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Elston Insights

21st January 2022

A rough start to the year

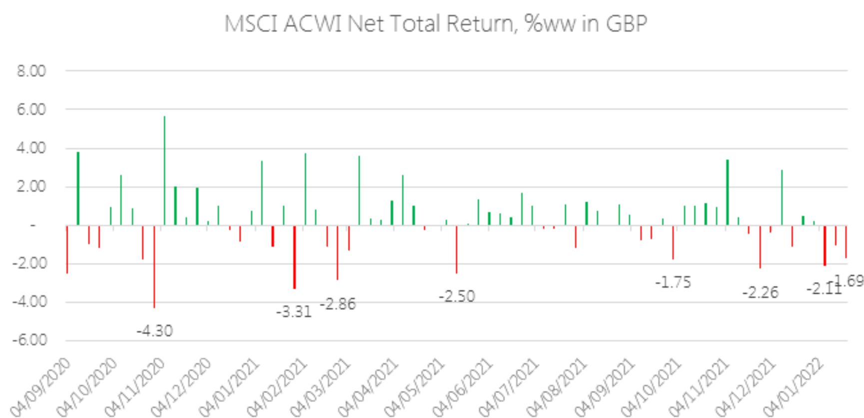
- Markets are repricing three key market risks, and facing a fourth
- More hawkish Fed posture, tech-sector fundamentals and energy/inflation pressure cloud the outlook
- Real risk of a Russia/NATO war

What happened this week

Equity market performance has taken a tumble, speculative assets have taken a fall. Why is this, and what has changed?

The last 4 weeks have seen negative returns for Global Equities, in GBP terms. USD weakness meant that in GBP terms last week's performance of -1.69% was not as dire as dollar-based indices, but it marks three consecutive weeks of market declines.

Fig.1. Global equities have experienced significant weekly losses, three weeks in a row



Source: Elston research, Bloomberg data

These moves reflect investors repricing three key market risks (hawkish Fed posture, tech-sector fundamentals and ongoing energy/inflation risk, and adding in a geopolitical fourth: the risk that the Russia/NATO confrontation over Ukraine ends up, in the event of diplomatic failure, with open war. Let's look at each in turn.

A more hawkish Fed posture

The US Federal Reserve's FOMC (Federal Open Market Committee), or the "Fed", is the interest-rate setting committee responsible for monetary policy, equivalent to the Bank of England's Monetary Policy Committee.

In mid-December, the Fed signalled that it was more likely to be raising interest rates and tightening monetary policy (winding down or "tapering" asset purchases) to keep inflation in check. This was largely expected and markets took this in their stride back then as, Fed thinking was catching up with market fears, meaning reduced risk of a policy error.

What changed is when the minutes of that December meeting were published on 5th January, it became clear that the thinking of the 11 members that make up the Committee was even more hawkish (meaning more likely to be raising rates aggressively) than the December summary announcement indicated.

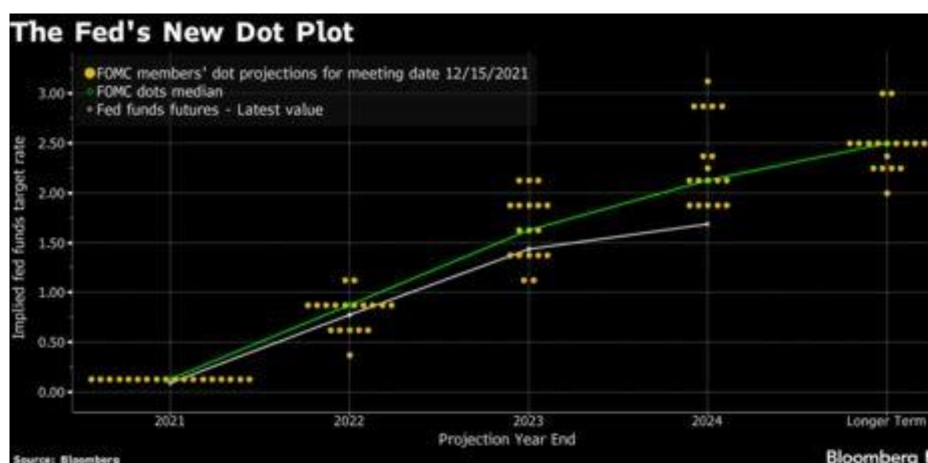
The minutes noted that "*given [members' outlooks] for the economy, the labor market, and inflation, it may become warranted to increase the federal funds rate sooner or at a faster pace than participants had earlier anticipated*," and that "it could be appropriate to begin to reduce the size of the Federal Reserve's balance sheet relatively soon after beginning to raise the federal funds rate."

The meeting considered the high US inflation numbers (+6.8%yy in November) and the fact that the potential disruption to the economy from the Omicron variant (which subsequently happened) would only add to inflation pressure.

This more hawkish stance has forced investors to adjust their expectations around the timing and pace of interest rate increases. Triggering a sell-off in equities, and rising nominal bond yields.

The minutes revealed that opinion is now unanimous as regard interest rates rising in 2022 – as indicated by the "dot plot" which shows committee members anonymised interest rate projections.

Fig.2. FOMC members interest rate projections



No more "Fed Put"?

Furthermore, there has been an ongoing historical precedent since Alan Greenspan was Chair of the Federal Reserve (1986 to 2003, but particularly in response to the collapse of the dot com bubble, that when extreme and protracted markets decline create a risk to the economy, the Fed has intervened and kept stimulus – and therefore sentiment – going. This was referred to as the "Greenspan Put" or the "Fed Put" as it is like buying a "Put Option" which is a derivative contract which protects the value of a share or index in the event of a decline.

Whilst that may be so in normal times, given concerns that inflation is running at the highest rate in decades, which is the Fed's main battle, there is the growing realisation from this generation of investors and manages, that perhaps the Fed won't step in to support markets in the event of an extreme decline this time round, and that has further added to risk-averse sentiment.

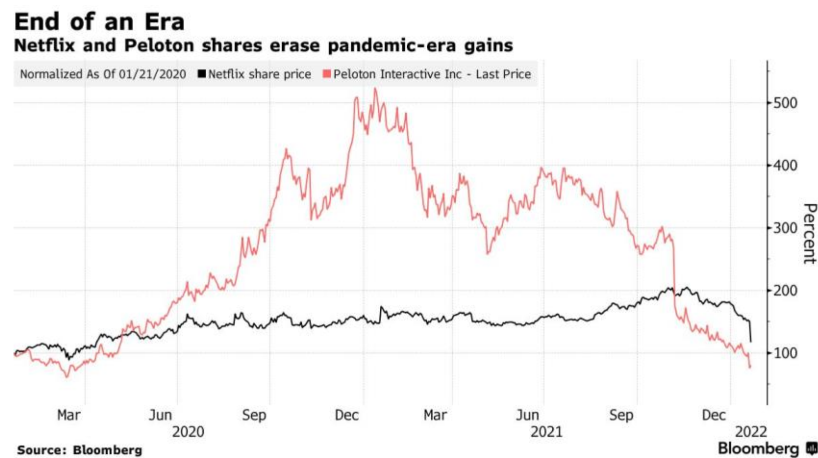
Tech sector fundamentals

Concerns around rising interest rates mean that "jam tomorrow" companies that have low to moderate earnings now, but projected high earnings long-time in the future earnings (growth-oriented companies, like technology), become relatively less attractive compared to "jam today" companies that have solid earnings in the near-term (typically more "boring", quality or value oriented companies, like consumer goods and utilities). This is why we were recommending advisers to be overweight Quality and Value factors in our 2022 Outlook.

Investors have been willing to pay very high valuations for high growth technology stocks (where valuation is defined by the share price relative to the company's earnings, or Price/Earnings Ratio (PER)). However if either the forecast growth of that sector (lower future earnings) or the interest rate used to value that future growth is higher, then the valuation of those companies will necessarily decline.

So concerns around Tesla's valuation, disappointing subscriber data reported from Netflix and a reduced earnings forecast / slowing demand for exercise bikes from Peloton has triggered notable declines in the value of those companies, which have both now reversed their pandemic-era gains.

Fig.3. Pandemic technology names have de-rated



As those are key holdings in many growth focused active funds, and Tesla and Netflix are large holdings in many US equity index funds, their share price declines have dragged US equity market returns down too.

Rotation into Value

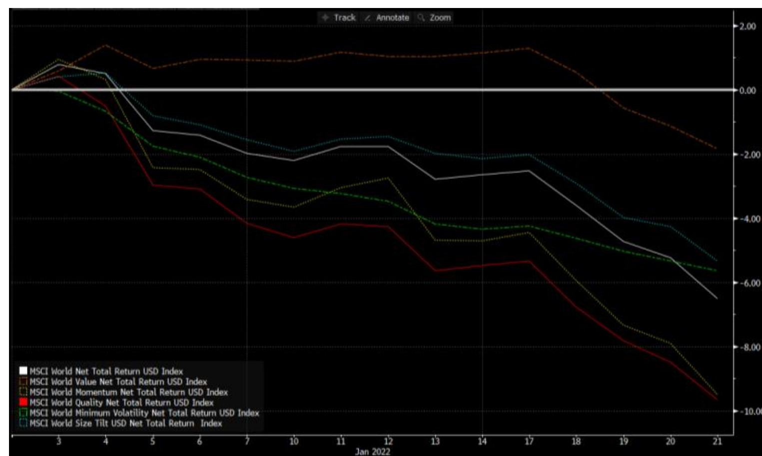
From post-pandemic June 2020 to date, performance of world equity Value factor has caught up with the technology sector as fears of inflation increased. Companies with a strong Value factor are typically "shorter duration", cash generative businesses whose valuation is underpinned by current earnings. As fears around rising inflation and interest rates increased, these Value-factor exposures have gained in appeal relative to "longer duration" Technology sector whose valuation is underpinned by distant earnings growth. Put differently, investors are valuing "jam today" over "jam tomorrow".

Fig.4. Since June 2020, world equity Value-factor has caught up with world Technology sector, returning +32% in GBP terms

Source: Bloomberg, 30-Jun-20 to 21-Jan-22, in GBP terms,

For the same reason, Value factor equities have been defensive year-to-date, declining -1.85%, compared to -9.49% for Momentum factor, and -6.51% for MSCI World.

Fig.5. World equity factors, performance year to date (GBP terms)



Source: Bloomberg, 31-Dec-21 to 21-Jan-22, in GBP terms,

The dispersion between styles and segments within equities is similarly pronounced in the UK.

UK Small Caps as a higher risk asset have declined -6.12%, comparable to world equities. The broader FTSE All Share is flat at +0.27%, the large cap FTSE 100 is +1.53%, whilst our UK Equity Income index, the Freedom Smart-Beta UK Dividend Index, is +4.32%. This is because, returns are underpinned by dividend income, as well as an exposure to energy and financials that benefit from a high oil price/rising rate environment.

Fig.6. UK equity segments, performance year to date (GBP terms)

Source: Bloomberg, 31-Dec-21 to 21-Jan-22, in GBP terms,

In summary, the prospect of a rapid rise of interest rates makes more “frothily valued assets” lose some of their froth. This has played out in the technology sector, whilst the ultimate frothy asset –

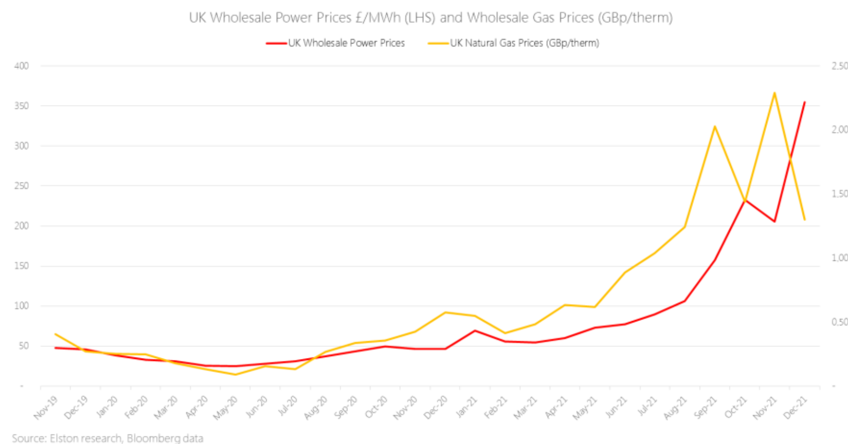
Bitcoin – has lost half its value. Our view is that, in the long-run, Bitcoin is speculative, has no intrinsic value, and has no place in retail investor portfolios.

Energy and inflation pressure

In the world of real assets, the oil price had its fifth weekly gain taking the oil price to a 7 year high on robust demand and limited supplies.

Rising costs of oil and gas are feeding through into wholesale power prices that are inflationary in nature as they affect the input costs of goods and services alike.

Fig.7. UK equity segments, performance year to date (GBP terms)



Energy supplies could be disrupted further if geopolitical risks increase with a real risk of war in Ukraine.

Geopolitical risk: a European war?

Despite a flurry of urgent diplomatic activity, the risk of a proxy or even direct war between NATO and Russia over Ukraine is real and worrying. The background to this conflict is deeper than appears, and goes back to the fundamental differences between Easter and Western Ukraine that date back to 1918.

We see four potential scenarios:

1. **Extreme Worst Case "the race to occupy":** fears of a US/NATO troop deployment trigger a full-scale invasion of all of Ukraine and result in its East/West partition.
2. **Worst Case "the Georgia scenario":** Russia recognises and "protects" the two breakaway provinces in the Donbass region, there is localised fighting in eastern Ukraine.
3. **Base Case "the solution is there is no solution":** US/NATO and Russia step back from the brink of a hot war, some face-saving diplomacy is worked out, but this frozen conflict remains frozen.
4. **Best Case "a solution is found":** all parties agree to abide by and implement the stalled Minsk Agreements, the breakaway regions remain part of Ukraine, NATO backs down

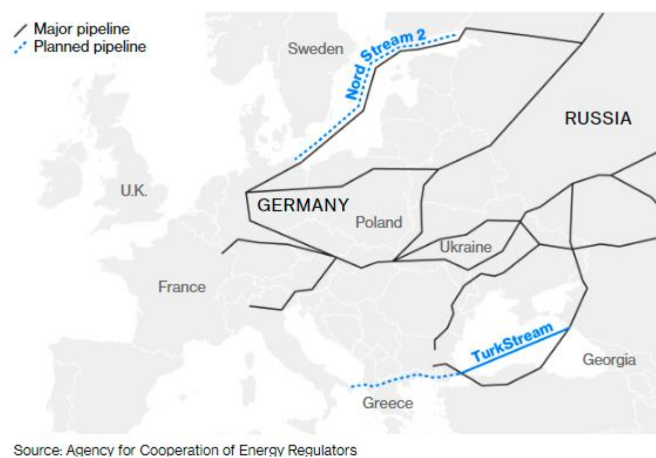
from supporting Ukrainian membership but leaves the door open, Russia pulls troops back from the borders.

Scenarios 1 would impact global risk sentiment and could trigger a flight to safety into Treasuries, Gilts and Gold. The risk of war in Ukraine will have a direct impact on energy prices which could spike further as fears abound a reduction in Russian oil supplies or a disruption to the physical infrastructure of gas transiting through Ukraine.

Scenarios 2 to 3 would have lower impact on global risk sentiment, but still impact energy prices.

Scenario 4 would remove this situation from risk sentiment and could take some pressure off energy prices, which would provide some welcome relief to inflation pressure.

Fig.8. Russian gas pipeline: export infrastructure to Europe



How have portfolios we consult on been positioned going into these risks?

Whilst the extent and timing of these risk factors impacting markets was not predictable, the directionality of those risks was.

Our concerns around market levels, "long-duration" tech valuations, and inflation meant that the investment strategies we proposed to wealth managers and adviser firms may have helped insulate client portfolios somewhat from the declines, and focused on the right areas that could benefit, rather than suffer from, those risk factors.

Firstly: when investing in risk assets such as equities, it's hard to "hide" when a bout of volatility unexpectedly spikes like this. However, you can adapt the level of risk that a portfolios is exposed to using "dynamic asset allocation". To do this, we review a statistical measure – our Market Risk Indicator – at the end of each month. As the indicator implied that markets were "overbought" in December, we maintained our dynamic asset allocation posture to the lower end of agreed asset allocation ranges, meaning that *we were recommending to be positioned relatively conservatively, going into the year.*

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Secondly: within equities, our concerns around technology valuations means that we have been advocating an ***overweight in Quality (high profit margin, high Return on Equity) and Value (low valuation, steady earnings) factor exposures.*** These factor-based exposures should be better insulated from a sustained de-rating than capitalisation-weighted indices that have more technology exposure. For those who have actively sought to deconcentrate US equity exposure, the use of an *Equal Weight security index* – which allocates to each company of the S&P 500 equally, rather than based on their market capitalisation – has also limited the damage caused by tech sector performance.

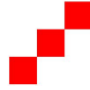
Thirdly: with fears around ongoing energy pressure leading inflation to last higher for longer, and to revert to above trend levels, we have been advocating ***an allocation to Liquid Real Assets for inflation protection.*** Our Liquid Real Assets Index strategy combines higher risk real assets such as commodities, gold and natural resources, with lower risk interest-rate sensitive assets.

Summary

Markets adapt to price in new information. And there's been lot of the new information in the last three weeks that is negative. A Fed that is more hawkish than expected, de-rating the valuation of technology shares, energy and inflation pressure and the highest risk of a US/Russian war since the Cuban Missile Crisis. Whilst it is important to look through the noise to maintain a long-term perspective, there is scope for being adaptive – by sector, style or risk factor within equity allocations – to position portfolios accordingly.

Henry Cobbe, CFA

Head of Research, Elston Consulting



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