INVESTMENT OUTLOOK Q2-2022

RUSSIA'S INVASION EXTENDS A DIFFICULT START TO 2022

Russian's invasion of Ukraine shocked us all at Wealthify, and our thoughts are first and foremost with those affected. While this initially caused a drop, most major share markets are now back to where they were before the invasion. The most significant ongoing impact of the war is the upward pressure on prices of commodities, which feeds through to the prices of most goods and services. As a result, inflation and elevated price levels driven by supply chain issues have become more pervasive as an ongoing issue for consumers.

The duration of the conflict will weigh on economic growth, which was anticipated to slow through 2022, albeit from above-trend levels. Economic and inflation outcomes will also be different among countries and regions. Europe may be most affected given its geographical proximity to the conflict and closer trade links with Russia, predominantly its dependence on gas and oil imports. Newly introduced sanctions mean we are likely to see a continuation of supply-chain frictions first sparked by the Covid-19 pandemic.

Across the developed world, labour markets remain tight with participation rates still lower than pre-pandemic. This has boosted wage growth, particularly in the United States. Covid-19 cases have also risen notably worldwide, but the broad success of the vaccine rollout means that deaths remain proportionately lower, particularly in Developed Markets. This has allowed most governments to avoid a prolonged tightening of restrictions, although China still have a Zero-Covid policy which has seen large-scale geographically selective lockdowns still enforced. Ongoing lockdowns of this nature are a threat to the global economy due to their disruptive effect on supply chains.

The Federal Reserve (Fed) and Bank of England (BoE) have indicated their goal of normalising monetary policy and combating inflation through actual and planned rate hikes in 2022. The main concern is that inflation expectations may become unanchored and influence longer-term expectations. While their focus has shifted strongly to inflation, central banks need to be conscious of growth impacts. Balancing growth and inflation targets in an elevated commodity price environment will be difficult, and there is a greater risk that the projected tightening of financial conditions which do not address supply side issues may cause greater-than-expected declines in growth.

SHARES OVER BONDS FOR THE LONG-TERM

Investors have had a difficult start to the year, with the actual and planned normalisation of monetary policy taking their toll on the prices of shares and bonds. It's important to see this in context. Both share and bond prices received tremendous support in the wake of the Covid-19 crisis as central banks and policy makers attempted to prevent a sustained economic downturn. Such significant fiscal and monetary assistance resulted in double digit returns for shares, and high single digit returns for bonds in 2021

2022 has brought a realisation from investors that large scale government spending, central bank debt purchases, and ultra-low interest rates are not sustainable indefinitely. While we continue to favour shares over bonds on a long-term basis, the return of bond yields to pre-pandemic levels has provided an opportunity balance our exposure with the goal of reducing overall volatility. The global economic outlook is increasingly uncertain given easing growth and high inflation, which continues to be exacerbated by geopolitical events. While we remain neutral on bonds in the short-term due to the current fog of inflation, bonds should provide protection against the risk of a potential rapid deterioration in the economic outlook.

We retain broad global property exposure, as post-Covid we expect the sector, outside the retail sector's well-known difficulties, to recover and provide an element of inflationary protection.

This document has been prepared by Wealthify's Investment team and the opinions expressed here are theirs.

TOP RISKS

Russia Ukraine and Inflationary pressures

The invasion has increased the level of uncertainty in energy and commodity markets, which are the bedrock of stable prices in the global economy.

Greater Central Bank policy uncertainty and possibility of a misstep

Many Central Banks have aggressively revised up their interest rates forecasts to combat record inflation. Negative growth impacts are a heightened risk.

New covid-19 variants are vaccine resistant.

Stock markets remain highly sensitive to rates of infection. A continued successful and evidently efficient vaccine roll out is key to support further gains.

Further China regulations and continued Covid restrictions

Tighter regulation of a wide range of sectors from tech to teaching in H1-2021 could spread further.

Geopolitical pressures

Western response to Ukraine crisis is highlighting fault lines between West and South. There is a risk that the conflict becomes a catalyst for deglobalisation and broader socioeconomic tension.

Post-Brexit UK

The UK's evolving trade relationships still weigh on investor sentiment.

INVESTMENT TYPE	OUTLOOK	RATIONALE
SHARES		
UK	+	While international investor sentiment towards the UK has improved, spurred on by a successful vaccine roll out and economic reopening, challenges remain. The FTSE-100 has been buoyed by rising commodity prices in 2022 with almost 25% of its weight in energy and basic materials. The FTSE-250 meanwhile has come under pressure due to its greater reliance on the UK economy and its smaller market capitalisation composition. This has led to diverging valuations, with the FTSE 100 now closer to fair value and the FTSE-250 is comparatively and historically cheap. We have trimmed our FTSE 100 exposure slightly but remain broadly positive on the outlook for UK shares.
US	+	US policy makers' rhetoric of supporting the economic growth outlook has changed somewhat in recent times, with soaring inflation an increasing focus. The actual and expected unwinding of easy financial conditions has brought with it much uncertainty and downward moves in valuations, which has increased the relative attractiveness of the US market which continues to lead in key areas such as innovation and corporate governance. In addition, the US economy remains relatively isolated from the Ukraine crisis.
Europe ex UK	-	The European Central Bank (ECB) continues to provide significant monetary support; however, this is waning, with clear plans to unwind the generous government programs that sought to offset the impacts of generally more severe lockdowns. With the threat of Covid-19 largely in the rear-view mirror for now, the Ukraine crisis threatens to derail Europe's economic recovery as surging commodity prices take their toll on already high inflation and slowing growth prospects. Despite rising risks of recession, European share prices are back at pre-invasion levels, and, in our opinion, not reflective of looming risks such as further sanctions which could include a ban on Russian gas.
Japan	=	Japanese policy makers remain committed to supporting the economy. Despite an ongoing successful vaccine rollout, virus curbs and the impact of rising energy prices on consumers have driven muted economic growth. There is no indication of a withdrawal of the strong government fiscal support and significant government bond purchases by the Bank of Japan (BoJ). This has led to distortions, with strong yen depreciation versus other major currencies (e.g., US dollar) with greater differentials in interest rates expected in the medium-term. We remain neutral on Japanese shares.
Emerging Markets	+	Apart from Russia, net exporters of commodities within Emerging Markets have been positively impacted by rising commodity prices in the wake of the Russia Ukraine crisis. Sentiment remains very weak in China, which dominates the emerging markets bucket. China's strict Covid-Zero policy has added to ongoing supply chain woes, with large scale lockdowns of key hubs (such as Shanghai) threatening to derail growth targets. This has added to heightened concerns surrounding China's regulatory action in the education and technology sectors which has driven volatility. There are signs of positive policy support and we remain positive on the long-term prospects for emerging markets.
Asia Pacific ex Japan	+	Higher commodity prices and rising interest rates in the developed world are putting pressure on Asian economies, particularly those that are sensitive to interest rates and those importing most of their energy requirements. This said, valuations are at historic lows with decent prospect for earnings growth in 2022. China remains a central risk for its own reasons as well as possible spill-over effects, but we remain positive on the long-term prospects for the region.
FIXED INCOME		
Government bonds		
UK	=	UK government bonds (gilts) have risen sharply on the back of rising inflation. We reduced exposure to gilts in January, which has been a positive. There's still much uncertainty in the UK bond market given the knock-on effects of the Ukraine crisis on inflation and growth. While yields are now comfortably higher than pre-pandemic levels, we remain wary of the risk of further inflation and maintain a longer-term bias toward short duration.
US	+	Investors have become increasingly concerned about significant tightening from the Federal Reserve given inflationary worries which have been exacerbated by surging commodity prices in the wake of the Russian invasion of Ukraine. As a result, yields on 10-year treasuries have risen sharply. We have added to our allocation here. With yields higher than they were pre-pandemic and inflation approaching its peak, we think the market may have got ahead of itself in its expectations for longer-term rates given the growth and inflation outlook.
Europe ex UK	-	We remain negative on the outlook for Eurozone government bonds. The ECB have provided clear signals that policy support will begin to be phased out against an economic backdrop that is increasingly uncertain due to the Ukraine crisis. Falling growth and high inflation exacerbated by Europe's heavy reliance on Russian energy are the main ongoing risks.
Japan	-	Japanese bonds offer little income and remain severely distorted due to the BoJ's "Yield Curve Control" program. While the BoJ might alter this program, there's little expectation for significant medium-term change.
Emerging Markets	=	Growing risks led us to trim our exposure to EM government bonds in January. We have maintained a small exposure as they offer a strong yield premium compared to Developed Markets, which comes at the cost of higher volatility. Similarly, their currencies appear undervalued, offering an additional supportive factor through the cycle.
Corporate Credit		
UK	=	Against a backdrop of rising government bond yields, UK corporate credit has come under pressure. Spreads have generally widened in 2022, indicating investors heightened concerns around the economic outlook. With high levels of volatility, we remain cautious here with a strong preference for short-duration bonds in this exposure.
US	=	US corporate bond spreads have been volatile of late given the uncertainty related to growth, inflation, and geopolitics. Spreads have generally widened in 2022, indicating investors heightened concerns around the economic outlook. As with other regions, we continue to prefer Investment Grade over High Yield, given that the additional risk/reward premium on offer is unconvincing.
Europe ex UK	-	With the ECB signalling that it will taper its bond buying program and clear economic headwinds and risk, these bonds are uncompelling, particularly compared to shares.
Japan	-	Like Japanese government bonds, Japanese corporate bond prices have been distorted by QE. We prefer share exposure, especially while Abenomics continues.
Alternatives & Thematics		
Environmental	+	Companies focused on reducing their environmental impact often have a competitive advantage due to greater resource efficiency, leading to lower costs. They may also experience lower downside risks due to more robust corporate governance, and this can support greater diversification benefits.
Global Real Estate	+	Covid-19 placed real estate under pressure, we now see this strain easing. The retail sector's woes are well documented, but a sectorally and regionally diverse portfolio remains fundamentally appealing given constrained supply and as a hedge against inflation.