KINGSWOOD

PROTECT AND GROW YOUR WEALTH

Q1 | 2022

INVESTMENT OUTLOOK

SUMMARY

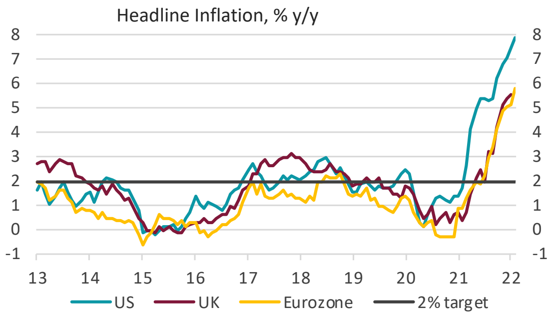
- The war in Ukraine is primarily a humanitarian catastrophe but has also worsened the global economic backdrop.
- It is exacerbating the surge in inflation, which now looks set to remain well above target over the next couple of years.
- It will also exacerbate the cost-of-living squeeze faced by consumers although should not de-rail the global recovery.
- Monetary policy should still be tightened significantly in the US and UK over the coming year despite events in Ukraine.
- Bond yields are expected to continue their upward trend, assuming Ukraine-related worries do not intensify.
- Equities should also in time resume their upward path as long as the Ukraine crisis does not worsen significantly.
- Prospective returns for equities remain higher than for fixed income where return prospects remain poor.
- US equities should underperform while the UK, Asia and emerging markets should outperform.

ECONOMY

The last three months have witnessed a big change. The major central banks have belatedly woken up to the fact that they woefully under-estimated the size and longevity of the surge in inflation. The big question facing markets now is how much tightening they will carry out to bring inflation back under control at a time when the Ukraine crisis is threatening global growth.

Inflation has risen sharply almost everywhere, albeit with the odd exception such as China. Headline inflation has picked up to multi-decade highs of 7.9% in the US, 5.5% in the UK and 5.1% in the Eurozone. And it looks certain to increase further over coming months given the latest jump in energy prices.

Inflation has risen sharply in the US, UK and Eurozone



Source: Refinitiv

Core inflation, which excludes food and energy prices, is the primary focus of central banks and has also risen substantially, albeit by rather less than headline inflation. It is running well above the 2% level targeted, and in the case of the US is as high as 6.4%.

Supply bottlenecks have driven up goods inflation sharply but overall should slowly ease over the coming year even though the crisis in Ukraine is now causing new shortages and price spikes. Spending is switching away from goods, where it has been unusually high, back to services where it has been depressed.

However, labour markets have tightened much faster than expected, with unemployment down to around 4% in the US and UK. Record job vacancies and worker shortages have driven up wage growth and labour markets look set to remain very tight for some time.

Finally, commodity prices have been given a further major uplift by the war in Ukraine. Most importantly, oil prices have surged to *above* $100/bbl but industrial and agricultural prices are also up sharply

While inflation should still fall back over the coming year, it looks set to remain well above the 2% targeted by central banks. Moreover, risks remain to the upside as additional Western restrictions on Russian oil and gas supplies would drive energy prices up further still.

As with inflation, the growth outlook is also more uncertain than normal, although no longer because of Covid. Economies have now largely reopened although the big exception here again is China, where its zero Covid policy carries the risk of renewed lockdowns.

Inflation is running above wage growth and **consumers face a significant hit to their real incomes**. This cost-of-living squeeze is now being worsened by the crisis in Ukraine, although governments will very likely take further action to shield households from the full impact. Individuals will also very likely run down some of the excess savings built up during the pandemic, which amount to over 10% of GDP in the US and UK.

Monetary tightening will also be a drag on growth but will take time to feed through and the effect should not be that large. Household and corporate finances are in good shape, most mortgages in the US and UK are fixed rate, and interest rates will remain very low by historical standards.

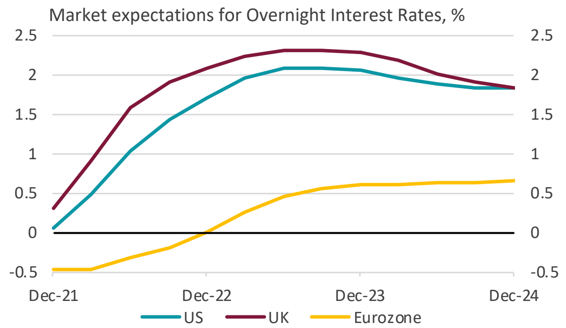
All this leaves us believing that while growth will be lowered by the crisis in Ukraine, **the global recovery should not be derailed**. Downside risks are greatest in Europe as it is much more dependent on Russian oil and gas imports than other regions. A blocking of Russian energy exports by Europe, rather than just the US and UK, would very likely tip the region into recession.

Central banks have stepped up their monetary tightening plans substantially in recent months and are likely to be scaled back only a little by the crisis in Ukraine. The prospect of inflation rising even further near term will increase fears of a wage-price spiral and make central bankers reluctant to respond to a slowdown in growth,

The Fed looks set to start increasing rates later this week with a 0.25% rise and follow up with several further increases over the rest of the year. Here in the UK, rates also look likely to be raised another 0.5% or so over coming months but the pace of tightening should then slow significantly. Rates currently look likely to end the year at around 1.5% or so in both the US and UK.

Policy should also be tightened by an unwinding of quantitative easing (QE). The BOE is already starting to run down its balance sheet and the Fed is likely to start doing so in the summer. By contrast, the ECB will continue with its QE until the summer and looks unlikely to start raising rates until late this year.

Markets still expecting a marked rise in US & UK rates this year



Source: Refinitiv

FIXED INCOME

The prospect of much more rapid monetary tightening has led to a **marked rise in government bond yields**. 10-year yields in the US and the UK peaked at 2.0% and 1.5% respectively, some 1.5% higher than their lows in August 2020. Just recently, yields fell back as government bonds benefited from their safe-haven status and the alarm over Ukraine, but the reprieve proved short-lived.

Even though UK gilts have made money as the crisis has intensified, they have still lost around 6% year-to-date. Yields would very likely fall back further if the crisis worsened but should head higher again further out. Interest rates should eventually peak higher than the market expects if it proves difficult to return inflation to 2% as we expect. Additional upward pressure should also come from an unwinding of QE.

All this leaves medium term **prospects for conventional government bonds continuing to look very poor** even if they are providing some protection in the current crisis. Inflation-protected bonds should fare somewhat better. That said, while they do protect against rising inflation expectations, they are vulnerable to any rise in real rates.

Corporate bonds have also suffered this year but should perform rather better than conventional government bonds going forward. Their yield pick-up over government bonds has widened out from last year's lows, leaving them yielding 3-3.5% in the UK and US. Still, with yields set to trend higher, returns are likely to be only 2% or so.

Prospective returns look somewhat better for higher yielding areas, such as emerging market and high yield debt, and asset backed securities with their predominantly floating rate structure. However, these are niche areas, limiting the size of any potential exposure.

All this leaves us planning to retain a sizeable underweight to fixed income, particularly government bonds. We also intend to keep the average maturity of our holdings relatively short to limit the hit from any further rise in yields. As for cash, it will be paying slightly more than before but will provide little protection against inflation.

EQUITIES

Equity volatility has picked up considerably this year. Markets first had to adjust to the prospect of a considerably faster tightening of policy and then the Russian invasion of Ukraine. Global equities as at 14 March are down some 12% from their high in early January.

Some weakness is typical at the start of Fed tightening cycles but this is then usually followed by renewed gains on the back of continued gains in corporate earnings. Assuming no further major worsening of the crisis in Ukraine, this should also be the case this time.

While the outlook for growth has deteriorated, we do not expect the global economic recovery to be derailed by current events. Importantly, companies generally have sufficient pricing power to limit the hit to their margins from the marked rise in costs.

Equity valuations are also now less of a concern. The forward-looking price-earnings (P/E ratio for global equities has fallen from a high of over 20x in 2020 back to the long-term average of around 16x.

Furthermore, equities have the attraction of offering a significant amount of inflation protection. They should garner support from the considerable amount of money which is still sitting in cash and losing value in real terms.

None of this is to say that equities would not yet fall further if the Ukraine crisis worsened. That said, past experience is that sell-offs related to military conflicts have tended to be short-lived with markets regaining their losses within the space of a few months.

The bottom line is that **we still expect equities to outperform fixed income over the medium term.** Our stance therefore remains to ride the current market volatility and where possible take advantage of it.

Since early December, **there has been a major change in market leadership.** The US has swung from outperforming to underperforming, while Asia and emerging markets, the notable laggards of last year, have started outperforming, as did the UK.

However, this shift has been disrupted by the crisis in Ukraine. The US is once again outperforming, benefiting from its relative energy self-sufficiency, a strengthening of the dollar and the dip in government bond yields. Similarly, the UK has unwound a good part of its recent outperformance.

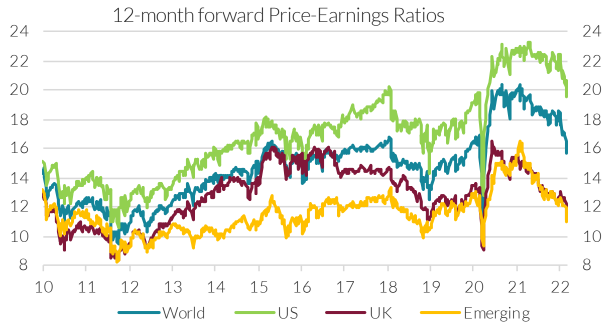
We believe this reversal should prove temporary with the US underperforming again, as and when concerns over Ukraine recede. The US underperformance earlier this year was part and parcel of a more general **rotation out of expensive 'growth' stocks into the cheaper 'value' areas of the market.**

The rise in bond yields provided the catalyst for the extreme valuation gap between these two areas to start to be unwound. Growth stocks suffer more than value stocks from higher yields because a much greater part of their earnings stream is far out into the future and becomes worth less as yields increase.

Valuations very much still argue for a renewed rotation over the medium term out of the US into cheaper markets. The P/E premium of the US to the rest of the world has hit a new high of 60%, double the 30% average over the last ten years. By contrast, Asia/Emerging markets and the UK are all trading on P/E ratios some 25-30% below the global average.

The US should continue to be the prime casualty of this rotation, with the UK, Asia and emerging markets the main beneficiaries. Performance, however, will also to some extent be dictated by the policy stance of the authorities in each region.

US equities look very expensive versus the UK and Emerging markets



Source: Refinitiv

This is a negative for the UK and US as they are leading the charge to raise rates. At the other end of the spectrum, it is a positive for China where policy is starting to be relaxed in a bid to prop up growth. It should also be a support for the Eurozone where fiscal and monetary policy is set to remain expansionary for longer than in the US and UK.

We believe allocations to themes can add to performance. All the same, many of the more obvious ones such as technology, artificial intelligence and climate change have a bias towards growth stocks. This has meant they have suffered from the move towards value and unwound a good part of their previous outperformance. Longer term, we still believe allocations to such areas, which are especially prone to hyperbole and speculative bubbles, should add value if the exposures are selected and based on sound fundamentals.

We also continue to favour small and mid-cap stocks. Their cyclical bias should mean they benefit from a continuation of the economic recovery. In the UK, they have recently given back a good part of their past outperformance and no longer look expensive, while in the US they look very good value compared to large cap.

ALTERNATIVES, COMMODITIES & PROPERTY

Alternatives which aim to provide moderate returns regardless of the moves in bonds or equities, continue to look quite attractive given the poor outlook for fixed income. The proviso here is that many such funds in the past have failed to deliver the stable positive returns they promised, making fund selection critical.

Energy and other commodities also have obvious attractions in the current environment. That said, the scope for further gains in prices from current already very elevated levels now looks quite limited unless the Ukraine crisis takes a further turn for the worse. Commodity-related equities look better placed as they still seem undervalued compared to commodity prices.

Gold has benefited from the war in Ukraine and has tested $2000/oz. It remains a good source of protection both against inflation and major risk-off move by markets, although it is vulnerable to a rise in real yields.

Finally, there is property. As with infrastructure, the outlook has improved because of the upturn in inflation and the superior inflation protection offered by such assets compared to equities more generally. Still, illiquidity remains an issue for many property investment vehicles and high streets and offices continue to face headwinds.

MARKET VIEWS

ASSET CLASS		
Cash	●	Interest rates are rising but will remain relatively low and well below inflation
Fixed Income	●●	Inflation and policy tightening to drive yields higher and return prospects are poor
Equities	●	Earnings gains mean equities should in due course resume their upward path
Liquid Alternatives	●	Considerably more attractive source of return and capital protection than government bonds
Commodities	●	Offer protection against rising inflation and also in case of gold the risk of a major sell-off
Property	●	Inflationary environment positive but illiquidity an issue and retail/office space face headwinds
FIXED INCOME		
Government Bonds	●●	Monetary tightening to drive yields higher and prospective returns are minimal
Inflation-linked Bonds	●	Valuations are expensive but offer some protection against pick-up in inflation
Corporate Bonds	●	Spreads over government bonds remain quite low and return prospects are limited
EQUITIES		
REGIONS		
UK	●	Very cheap and should benefit from further rotation away from growth into value
US	●●	Valuations are very high and should suffer from renewed rotation to cheaper markets
Europe	●	Most vulnerable to Ukraine crisis but policy more expansionary than elsewhere
Japan	●	Economic recovery slower than elsewhere but market is cheap
Asia/Emerging Markets	●	Policy in China is turning more positive and valuations are relatively cheap
THEMES		
Infrastructure	●	Offers enhanced inflation protection and a beneficiary of increased government spending
Technology & AI	●	Growth prospects remain strong but headwinds from rotation to value and tougher regulations
Healthcare	●	Ageing populations and biotech innovation are attractions as are cheap valuations
Frontier Markets	●	Valuations are cheap and growth prospects strong
Climate Change	●	Major long-term growth area and source of opportunities where valuations not excessive
Natural Resources	●	Commodity prices to remain elevated and mining and energy sectors are still relatively cheap
Small & Mid Cap Stocks	●	Cyclical bias means should benefit from continued economic recovery

Our view reflects our assessment of the relative attractiveness of each asset class after taking into acccount its riskiness

Change = change in view over the last quarter

● = POSTIVE ● = NEGATIVE ● = NEUTRAL