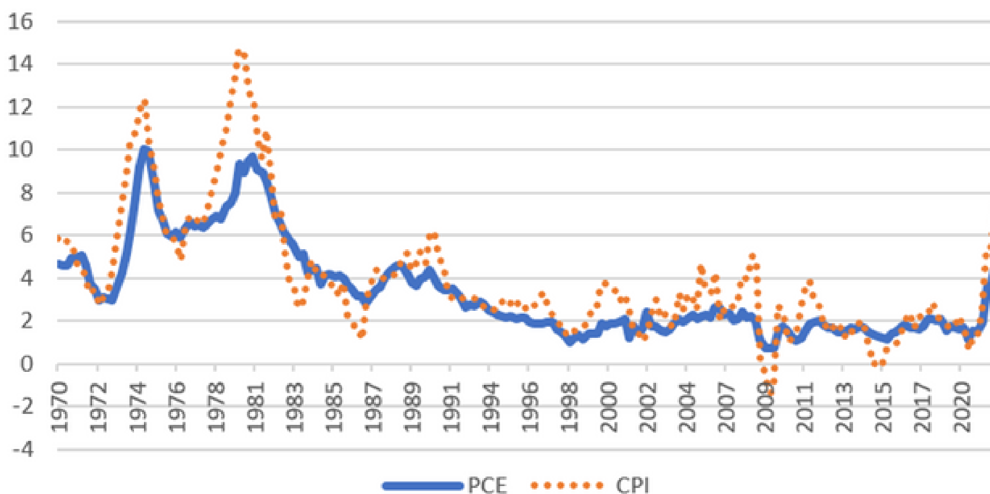
Our working investment thesis is that high inflation, the biggest challenge to markets, will ultimately not become entrenched and indeed will moderate, starting later this year but more meaningfully into 2023. We have a bias towards equities. However, we are also aware that this outcome is far from certain at this juncture and, thus, are careful about the selection of securities that are more sensitive to inflation and higher interest rates. For example, investors should asses which companies have less pricing power or higher input costs, especially commodity inputs, as well as those companies which are more sensitive to higher interest rates, such as highly indebted companies.

Inflation: 40-Year High

"The labour market is very strong, and inflation is much too high" commented Federal Reserve Chairman Jay Powell to the National Association for Business Economics in mid-March. In mid-April, he added **"It is absolutely necessary to restore price stability."** No kidding: US consumer price inflation surged by 8.5% y/y in March, the highest level since the early 1980s when Ronald Regan was president and Paul Volker, then Fed Chairman, spearheaded a campaign against inflation that saw interest rates reach 20% (yes, 20%) in 1981.

"The labour market is very strong, and inflation is much too high" - Federal Reserve Chairman Powell

PCE inflation, the Fed's preferred measure, was +5.4% y/y in February, the highest since 1983. Bear in the mind that the Fed's inflation target is 2%. The prices component of the US ISM manufacturing PMI survey for March was an eye-watering 87.1. The services PMI was similar at 83.8. Signs of inflation are everywhere.



Source: One Heritage, Bloomberg

Why is inflation so high?

Suspects are numerous. Soaring energy prices are certainly a culprit, especially with respect to European inflation, and the Ukraine war has made this worse. Energy prices were already high before the conflict began. Strong demand growth for oil strained supply in 2021 as many countries emerged from lockdowns.

Brent crude oil is 50% above its 10-year average. According to the International Energy Agency, 1.5mb/d of Russian oil and refined products could be removed from the market in April, expanding to nearly 3mb/d in May as sanctions bite and firms pull out of doing business with Russia. Against these pressures, President Biden announced the release of 180mm barrels of oil from US strategic reserves over the next six months.

The US jobs market is particularly strong– there are 1.8 jobs available on average for every jobseeker– and that is forcing companies to pay more to fill positions, leading to the strongest wage growth in years with average hourly wages rising by 5.5% y/y. Nearly 4.4mm people in the US quit their jobs in February, close to the 4.5mm record in November 2021, a year in which 47.8mm workers left their jobs of their own accord. Record numbers of people leaving one job to go to a better job is an indicator of an extremely robust employment market.

"Global supply chain stresses and soaring energy prices have been the biggest drivers of inflation"

However, this is a US-centric narrative. With the major exception of high energy prices – no doubt a key driver of inflation in many countries - it fails to fully explain high inflation in countries where growth outlooks are more challenged and jobs markets not nearly as tight, such as the UK (March CPI was 7.0% y/y) and Europe (7.4% y/y). The implication is that **global supply chain disruptions due to Covid have been a driving force of higher prices**, as has been hypothesized for some time.

For example, China, the global manufacturing centre these days and home to 6 of the 10 largest container ports in the world, still has an active zero Covid policy. Indeed, at the time writing, Shanghai, with its 25 million residents, is slowing emerging from a 4-week lockdown while Beijing may be about to enter one. Throughput at these ports is impacted by on-again, off-again factory closures across the country. Major car plants have closed. Major electronics factories have closed. China is not the only source of supply chain constraints, but is probably the most important.

A recent survey of German companies by the German Chamber of Commerce in China found that '51% of Germany companies' logistics and warehousing and 46% of German companies' supply chains are completely disrupted or severely impacted by the current Covid situation in China.'[1] Only 7% of companies surveyed reported no impact.

Container prices have risen significantly due to the pandemic. Bloomberg reports that while the price of a 40-foot shipping container fell by 11% in Q1 2022, it was still double the price of a year ago and 'several times higher than 2019 levels'. The article

[1] https://china.ahk.de/

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cites calculations by the International Monetary Fund that the doubling of freight rates adds 0.7% to inflation, meaning an extra 1.5% increase in prices in 2022, and can take up to 18 months to moderate.

Additionally, the war in Ukraine is having a significant impact on commodity prices beyond oil and gas to the likes of wheat, fertilizers and base metals. The second derivative effects of these increases, such as food scarcity, have yet to play out in full.

Finally, the increase in global money supply by central banks has also been put forth a key driver of inflation. However, central banks have been 'printing money' (an addition to a digital ledger, not a physical act) for over a decade, yet inflation only really picked up when supply chains broke down during the Covid epidemic.

"Markets are pricing in approximately 250 basis points more in rate hikes by the Fed this year"

The outlook for inflation

Both the Federal Reserve and European Central Bank forecast inflation to moderate significantly towards the end of this year and into 2023. The Fed's median forecast for Personal Consumption Expenditures (PCE) inflation, its preferred measure, is +2.7% in 2023, half the current level. The ECB's Harmonized Index of Consumer Prices (HICP) is expected to fall from 5.1% in 2022 to 2.1% in 2023.

Underpinning these forecasts for moderating prices are 1) base effects, which simply refer to future inflation data being compared to levels that are already elevated, thereby making a more favourable comparison; 2) the expectation that energy prices, which have been particularly inflationary in the UK and Europe, will decline; and 3) the gradual healing of global supply chains.

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What could derail the outlook for price moderation?

First, the risk that even though supply chain friction disappears, inflation remains. That is, the theory was wrong, or more likely that the situation has evolved beyond supply chain problems. The reality is that the global economy is a highly complex system that defies forecasting at times.

Second, the risk that high inflation expectations become entrenched. At present, consumer expectations for the inflation rate in 3 years are at 3.67%, higher than average but, arguably, not at a worrying level.

Third, that China pursues a zero Covid policy *ad infinitum*. This will not happen, of course, but there is currently no clarity on when the policy will end.

Finally, there is risk of energy prices remaining particularly high, or even rising further, for an extended period due to the war or other unforeseen events.

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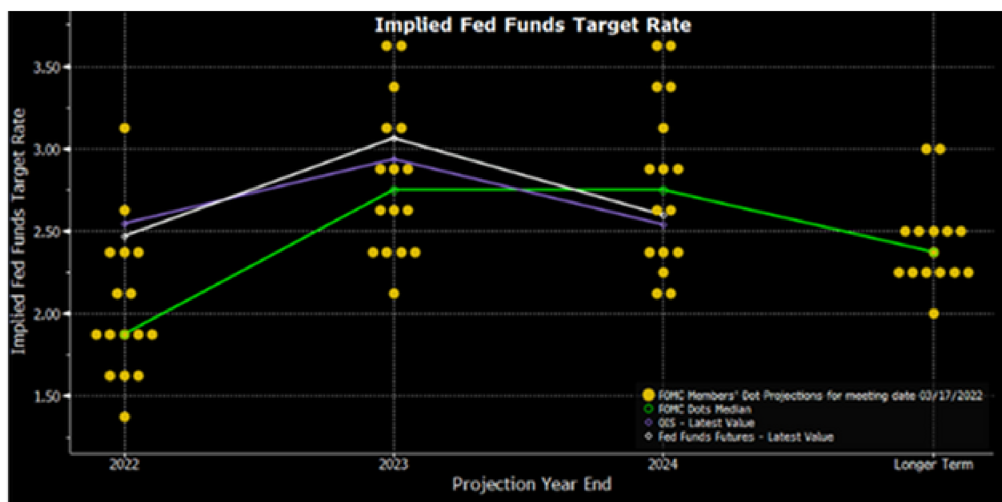
The Bond Market: Lots of Heavy Lifting to Come from the Fed

Chairman Powell appeared to agree in his comments to the NABE regarding the belief that inflation will wane as supply chains improve, albeit it with a major caveat: “It continues to seem likely that hoped-for supply-side healing will come over time as the world ultimately settles into some new normal, **but the timing and scope of that relief are highly uncertain**.” In short, easing supply chain problems may bring about a meaningful reduction in price growth. At some *unknown point in the future*.

This uncertainty helps to explain why there is a broad range of views by FOMC members regarding the path of the benchmark US rate over the next 12–24 months. According to the Fed’s ‘dot plot’, the FOMC members’ median forecast for the Fed Funds rate at the end of 2022 is 1.87%, but with a range of 1.38% to 3.31%. Note also that the 2022 year-end interest rate implied by Fed Funds futures is 2.7%, substantially higher than what is implied in the dot plot. **The bond market forecasts consistent rate hikes through the year starting with a front-loaded 50bps increase in May.**

"The ‘wall of worry’ that equity investors always face is somewhat higher than usual"

Implied Fed Funds Rate: 2022, 2023 and 2024



Source: One Heritage, Bloomberg

Even so, the Fed has only just begun its tightening cycle in March. And even then it saw fit to raise rates by only 25bps to a target range of 0.25% to 0.5%, **a level that one can say is at best highly accommodative but perhaps controversially low given surging prices and a strong jobs market**. Consider that the dual mandate of the Federal Reserve is to ‘pursue the economic goals of maximum employment and price stability.’

Against this, there is the uncomfortable thought that raising interest rates will not fix the twin problems of supply chain stresses and high energy prices. However, Mr. Powell has commented that raising interest rates will cool the jobs markets, thereby quelling another inflationary pressure.

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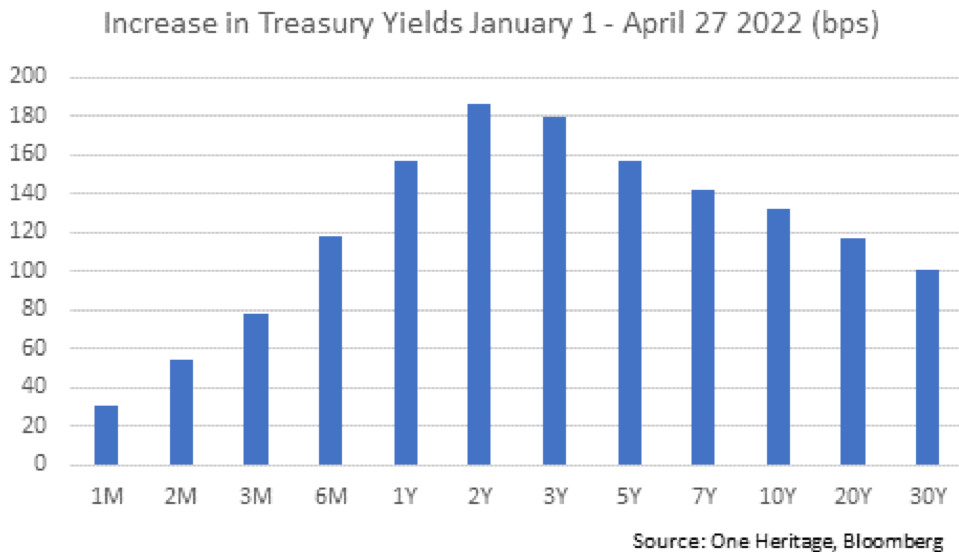
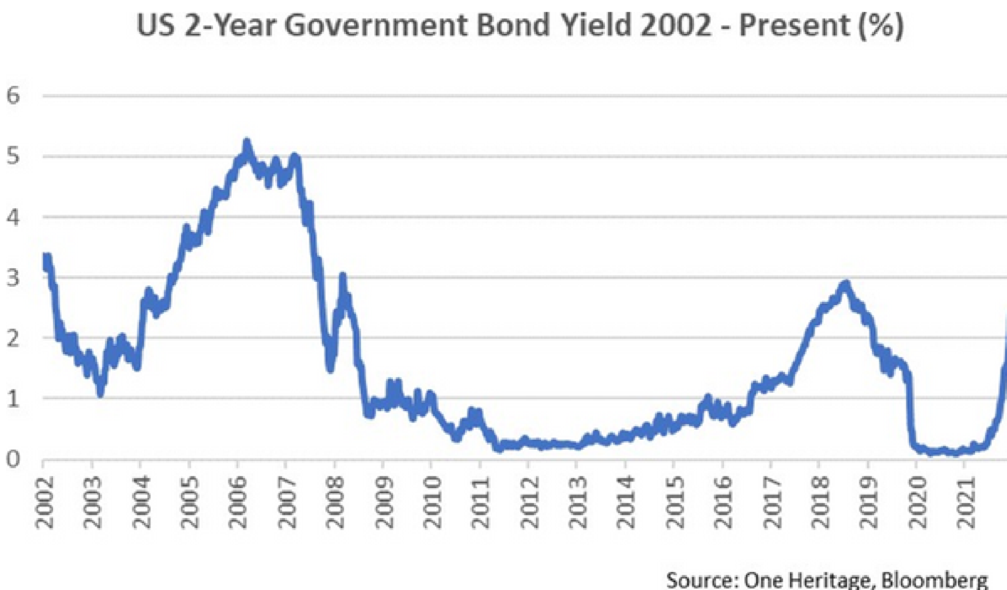
Bonds – Under Pressure

In the meantime, bond investors have not been waiting quietly to act. Flows from bond funds have been consistently negative in 2022, with investors correctly expecting the US Treasury yield curve to rise – and bond prices thus to fall – in anticipation of higher interest rates. And rise it has, across all maturities on the curve. 2-year Treasury yields have led, gaining 187 basis points. What is most remarkable about this move is not its size but rather its speed.



As recently as September, the 2-year Treasury yielded a measly 0.2%. By April 21st, the yield had jumped to 2.68%. Most of those gains occurred in Q1 2022. The longer end of the yield curve has also risen but by less, leading to a flat yield curve that is flirting with inversion.

Going forward, **we expect the US yield curve to move higher again albeit at a more modest pace**, apart from shorter maturities under 1-year which should move more quickly as the Fed acts.



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Global corporate bonds lost 7% in Q1. This was the worst quarterly performance in over a decade.

Aside from interest rates moving higher, another issue facing investment grade corporate bond investors is that corporate credit spreads tightened at the end of March with the improvement in risk sentiment. While further credit spread tightening is possible, the fact is that the current credit spread for 10-year BBB-rated bonds is 173bps, which is already tighter than the 5-year average of 212bps.

In our view, the return from US corporate bonds for the rest of the year is more likely to depend on fluctuations in the yield curve and inflation expectations rather than movements in credit spreads. **In terms of portfolio management, we have been looking to fixed income investment product with rate-reset features.**

Should inflation indeed start to moderate into the second half of 2022, **the repriced yield curve may provide fixed income investors with attractive entry points**. Until then, we proceed with caution.

Finally, one pleasing result of the rise in bond yields has been **a significant reduction in global bonds that have a negative yield**. Negatively yielding bonds have been a bane of investors: hard to understand, even harder to explain, with poor outcomes for investors, and carrying unsettling implications of dysfunctional economies and markets. **At the peak of negative yields in 2019, a staggering 40% of global government bonds had a negative yield**, meaning that an investor who bought and held such a security to maturity was guaranteed to lose money. This has since fallen to close nearly zero with the exception of some Japanese government bonds. Investors should be glad to see the back of negative interest rates and bond yields. They have been terrible for conservative investments within pension funds and insurance products and for savers more generally.

"Negative yields in bond markets are thankfully becoming a thing of the past."

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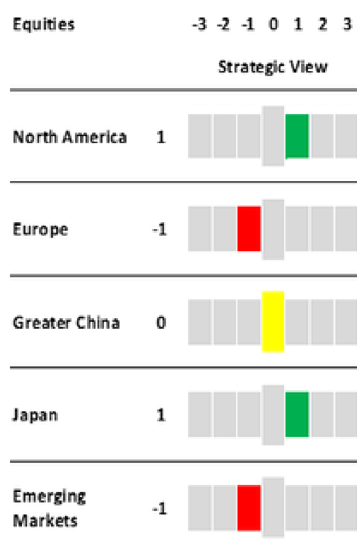
Equity Strategy



We maintain a strategic bias (time horizon greater than 12 months) towards equities. Our overweight view is expressed via a preference for North American equity markets and parts of Asia, principally Japan and Hong Kong.

The wall of worry for equity investors is higher than usual, but still surmountable. Previously elevated equity valuations in the US have improved with the market correction. Robust economic growth coupled with high single-digit earnings growth should underpin stocks. Inflation should moderate in the second half of the year. Investors have had plenty of time to assess the Fed's course of action.

Europe is closer to the war, dependent on Russian energy exports, and has a lower growth outlook. The ECB has its hands tied, caught between a material slowdown in growth and a surge in inflation. In the UK, the risk of recession in the second half of 2022 may be as high as 50%. We remain cautious on European equities and the currency while acknowledging that are always opportunities in such a large market and that EURUSD is already at a multi-year low.

China continues to pursue a zero-Covid strategy that has been extraordinarily successful at keeping cases at bay. But lockdowns, quarantines and some degree of national isolation are impacting economic performance. We expect some combination of fiscal and monetary stimulus but are unsure of the timing. However, the Hang Seng Index trades at a compelling valuation and offers value for patient investors.

We are overweight on Japanese equities due to a combination of attractive valuations, reasonable prospects for earnings growth, share buyback activity, and currency weakness. In the very short-term, however, we do see headwinds from the slowdown in China.

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Equities: The Wall of Worry Remains – But Plenty of Good Businesses to Own

The Vanguard Total World Stock Index Fund ETF (VT) peaked in November and as of April 27th is at its lowest level of the year, a decline of -14.6%. This was the first correction (a decline of at least 10%) in two years since the Covid-induced bear market of 2020 in which a recession and a very steep decline in stock prices were squeezed into a few months.

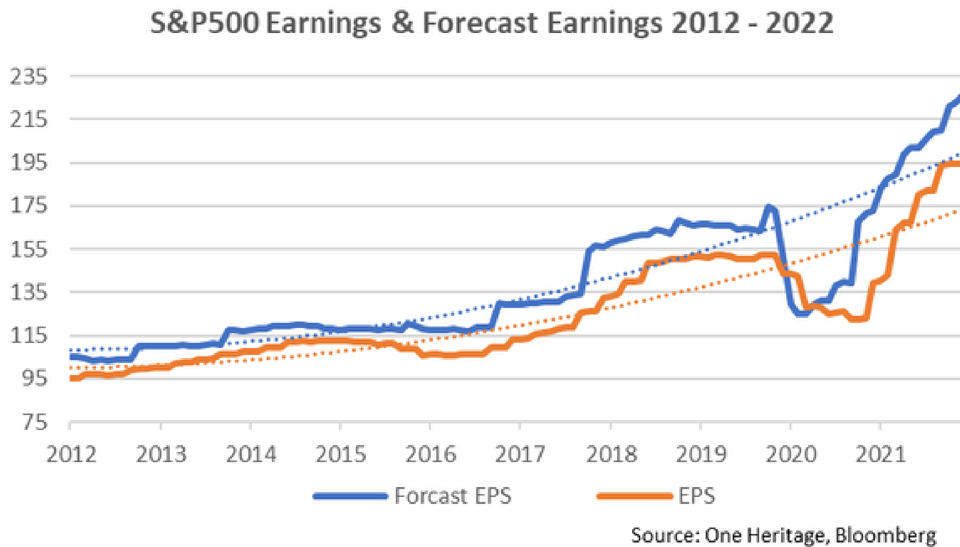
This correction, which is still underway, has been predominantly due to the surge in inflation and bond yields, and the Ukraine war. There has also been notable weakness in some technology stocks. Additionally, equity markets were also looking a little overbought at the start of the year. Commodity sectors such as Energy and Materials have outperformed.

"The 'wall of worry' that equity investors always face is somewhat higher than usual"

Overall, the 'wall of worry' that equity investors always face is somewhat higher than usual. Inflation, war, rising rates, flattening yield curves, and quantitative tightening are all concerns. Our view, however, is that inflation will moderate in the second half of the year and that bond yields will remain reasonably low by historical standards, creating a more benign environment for equities.

US Equities – Positive Bias

The odds of positive US equity returns are historically stacked in favour of investors when the economy is expanding, as is the case at present. The US economy may expand by 3 – 3.5% in real terms in 2022. Nominal growth may be over 8% due to high inflation. We expect reasonably robust corporate earnings growth in the US in the mid-to-high single digits, underpinning the equity market. The annual compound growth rate in US earning over the past decade is 7.4%.



"An expanding economy and average earnings growth should underpin US equities"

There has been some discussion of the likelihood of recession in the US. On several occasions recently the yield curve has flattened and inverted, with 2-year Treasury yields slightly higher than 10-year yields. Historically, inverted yields curves have often been a forerunner of recessions.

We are not overly concerned at present with respect to the flattening yield curve and its implications for equity returns. The yield curve is not 'flashing red' - yet. First, in our view, the 3-month yield versus 10-year yield is a more important indicator. That spread is steep (but will narrow). Second, the yield curve needs to stay inverted for a lengthy period to count as a signal at present, it is no longer inverted. Third, if the yield curve does invert and stays that way, recessions still do not typically occur until quite a long time afterwards, often more than a year.

Moreover, several important economic indicators in the US, for example employment data and ISM surveys, point to a buoyant economic environment. There are exceptions: US consumer spending, for example, is muted as high prices bite.

US equity valuations have reset lower. The S&P500 trades at a multiple of 18.3x estimated earnings for the next 12 months. This is a much more tolerable level than the +22x multiple that was attached to the market throughout 2021. Current valuation

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multiples are only a couple of turns higher than the long-term average. This is acceptable when considering that, first, the cost of capital is still at low levels – even after the move higher in bond yields – and, second, average return-on-equity (ROE), a key measure of profitability for the S&P 500, is at intrinsically higher levels these days.

Higher equity valuations levels in recent years have been in part justified on both a relative and absolute basis by historically low interest rates and bond yields. Thus, inflation once again becomes central to the outlook for equities. In our opinion, current equity valuations are eminently sustainable in a non-recessionary environment with low rates and bond yields. However, there would be a strong argument for lower equity valuations if we were to enter a new period of systemically higher costs of capital.

"There would be a strong argument for lower equity valuations if we were to enter a new period of systemically higher costs of capital"

Companies Make Stock Markets

While macroeconomic issues dominate the debate regarding future equity market performance, **investors should (always) remember that there are still plenty of great companies to own at the individual stock level**. Powerful business trends continue to offer opportunities, ranging from extremely specific areas such as the implementation of robotics in surgery to much broader areas such as the ongoing adoption and growth of cloud computing.

We also think that there are interesting business opportunities in so-called Metaverse applications. This trend has already taken hold in online gaming and will likely expand into B2B and B2C applications.

And new avenues for equity investors to explore are emerging. Work-from-home, for example, has become a significant development that is creating opportunities for software development. The successful introduction and global implementation of mRNA vaccines to combat Covid-19 demonstrated to the world the potential for advancements in medical treatments.

From a more anodyne perspective, we like the Financials and Health Care sectors, as well as mid-cap stocks in the US. Additionally, the correction in technology stocks is also presenting opportunities.

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Hang Seng Index - Price Is Everything. Especially When Everything Looks Terrible

Pretty much everything that could have gone wrong for the Hong Kong equity market has gone wrong. The city's economy has been crushed by austere anti-Covid policies, still in place even though the University of Hong Kong estimates that over 4mm people, more than half the population, have already contracted Covid. Non-residents have been banned from entry for nearly two years. Only a tiny trickle of flights come in and out of the eerily silent airport. Business chambers report an exodus of talent as quarantine restrictions curtail ease of movement. The population is shrinking due to emigration. Boarded-up shops are a common sight, yet property prices and rents remain notoriously high. **Chinese internet stocks, the key growth pillar of the index, have been falling for months on regulatory concerns**.

Perhaps the final straw for the Hang Seng Index – and certainly the war did not help – was news of Omicron potentially taking hold in China. What would be the result of that? To date, we still do not know. In a few tough trading sessions in March, **the benchmark Hang Seng Index shed thousands of points and hit a multi-year low of 18,415 on March 15**.

"In our view, the Hang Seng Index offers compelling value at the current level for patient investors"

And that was the time to buy. Everything has a price. But working out what the underlying value of an asset is relative to that price is one key to investing success. For the Hang Seng Index, previous major selloffs turned into equally major buying opportunities when the index reached lows of 1.0x – 1.1x book value. Such was the scale of the decline this time around that **the index valuation briefly reached 0.75x book value**, an historic low. In fact, **this valuation level was even lower that the bottom of the market during the Asian Financial Crisis in 1997**.

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The index then recovered by over +20%, helped at the time by $4.4B of inflows into ETFs that track the index, the biggest inflow in 20 years. However, China's recent, unprecedented lockdowns have once again sent Hong Kong listed stocks down. At 0.85x book value, in our view the Hang Seng Index offers compelling value at the current level for patient investors. Everything has a price that's right.

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