Beyond the uncertainty

Whilst our interest in the events unfolding in Ukraine, for this article, is primarily as investors, we do of course recognise the human tragedy that this represents and hope that the situation can be steered to a peaceful conclusion in the very near future.

Even with all the massive uncertainty that surrounds a war, there are some things that remain quite predictable. This is because markets don't like uncertainty, and there are few things in life that precipitate more uncertainty than a war.

So in terms of investing, safe haven currencies, such as the dollar and yen, should do well, as should arms manufacturers, oil companies and traditional stores of value like gold. Everything else will normally take an immediate lurch downwards. However, amid all the sound and fury and column inches that the Ukraine invasion is generating, what has really changed?

Well, we have a new and potentially more precarious political situation in Europe, but politics is not something that markets usually worry too much about, unless it directly affects the economy. Having a hostile neighbour on your border is not very different, in an age where everyone has submarines and cruise missiles, from having a hostile power a thousand miles away, and it's hard to imagine President Putin

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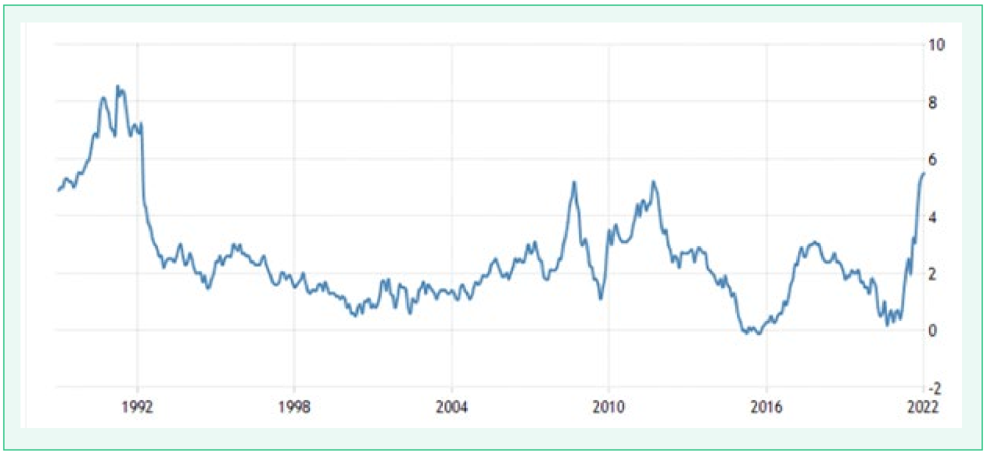
extending his aggression to the Baltic states, at least for the moment. In the short term, markets usually overreact to events, or simply react in the wrong way. At Collidr, we are continuing to focus on the longer-term implications for global markets.

Notwithstanding the ripples caused by the Russian invasion of Ukraine, the market environment, and the emerging global themes, remain unchanged. Inflation continues to rise in many countries. The January figures for the UK were +7.8% for the headline RPI, and +5.5% and +4.9% for CPI and CPIH respectively (CPIH is the Consumer Price Index including owner occupiers' housing costs). These numbers represent a multi-decade high for inflation in the UK, driven by higher fuel and food costs. However, wages have not kept pace, and the result has been that regular pay has fallen by 0.8% in real terms. Similarly, the January print for US inflation of 7.5% was the highest since 1982, with real average hourly earnings falling by 1.3%.



Source: Trading Economics/ONS

Whilst high inflation is a concern, the objective of the recent small rate rises in the UK seems to be more about sending a message to markets and heading towards some 'normalisation' of monetary policy, rather than actively combating rising prices. Indeed, if this were the only concern, it is hard to see how tweaking base rates by a few decimal places of a percent could do much and, at a time when the spending power of consumers is already being hit hard, it would also seem quite unnecessary. The rises seen in the cost of energy are supply-driven and originated overseas; they will not be contained by rate rises. For instance, one immediate by-product of the war in Ukraine has been the impact to oil and gas prices.

In the developed world, it is often said that inflation provides the best hope for dealing with the debt burden accumulated by quantitative easing and COVID-19 support during the past decade. While it is true that developed nations cannot realistically grow their way out of debt, as some emerging countries might, inflating away the debt is not an ideal solution either, as it raises the cost of government borrowing in the index-linked market. The UK's monthly interest payments on its debt topped £6.1bn in January, up from £4.5bn a year ago.

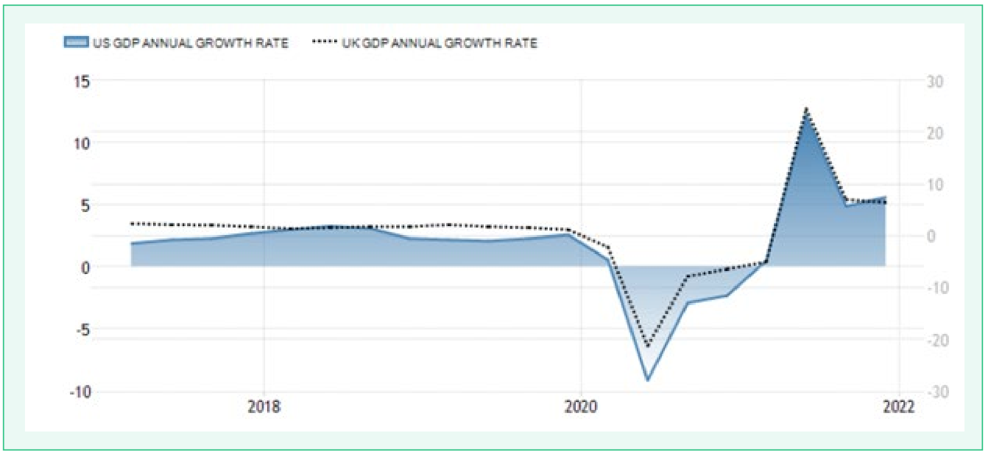
There is one further point for investors to consider. With inflation having been low for so long, there are now many investors who have never experienced inflation in real life; it is a theoretical problem that they read about at university, and that their parents described, along with tales of three-day weeks and rolling blackouts. Hence, to some degree, we are in unexplored territory, and we need a strategy to counter not just inflation as a concept, but a particular kind of inflation, coming from very specific causes, largely beyond the control of interest rates.

Fortunately, there are many ways that this can be done. Aside from the obvious direct investment in index-linked bonds, we can access inflation in specific areas of the economy, such as energy and resources. The UK oil giants, against a backdrop of sharply falling global markets, have seen share price rises of up to 27% this year. This has meant that many income-seeking funds, and those with a value tilt have seen strong outperformance versus more growth-focused or sustainable remits. Similarly mining stocks have started to rally, driven by supply-side disruption and consequent price rises.

Of course, supply-side disruptions are exacerbated by the fact that they coincide with what should be a period of increasing demand. As the world emerges tentatively from COVID-19, we should have seen a sustained improvement in economic activity and a recovery in global GDP. This has been happening, but the ebb and flow of COVID-19 news has meant that it has been somewhat more fitful than might initially have been hoped. UK GDP has now exceeded pre-COVID levels, but this has been far from a smooth recovery, and was only achieved in November last year – before Omicron hit in December. The recovery has been different across the developed nations, with the US economy hitting its pre-COVID level in the third quarter of last year. US annual GDP growth stood at 5.6% for the fourth quarter of 2021, which is an impressive bounce back from a pandemic-induced decline of 3.4% in 2020.

However, beneath that US headline lurks the reality that a great deal of that gain was due to companies rebuilding inventories, rather than actual demand improving, and January's ISM Manufacturing Survey showed new orders still rising – but at a slower pace. The US labour market seems to be retreating, with 4.6 million more vacancies than unemployed workers in December, and US new home sales also slumping in January.

Economists have been quick to rein in their forecasts, citing a hit to Q1 numbers from reduced services spending at the tail end of the Omicron wave.



Source: Trading Economics/ONS

If there are multiple ways for investors to adapt to higher inflation, playing lower growth is a bit more challenging. It is fair to assume that sectors that were hit hardest during the pandemic should prove to be relatively attractive during the global recovery, as it is hard to imagine companies involved in, say, travel, faring worse now than they were a year ago. But, on the flipside, those companies that were most resilient during the past couple of years, are now being sold down – technology is the obvious example of this.

In the present environment of multiple uncertainties, investors would do best to focus on reproducible, recurring revenue streams, such as might be found in the 'bond proxy' stocks, selling essential household goods. Even some tech giants fall into this category, with their solid recurring ad revenues, such as Alphabet (Google), and the oft-criticised Meta (Facebook). Infrastructure is also worthy of consideration; their costs are linked to inflation, but so are their revenues, and economic recovery, together with population growth, should make this a robust sector. Bond markets may be hard pressed to provide a profit for investors in an environment of rising rates, but there are low-correlated liquid alternatives that can help to buffer a portfolio against the volatility of equities.

At Collidr, we began the process of battening down the hatches for the turbulent times ahead in September last year, as well as continued the process after January's falls. By careful analysis of the behavioural characteristics of funds, we believe that it is possible to construct a portfolio to weather the storm, whilst still providing exposure to the upside that clearly exists in certain markets and sectors.