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momentum

Calm before the storm

Global Matters Weekly

26 September 2022

– **Mark Wright, CFA**

Not long back from my first holiday abroad since the pandemic, I was looking out my window longing to be back swimming in the warm Mediterranean ocean off the East coast of Mallorca. I will spare you the details of the travel chaos we experienced both ways, it was a lesson learned!

I was expecting 10 days of sun and nothing much else weather-wise, but it didn't quite turn out like that. We were fortunate enough to witness not just one but two thunderstorms. I say fortunate because they served as a healthy reminder that it is always calm before the storm.

When it rains in Mallorca it doesn't just rain, it pours and not only does it pour, it hails! One minute I was soaking up the sun, swimming in the sea with little care in the world, the next I was running back to the hotel to take cover from giant hail stones. The speed with which the weather turned was breath-taking, but maybe not quite as remarkable as the speed with which inflation has gone from close to zero in the UK and other parts of the world, to double digits now.

For the last three decades, inflation had been relatively calm - mostly range bound between 1% and 3% in both the UK and United States. There had also been little in the way of interest rate volatility for over a decade. In the UK, the Bank of England had kept the base rate below 1% since 2009.

However, the latest UK inflation print is close to double digits (and comfortably double digits for those who prefer to reference RPI)[1]. It was looking unlikely to stop rising any time soon, but UK Prime Minster Liz Truss's latest policy to alleviate pressure on household finances by capping energy bills should hopefully bring peak inflation much nearer. It does, however, also risk inflation remaining elevated for longer.

Central bankers now appear to be in competition to see who can raise interest rates the quickest, driving the cost of credit up for borrowers. They, and other policymakers, appear to be getting off lightly for causing one of the worst cost of living crises in living memory. We now find ourselves in the eye of an inflationary storm and are all paying the price for significant

We now find ourselves in the eye of an inflationary storm

policy errors that are eroding people's standard of living at an alarming rate. Russian President Vladimir Putin's invasion of Ukraine has certainly not helped, but inflation in both the UK and US had already started to take off before any Russian tanks had crossed the Ukrainian border.

The first policy error was the complacency with which central bankers naively believed that high inflation had been defeated and was a thing of the past. Their complacency was best demonstrated when Chairman of the Federal Reserve Jerome Powell stated just two years ago in August 2020, that the Fed would relax its inflation target, willingly allowing inflation to temporarily run hot in an attempt to instead target average inflation over a cycle. It didn't get much coverage at the time but in one fell swoop, the seeds were sewn for previously well-anchored inflation expectations to start rising.

The second was a complete lack of foresight and disregard for basic economic principles. It is frustrating to read almost daily quotes from central bankers that suggest they are simply reacting to the latest inflation print or data on economic activity. Any economics student will tell you that monetary policy acts with a significant lag and central bank policy should always be addressing inflation 18 months to two years out from the present day.

There is also a well-known relationship between unemployment and inflation that on a graph, plots what is called the 'Phillips Curve'. This shows us that low levels of unemployment leads to higher levels of inflation. Central bankers seem to have ignored this relationship in recent years. Governments around the world devised policies to deliberately keep unemployment low during the pandemic[2]. It barely rose above 5% in the UK and very quickly started to fall at pace in 2021; a time when the Bank of England was still printing money along with many other central banks around the world. The European Central Bank was even still printing money when inflation was north

Sources: 1Inflation and price indices - Office for National Statistics (ons.gov.uk). 2Job retention schemes during the COVID-19 lockdown and beyond (oecd.org). Unless stated all figures sourced from Bloomberg Finance, L.P

of 8%! Why? Because of an apparent obsession for policy to be consistent with prior forward guidance.

Forward guidance has become a commonly used monetary policy tool within the last decade. Central banks essentially guide the market as to where interest rates are heading. In theory, it should reduce economic volatility as individuals and businesses can make spending and investment decisions with an idea as to where the cost of finance is trending. However, the problem is that stability breeds instability, and forward guidance in itself can be counterproductive by dampening the impact of each interest rate decision on asset markets and the economy.

The last two policy errors didn't sit with central banks but instead with politicians. Poor energy policy has made the UK and the rest of Europe highly vulnerable to energy shocks. In the case of the UK, an inability to press on with more nuclear power generation and an unwillingness to invest in gas storage facilities has been a grave policy error. In Europe, the decision by industrial powerhouse, Germany, to rely so much on Russia to satisfy its energy needs was an even bigger policy error. The antiquated link between gas prices and electricity prices is yet another, given that over 40% of the UK's power generation now derives from renewable energy sources at a substantially lower cost of production[3]. Both the UK and the rest of Europe now appear to be waking up to this issue.

Lastly, Government policies during the pandemic were driven far too much by health considerations and specifically one isolated healthcare issue. The stress placed on supply chains across the world from overzealous Covid-19-related work restrictions has contributed significantly to today's runaway inflation. This will sadly now likely lead to considerable ill-health, as a consequence of greater poverty. Added to the increased incidences of cancer from missed screening appointments during the pandemic and greater cases of mental health suffering, it begs the question whether society really benefitted from those heavy-handed policies that restricted economic activity

Sources: [3]How much of the UK's energy is renewable? | National Grid Group. Unless stated all figures sourced from Bloomberg Finance, L.P

The **Marketplace**

- Global equities fell by 5.1% last week
- The past week saw 500bps of global rate hikes across 15 central banks including The Federal Reserve and the Bank of England
- Brent crude fell by 5.7% over the week to $86.15 a barrel
- Gold fell by 1.9% to $1643.9 per ounce

Market **Focus**

US

- US equities returned -4.6% last week
- The Federal Reserve followed through on market expectations by delivering a third straight 75bp hike, bringing the fed funds rate above 3%. Chairman Jerome Powell's tone for the future suggested that there would be no pivot in rate hikes until inflation was brought under control

UK

- UK equities returned -2.8% last week
- The Bank of England hiked interest rates by 50bps for a second consecutive meeting, taking the Bank Rate up to 2.25%. Opinion was split among the committee with votes ranging from a 25bps hike to a 75bps hike
- UK Chancellor Kwasi Kwarteng announced the largest tax cut package since the 1970s in an inaptly named 'mini-budget'

Europe

- European equities returned -4.3% last week
- Russian President Putin declared a "partial mobilisation" which will see Russia's reserves called up to support their invasion of Ukraine.
- Inflation shows few signs of slowing as German producer prices were up by 45.8% in August on a year-on-year basis (vs. 36.8% expected)
- Italy's far-right Giorgia Meloni looks set to become the country's new prime minister, according to exit polls emerging after Italians cast their votes on Sunday, 25 September

Asia/Rest of The World

- Global emerging market equities fell 4.0% over the week
- Japanese equities fell by 1.2% over the week
- Japan intervened to support the value of the yen for the first time since 1998. The intervention led to a sharp pullback that saw the yen close at 142.39 from above 145 per US Dollar
- Both Japan and Hong Kong have announced lifting of Covid-19 travel restrictions for international travellers after more than two and a half years of stringent controls

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Asset Class/Region	Currency	Currency returns			
		Week ending 23 Sep. 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	-4.6%	-6.5%	-21.9%	-16.1%
United Kingdom	GBP	-2.8%	-3.3%	0.4%	6.1%
Continental Europe	EUR	-4.3%	-5.7%	-20.2%	-16.7%
Japan	JPY	-1.2%	-2.4%	-2.4%	-4.0%
Asia Pacific (ex Japan)	USD	-4.3%	-9.3%	-23.6%	-25.3%
Australia	AUD	-2.4%	-4.7%	-8.2%	-6.7%
Global	USD	-5.1%	-7.1%	-23.6%	-20.3%
Emerging markets equities					
Emerging Europe	USD	-6.5%	-6.4%	-79.0%	-80.4%
Emerging Asia	USD	-4.4%	-10.0%	-26.1%	-28.0%
Emerging Latin America	USD	-0.1%	-0.2%	6.3%	-1.2%
BRICs	USD	-3.9%	-8.8%	-25.6%	-30.4%
China	USD	-5.6%	-12.3%	-29.4%	-34.2%
MENA countries	USD	-3.1%	-5.5%	-0.9%	1.4%
South Africa	USD	-5.4%	-9.3%	-19.2%	-20.8%
India	USD	-2.9%	-4.2%	-7.3%	-10.3%
Global emerging markets	USD	-4.0%	-8.7%	-24.7%	-26.8%
Bonds					
US Treasuries	USD	-1.1%	-2.6%	-12.1%	-12.6%
US Treasuries (inflation protected)	USD	-1.9%	-4.4%	-12.2%	-10.3%
US Corporate (investment grade)	USD	-1.6%	-3.4%	-17.2%	-17.8%
US High Yield	USD	-1.7%	-2.6%	-13.6%	-13.3%
UK Gilts	GBP	-5.6%	-8.8%	-26.2%	-26.1%
UK Corporate (investment grade)	GBP	-4.5%	-6.3%	-22.4%	-22.9%
Euro Government Bonds	EUR	-1.6%	-2.9%	-15.8%	-16.8%
Euro Corporate (investment grade)	EUR	-1.5%	-2.4%	-13.8%	-14.5%
Euro High Yield	EUR	-1.4%	-2.0%	-13.0%	-13.5%
Japanese Government	JPY	0.0%	-0.8%	-3.4%	-3.7%
Australian Government	AUD	-1.0%	-1.7%	-11.1%	-13.5%
Global Government Bonds	USD	-2.3%	-4.4%	-19.8%	-21.8%
Global Bonds	USD	-2.7%	-4.6%	-19.9%	-21.7%
Global Convertible Bonds	USD	-4.8%	-5.2%	-23.2%	-26.4%
Emerging Market Bonds	USD	-2.4%	-3.9%	-28.5%	-30.0%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 23 Sep. 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	-6.5%	-8.9%	-26.1%	-17.3%
Australian Property Securities	AUD	-5.4%	-11.1%	-28.6%	-25.1%
Asia Property Securities	USD	-3.4%	-2.8%	-11.3%	-15.2%
Global Property Securities	USD	-6.5%	-9.1%	-25.9%	-22.0%
Currencies					
Euro	USD	-3.0%	-3.5%	-14.7%	-17.3%
UK Pound Sterling	USD	-4.4%	-6.3%	-19.5%	-20.7%
Japanese Yen	USD	-0.1%	-3.1%	-19.7%	-23.1%
Australian Dollar	USD	-2.3%	-4.6%	-10.1%	-10.5%
South African Rand	USD	-1.6%	-4.7%	-11.3%	-18.0%
Swiss Franc	USD	-1.6%	-0.6%	-7.1%	-5.8%
Chinese Yuan	USD	-2.0%	-3.3%	-10.8%	-9.4%
Commodities & Alternatives					
Commodities	USD	-3.6%	-6.3%	14.5%	21.0%
Agricultural Commodities	USD	-1.2%	-2.1%	7.5%	18.9%
Oil	USD	-5.7%	-10.7%	10.8%	11.5%
Gold	USD	-1.9%	-4.2%	-10.1%	-6.1%
Hedge funds	USD	-0.1%	-0.2%	-3.8%	-4.2%

Source: Bloomberg. Past performance is not indicative of future returns

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