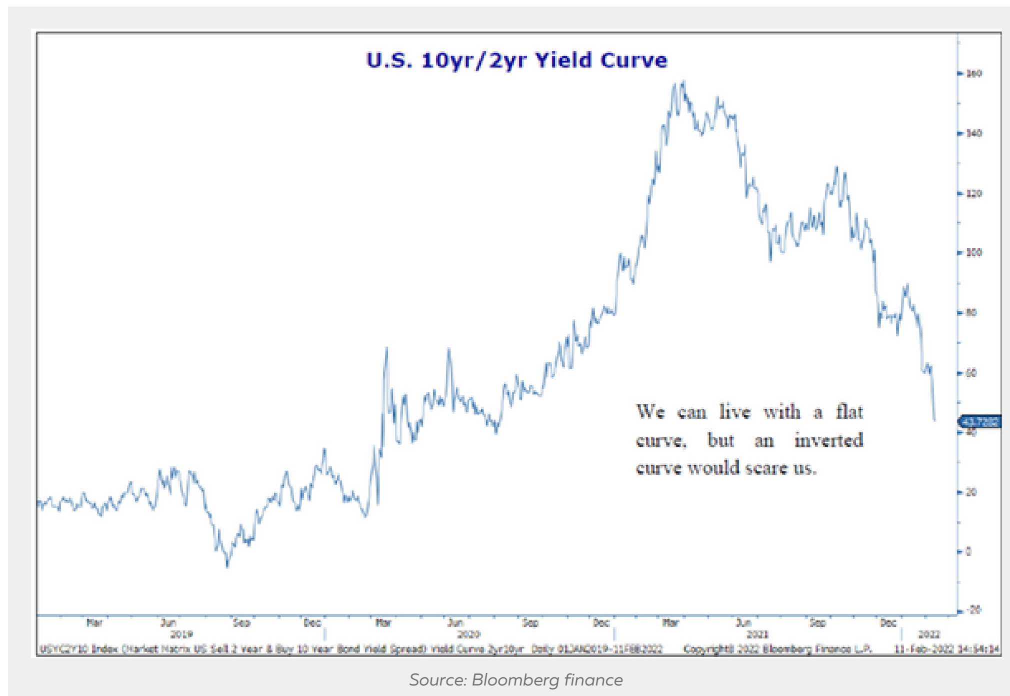
WEEKLY INVESTMENT **UPDATE** 6

The most important story in financial markets by a long way in 2022 is the global rise in bond yields. Global negative yielding debt peaked at over $18 trillion in January 2021 and now stands at just over $4 trillion one year later. The stock of negative yielding debt has fallen -70% since December (chart below). This reversal in interest rates will continue to exert a significant impact on the behaviour of financial assets.

Source: Strategas Research Partners

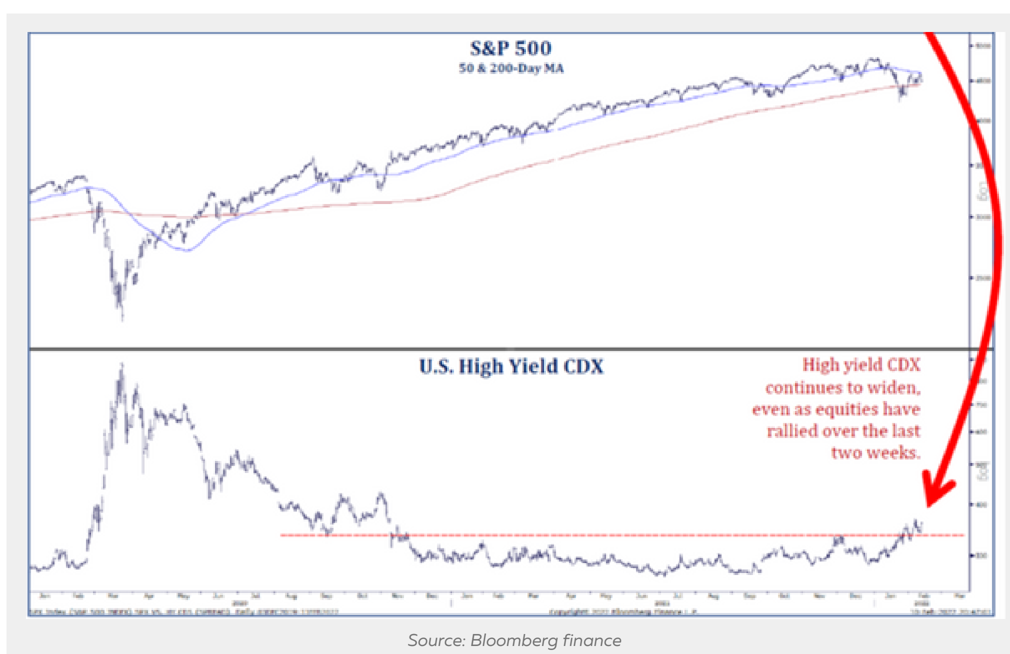
While maintaining a constructive outlook for equity returns in 2022, we have been highlighting during the past few weeks our increasing concerns over a deterioration in the underlying fundamental and technical foundation supporting equities and other risk assets. In our opinion the weight of evidence has now shifted to support a more conservative approach to risk exposure and to fine tune the composition of those segments of the portfolio where exposure is still maintained. Below we present some of the developments in financial markets that are leading us to adjust our portfolio positioning.

While both government and corporate bond yields remain low by historical standards, the rapid rate of change higher in yields is likely to start to have an impact on the real economy. Maybe not so much an issue for those stocks with low expectations, but certain to exert further downward pressure on those securities still priced for perfection. The chart below shows how the U.S. yield curve continues to flatten at a rapid pace. This flattening trend is neither uncommon during periods of Fed rate increases nor necessarily ominous for expected equity returns. However, it is rare to be so flat prior even to the first rate move and does reveal a growing market concern that the Fed will break something in its attempt to regain control over inflation.



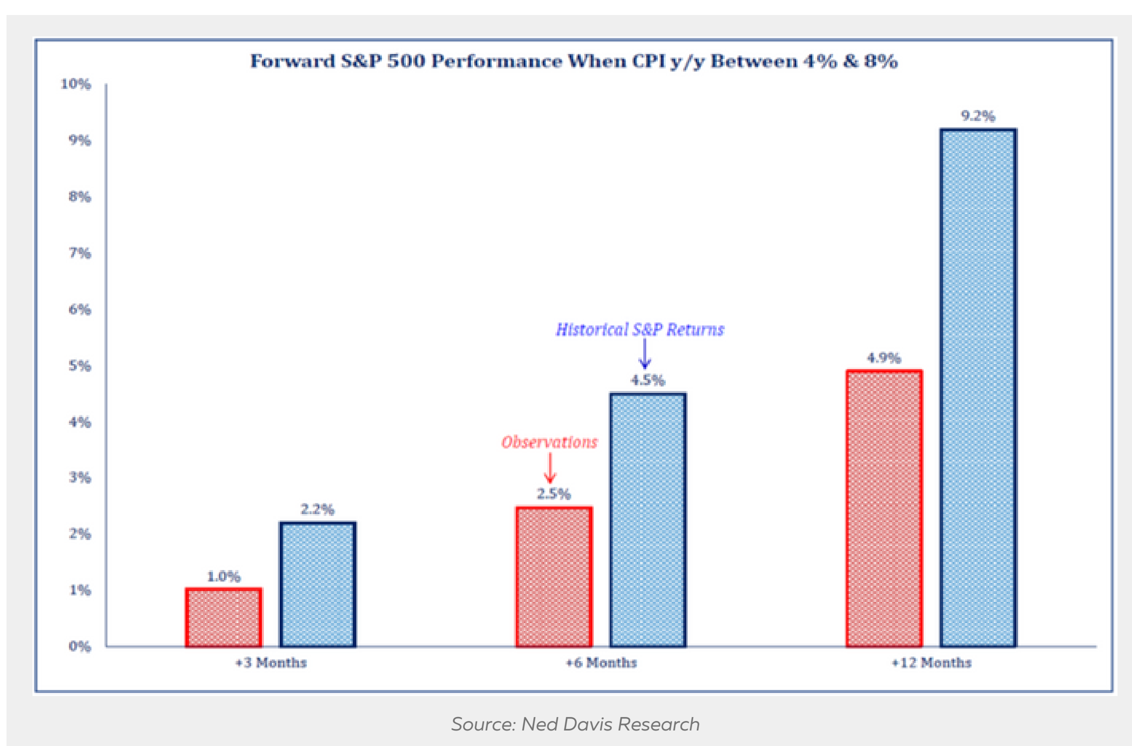
Source: Bloomberg finance

This message of growing investor concern is reaffirmed in the recent development of corporate yields. The chart below shows the recent trend in high yield spreads (weakest credits). Again, while we would acknowledge that spreads still remain at historically low levels, it is concerning that during the past two weeks in which the U.S. equity market has been attempting to rally, high yield spreads have continued to move higher – a concerning divergence.



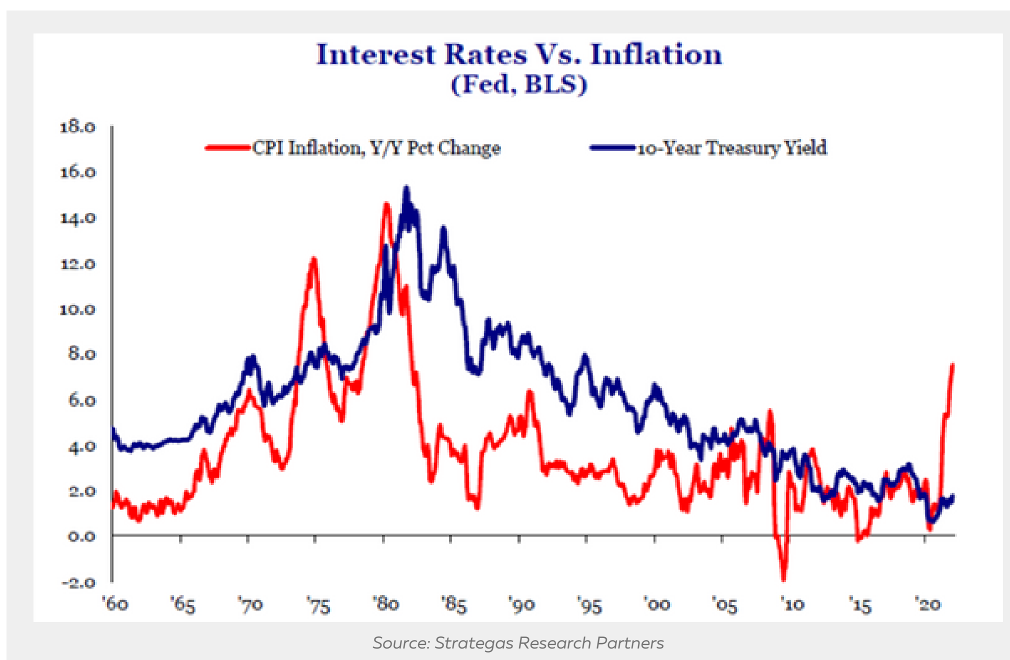
Source: Bloomberg finance

The source of rising yields and growing investor concern over the execution of monetary policy is clear for all to see. Can global monetary authorities put the inflation genie back into the bottle without causing too much economic pain? We have frequently highlighted in past writings that equity returns suffer as inflation rises. The chart below shows historical returns of the U.S. market when inflation is consistently in the 4-8% band – January headline inflation in the U.S. hit another new high at 7.5%. Essentially, forward returns over a 3 to 12 month period are approximately half what would be expected against a more normal inflation backdrop.



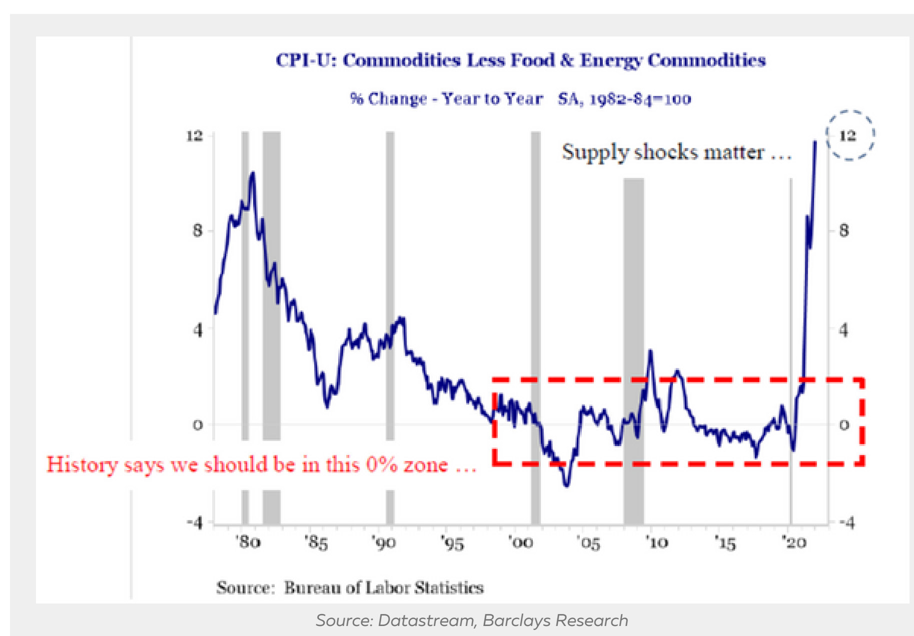
Source: Ned Davis Research

Taken in isolation, the chart below should lead one to question why the market remains relatively confident that the Fed will be able to get inflation under control – forward looking measures of inflation remain well behaved with medium-term inflation expected to settle at around the 3% level. The fact is that we are living through a period of the largest divergence between inflation and bond yields in modern times (chart below). Consensus expectations of inflation readings to reverse over the course of 2022 may still prove correct, but this view does rely on a number of things falling into place over which the Fed and U.S. government have little control.



Source: Strategas Research Partners

To better understand the difficult task that the Fed now faces in taming inflation, it is only necessary to examine the current trends in goods and services inflation. The current surge in inflation has predominantly been led by a rise in the price of goods. Mobility restrictions combined with generous government payments has resulted in a sharp increase in the demand for goods just at the time that corporates were in the worst position to satisfy this demand – years of underinvestment, covid restrictions, supply-side disruptions, etc. The first chart below shows that goods inflation remained close to zero for most of this century before rocketing to double-digit levels post-covid. One would expect this level of inflation to moderate as demand cools and supply increases. However, this is very dependent on no further supply-side shocks.

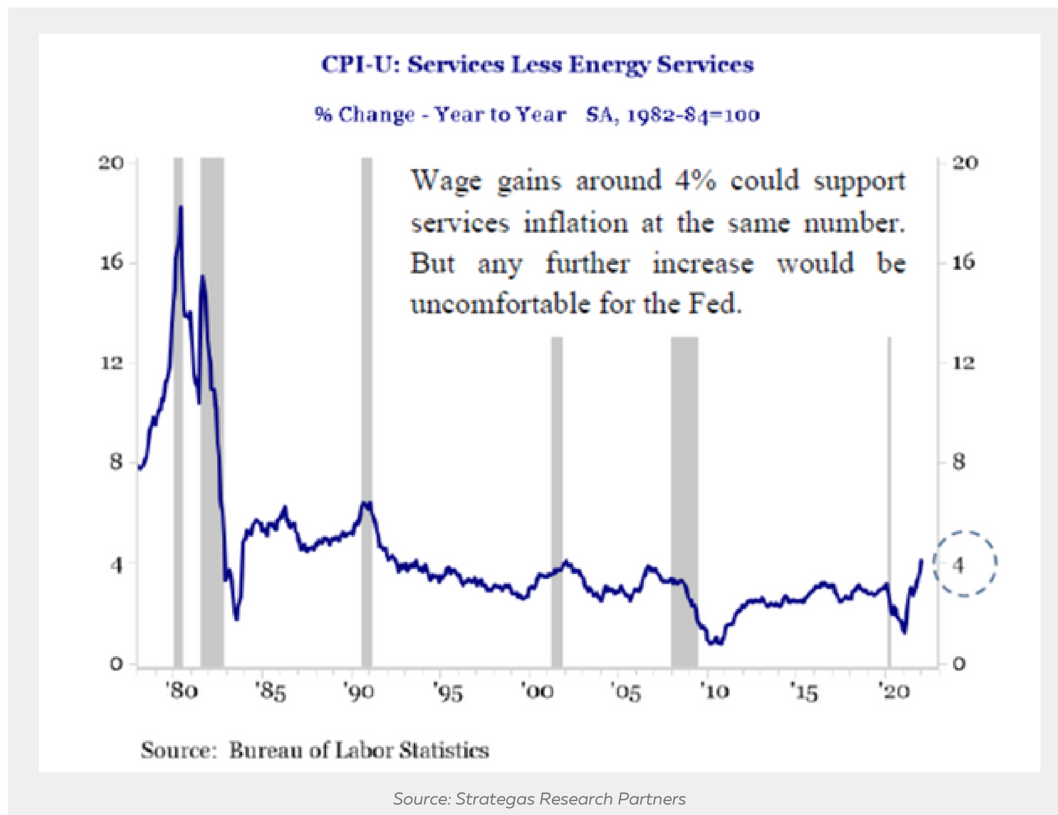


Source: Datastream, Barclays Research

One difficulty in getting goods inflation lower is that input costs remain stubbornly high. A lack of investment over many years in many segments of commodity extraction and production have created a clear supply shortage in many areas of industrial metals. Ironically, well meant efforts to wean the global addiction to fossil fuels have had their own detrimental impact from an inflation perspective. It is well known that an electric vehicle (EV) requires 4x the copper material as compared to a vehicle powered by an internal combustion engine. This says nothing of the demands being placed on many rare earths, cobalt, lithium, etc. The chart below showing the move higher in industrials metal prices is on the verge of breaking out to new all-time highs which could lead to a further surge as momentum investors pile in. Any successful fight against inflation requires quite the opposite outcome.

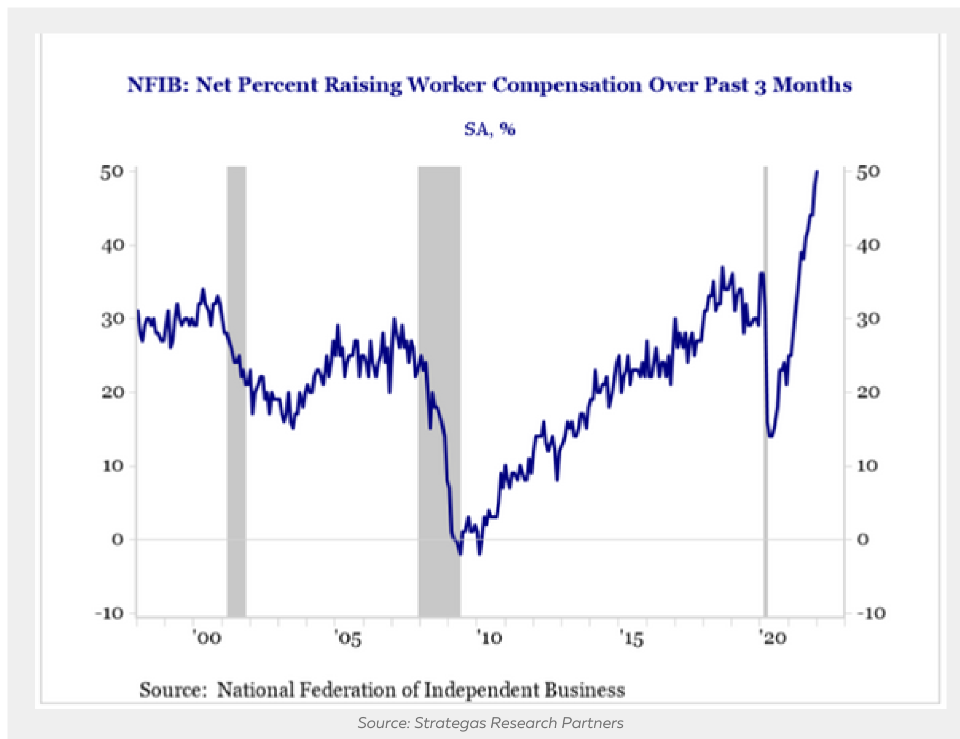
Source: IBES, MSCI, Datastream, Barclays Research

The importance of moderating goods inflation to resolving the inflation puzzle is understood better with a glance at the recent rise in services inflation (chart below). This inflation measure has only recently begun to move and is historically a bigger concern for monetary authorities as it tends to be a more ‘sticky’ type of inflation – that is it moves slower than goods inflation but is also harder to reverse. This measure of inflation is undoubtedly set to move higher in 2022. A large component is rents which have only recently started to move higher after a more than 30% surge in house prices.



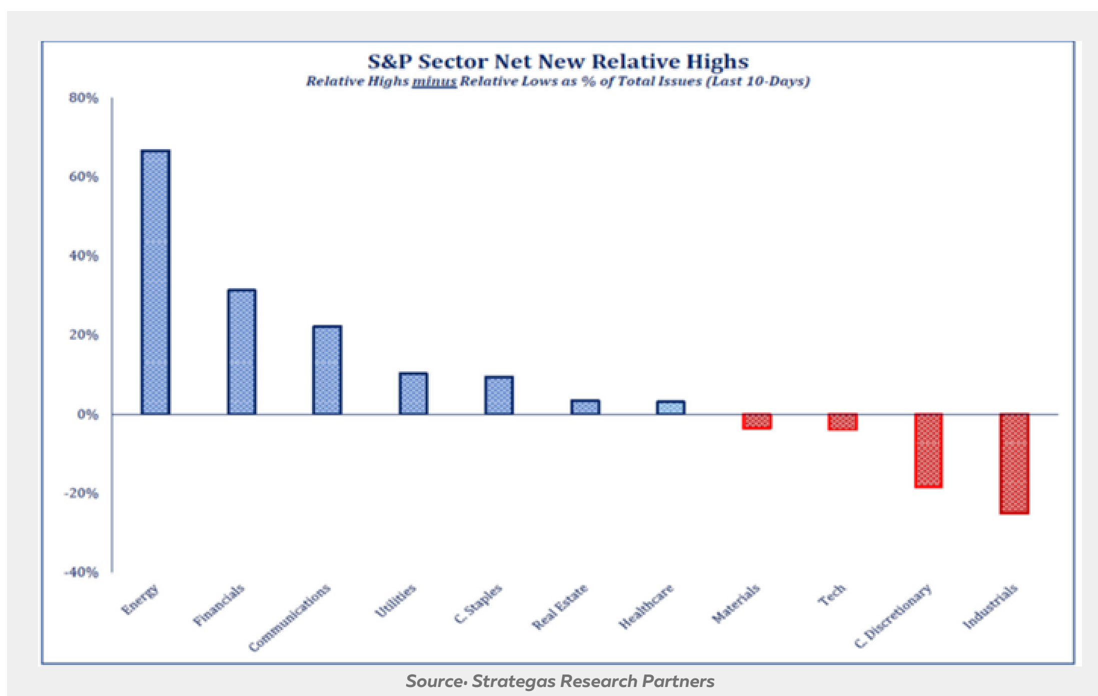
Source: Strategas Research Partners

The other large component of this inflation measure is wages. The big problem is that while the Fed has waited so long to tighten, a wage-price spiral has started. Walmart and Amazon are amongst the largest employers in the U.S. and have been very vocal in their need to make substantial increases to their minimum wage. Once a major source of disinflation, these companies are now increasing prices and the competition must follow. The chart below shows the rise in the number of small businesses in the U.S increasing prices over the last 3 months. The Fed needs help with wages and the only two sources of relief are an increase in labour supply or major improvements in productivity. To repeat, a moderation in inflation remains a distinct possibility, but a number of things need to fall into place before that outcome is certain.



Source: Strategas Research Partners

In addition to 1) the market signals from a flatter yield curve and rising credit spreads, and 2) the immense inflation challenge that the Fed must now tackle, we cannot ignore the recent shift in sector performance. The chart below shows the short-term strength of the main market sectors by measuring the net new relative highs of each sector (number of relative highs minus the number of relative lows as a % of total constituents in sector). Not surprising is the dominant position of Energy and Financials which continue to benefit from the rise in oil prices and interest rates, respectively. However, new to this measure is the improvement in the internal strength of the four traditional defensive sectors – Telecoms (now called Communications), Utilities, Consumer Staples, and Healthcare. Consistent with this more defensive message is the relative weakness in the economically sensitive Industrials and Consumer Discretionary sectors.



Source: Strategas Research Partners

Consistent with the message above, we do judge it prudent to reduce our risk exposure within the portfolios. To be clear, we are not yet making an outright bearish call on equities. We are simply reducing what has been a long-time near fully invested position to better reflect the building financial market risks. Our portfolios remain strongly positioned for the new environment with a substantial bias to the Value segments of the market on both a sector and geographical level.

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