

Executive Summary

The economic and geopolitical environment has evolved rapidly in the past three months. The human impact of Russia's military aggression towards Ukraine is real and immediate and we join all those who strongly condemn their actions and lament the unnecessary loss of innocent life.

For financial markets, the conflict in Ukraine and resultant humanitarian shock has dominated investor thinking. Longer term though, the prospects for growth, inflation and interest rates will once again take centre stage.

We summarise our views on the investment outlook as follows:

Growth a bit lower, inflation a bit higher

With Russia and Ukraine accounting for approximately 2% of global GDP and trade the direct economic impact of the conflict is relatively mild. However there are second order effects that undoubtedly will temper the pace of economic activity this year.

The most significant of these is through the commodity channel. With energy costs rising sharply, inflation is now likely to persist at elevated levels into the second half of 2022, before gradually moderating.

The US economy is proving the most resilient

The headwind of higher energy and food prices is expected to be more tolerable for the US. Current evidence suggests that a recession is unlikely over the next year in spite of the negative impact of additional inflation pressures and consequential higher interest rates.

The European economy came into the crisis with weaker momentum, suffering a larger Omicron-related headwind during the winter months. Now, closer proximity to the conflict is weighing on business and consumer confidence whilst inflation continues to rise.

Emerging economies are also in a tight spot, with consumer spending particularly sensitive to food and energy costs. In China, a zero-covid policy is proving difficult to enforce as outbreaks of highly transmissible variants keep rolling lockdowns a burden on the economic recovery.

Investment strategy - Implications

Markets are likely to remain volatile, with geopolitical and economic uncertainty higher than normal. This means selectivity and portfolio resilience are crucial.

In pursuit of long term real returns, the merits of equity and credit allocation remain compelling. We continue to see drivers of positive earnings growth and low corporate defaults this year.

Our portfolio stance favours equities and credit over government bonds, US and UK equities over Europe, China bonds and broad credit over emerging market debt, and physical gold as an effective hedge.

Our long term global philosophy supports continued engagement with risk assets, although we are operating with a heightened level of vigilance for signs of economic deterioration that might warrant a more defensive stance.



Introduction

The economic and geopolitical environment has evolved rapidly in the past three months. The human impact of Russia’s military aggression towards Ukraine is real and immediate and we join all those who strongly condemn their actions and lament the unnecessary loss of innocent life.

For financial markets, the conflict adds a new dimension to an already uncertain outlook, particularly the post-pandemic recovery and future path of inflation.

We noted in our 2022 Investment Outlook letter in January that the evolution of geopolitical risks “over the coming year could spell periods of higher volatility and have a meaningful impact on which markets emerge as leaders.”

Such volatility has duly arrived, creating a challenging environment for long term focused multi-asset portfolios. Despite a meaningful recovery in equities since the initial invasion (chart 1), daily gyrations have been vicious at times, with most markets posting losses for the first quarter.

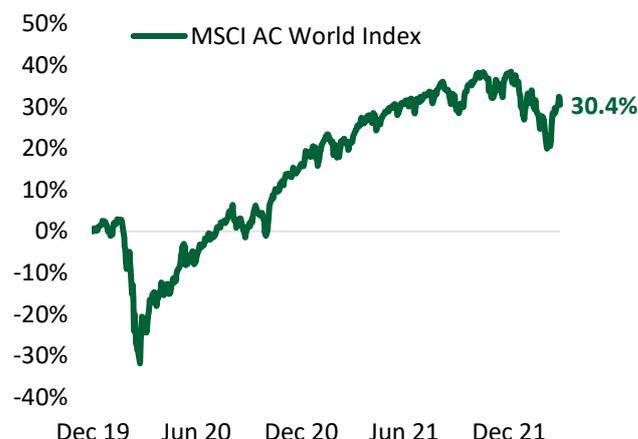
Bond yields have trended higher, as central banks have guided to a steeper rate hiking cycle. Importantly for inflation, commodity prices have surged, particularly core Russian exports like natural gas, wheat and oil, with meaningful effects on economic growth.

Quite rightly, the conflict in Ukraine and resultant humanitarian shock has dominated investor thinking since the initial invasion in late February. Longer term though, the prospects for growth, inflation and interest rates will once again take centre stage.

Growth a bit slower, inflation a bit higher

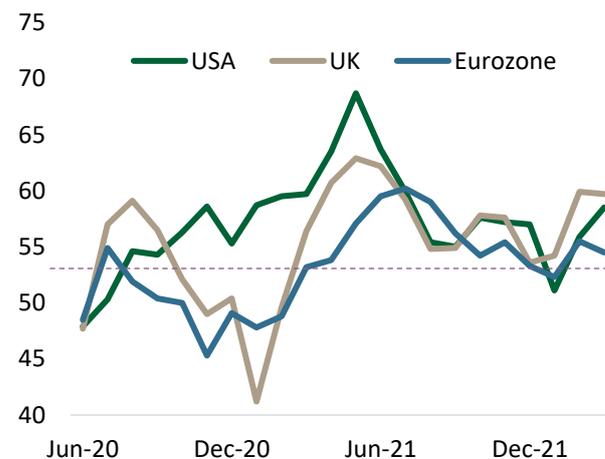
Our broadly constructive investment strategy since the 2020 Covid lockdowns has relied on the expectation that economic growth, particularly in the US, would surprise favourably. This approach worked well last year, as equities registered double-digit returns driven by remarkably strong earnings growth.

Chart 1¹: Equity markets have weakened in 2022



Before the Russian invasion of Ukraine, growth was reaccelerating with business activity bouncing back after Omicron driven disruption in the latter part of 2021 (chart 2). The OECD projected global growth of 4.5% in 2022, falling back to 3.2% in 2023².

Chart 2³: Economic growth had regained momentum



Russia and Ukraine do not play a significant role in the global economy. Accounting for approximately 2% of global GDP and trade, with limited financial linkages to advanced nations, the direct economic impact of the conflict is relatively mild.

However, there are second order effects that undoubtedly will temper the pace of economic activity this year and drive meaningful regional imbalances.

¹ Source: Bloomberg, total returns in USD, March 2022

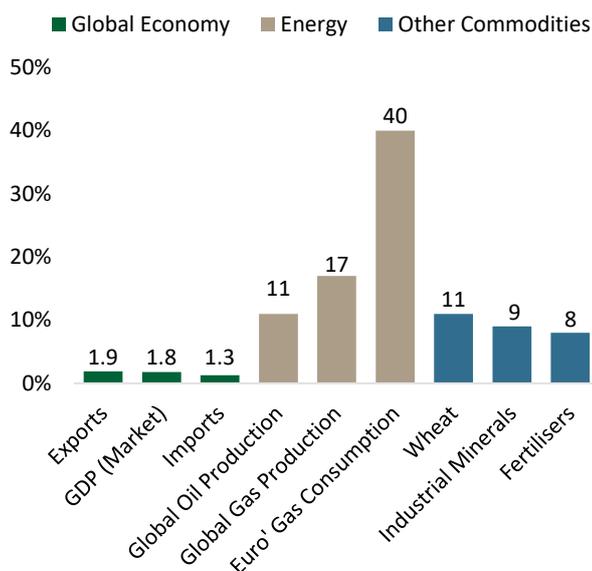
² Source: OECD Economic Outlook, March 2022

³ Source: Bloomberg, Markit composite PMIs, readings over 50 indicate expansion in business activity, March 2022



The most significant of these is through the commodity channel (chart 3). Russia and Ukraine combined account for c. 30% of global wheat exports and 20% of corn. Russia is the second largest oil producer representing c. 11% of global output and is responsible for almost half of European natural gas imports⁴.

Chart 3⁴: Share of Russia – commodities dominate



Both countries are also influential in other key inputs for the food and manufacturing sectors, such as palladium (heavily used in the auto industry), nickel (critical for steel and battery manufacture) and fertilisers.

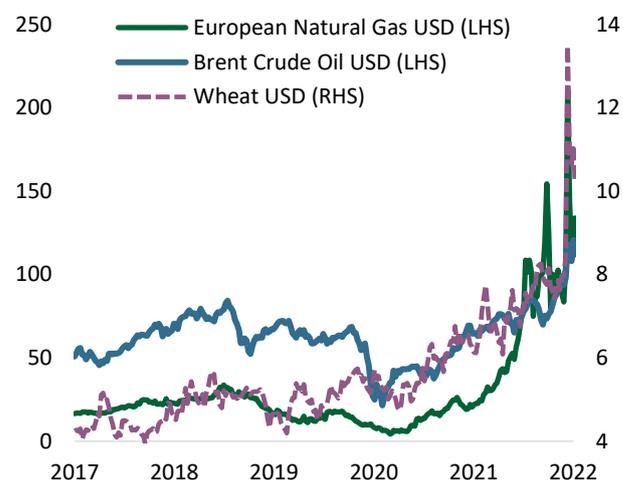
While some of the supply-side challenges caused by the pandemic have started to fade, the conflict represents a second negative supply shock to the global economy. As the prices of these commodities and raw materials have surged in recent weeks (chart 4), the primary concern is the impact on inflation.

Inflationary pressures were building throughout 2021, as pandemic-induced supply chain disruption combined with strong consumer demand for durable goods. The Federal Reserve, who were arguably too slow to acknowledge its persistence, have shifted gears in recent months. As Chairman Jerome Powell noted in a recent speech;

⁴ Source: IMF, Goldman Sachs Global Research, March 2022

The expectation going into this year was that we would see inflation peaking in the first quarter, then levelling out and see a lot of progress in the second half. That story has already fallen apart⁵.

Chart 4¹: Commodity prices have surged



Inflation is now likely to persist at elevated levels into the second half of 2022, before gradually moderating. As a result, consumers will feel the pinch as higher energy costs erode disposable income. However, the magnitude of this economic headwind will not be evenly distributed across regions.

The US economy is proving the most resilient

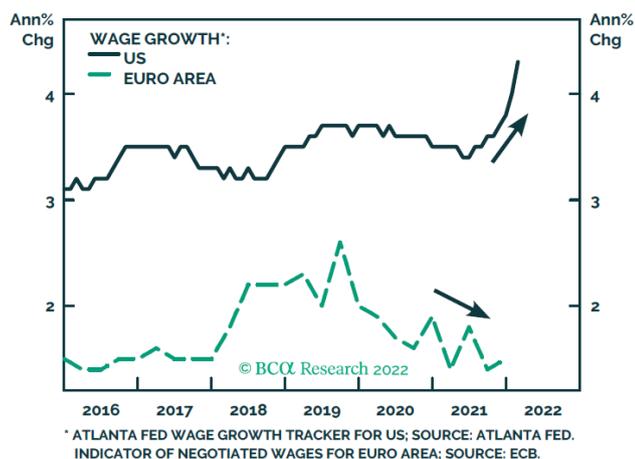
The headwind of higher energy and food prices is expected to be more tolerable for the US, with domestically produced oil and gas a partial offset to lost production elsewhere. These areas also represent a much smaller proportion of consumer spend than in 1970s, when energy-driven inflation was an important driver in the recession that followed.

For the consumer sector, substantial fiscal packages in recent years have bolstered the consumer balance sheet. A strong post-lockdown labour market recovery means that wage growth is softening the blow from higher prices in a way that is not evident in Europe (chart 5).

⁵ Fed Chair Jerome Powell, comments to a National Association for Business Economics conference in Washington, 21 March 2022



Chart 5⁶: European wage growth has been lacklustre



In addition to strong household balance sheets supporting consumer demand, US corporates have also built up cash and surveys show intentions to spend on capital expenditure have strengthened significantly over the past two years. With energy security and supply chain resilience likely to be a focus that persists, we expect fixed asset investment to be a continued source of US economic growth.

Current evidence suggests that the US economy is unlikely to tip into a recession over the next year in spite of additional inflation pressures and consequential higher interest rates.

The European economy came into the crisis with weaker momentum, suffering a larger Omicron-related headwind during the winter months. Now, closer proximity to the conflict is weighing on business and consumer confidence whilst inflation continues to rise.

Eurozone manufacturing firms face the unwelcome combination of higher input costs, renewed supply chain disruptions and little prospect of meaningful monetary or fiscal stimulus.

Europe is likely to see growth slow to a relatively pedestrian pace in the coming quarters. Even if we are to see a resolution to the Russia-Ukraine conflict in the near term, it will take time to restore confidence and manage the transition away from Russian oil and gas in a way that does not lead to persistently high energy costs.

⁶ Source: BCA Global Research, March 2022

Analyst expectations of Eurozone economic growth have plummeted, with business activity set to follow (chart 6)

Chart 6⁷: European economy set to weaken



Emerging economies are also in a tight spot, with consumer spending particularly sensitive to food and energy costs. In China, a zero-covid policy is proving difficult to enforce as outbreaks of highly transmissible variants keep rolling lockdowns a burden on the economic recovery.

Developed market central banks are currently well coordinated in their plans to tackle rising inflation with higher interest rates, but implementation might vary.

The Federal Reserve increased rates from near zero to 0.375% in March whilst the Bank of England hiked for a third time to 0.75%.

The European Central Bank is further behind the curve, and while inflationary risks have been made clear, they are likely to be more cautious in efforts to normalise monetary policy. What is clear, however, is that the kind of monetary and fiscal easing that restored confidence and facilitated a sharp economic rebound during the pandemic is unlikely to be repeated.

⁷ Source: Bloomberg, March 2022



Investment strategy - Implications

The economic mix of higher inflation, lower economic growth and rising interest rates is undesirable from an investment perspective, but not a complete change to the one we anticipated three months ago.

What has changed is that the risk of unforeseen and unintended outcomes has increased. Markets are likely to remain volatile, with geopolitical and economic uncertainty higher than normal.

This means selectivity and portfolio resilience are crucial. Diversification across asset types and manager styles is a key tenet of our investment philosophy, which we aim to bolster in the months to come.

In pursuit of long term real returns, the merits of equity and credit allocation still stands. We continue to see drivers for positive earnings growth and low corporate defaults this year, with recession still unlikely. We summarise our portfolio stance as follows.

Overall allocation to capital markets – favour equities and credit over government bonds

We highlight two key reasons for remaining constant on selective risk assets

Real government bond yields remain deeply negative, while equity valuations have improved

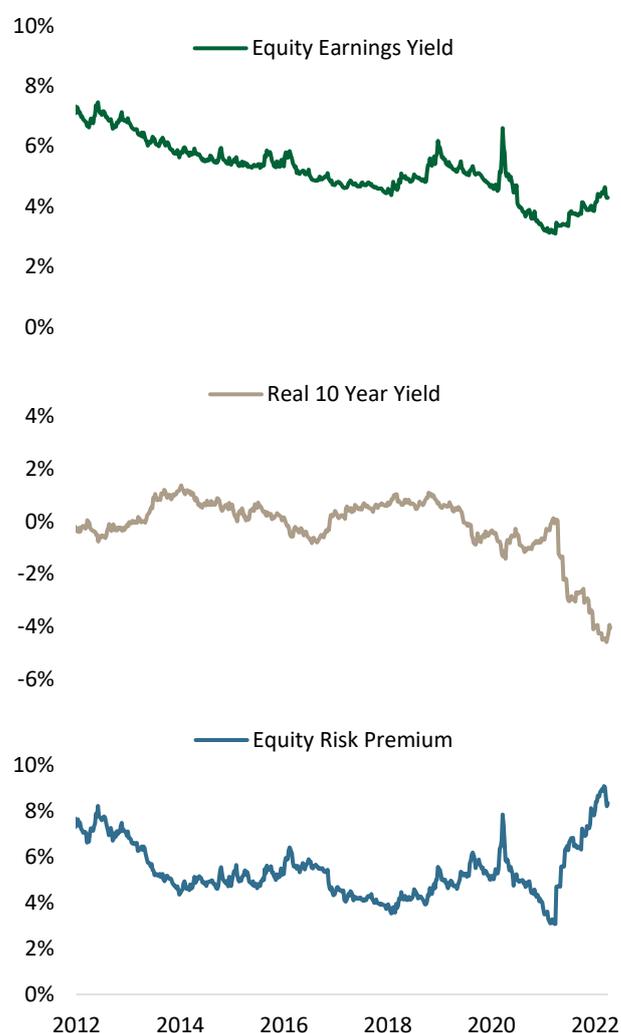
The absolute valuation of equities has improved from elevated levels in recent months, as earnings growth remained positive and share prices declined. Chart 7 shows the earnings yield for the US equity market (top panel) which represents current earnings as a percentage of current price.

This valuation metric has trended higher recently (i.e. more attractive), and now sits around the five year average. Meanwhile, the real government bond yield (middle panel) has collapsed into negative territory as inflation has risen sharply and bond yields remain low.

Importantly, equities represent a claim on future *real* cash flows. In this sense, they are a real asset with vital characteristics in an environment with higher inflationary pressures. As long as the economy continues to grow, which we expect, revenues and dividends should also grow.

While inflation may moderate over time, eroding the relative advantage equities have over bonds (bottom panel – the equity risk premium), it is expected to support equity investment for some time yet.

Chart 7⁸: Valuations favour equities as inflation rises



Corporate balance sheets are generally stronger than in recent years with a greater ability to weather higher interest rates

⁸ Source: Bloomberg, based on S&P 500 index and 10 year US Treasury yields less US Core CPI, March 2022



The strength of corporate balance sheets, particularly in the US, is a key justification for allocating to equities and credit (table 1). Companies have taken advantage of lower rates over the past two years, extending maturities and locking in favourable borrowing costs. Based on interest coverage ratios, the ability of companies to service their debt is as high as it's been since the late 1990s. This is expected to keep corporate defaults low and enable well managed companies to weather a more challenging economic backdrop.

Table 1⁹: US corporate health has improved

US Balance Sheet Ratios (ex financials)

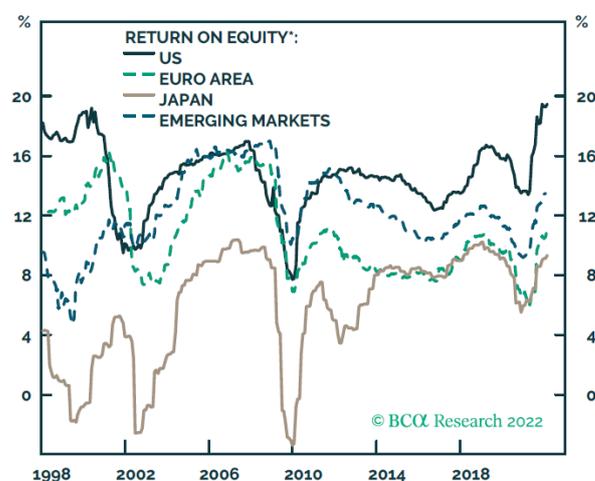
		2015	2019	2021	vs 2015	vs 2019
Profitability	ROE	11.0%	13.1%	19.1%	8.1%	5.9%
	EBIT Margin	9.5%	10.2%	13.2%	3.7%	3.0%
Leverage	Total debt/total assets	0.33	0.34	0.32	-0.02	-0.02
	Net Debt/Equity	0.65	0.76	0.61	-0.04	-0.14
	Net Debt/EBITDA	2.11	2.29	1.63	-0.48	-0.66
	Interest Cover	4.75	4.39	7.17	2.42	2.78
Liquidity	Current Ratio	1.52	1.30	1.39	-0.13	0.08
	Quick Ratio	1.06	0.91	0.98	-0.09	0.07
	Cash Ratio	0.60	0.48	0.55	-0.05	0.07
	Cash % total assets	11.5%	9.8%	11.6%	0.1%	1.8%
Refinancing need	ST debt/Total debt	11.2%	11.5%	9.8%	-1.3%	-1.7%
	Current LT debt/LT debt	8.6%	9.3%	7.2%	-1.4%	-2.1%
Interest rate	Eff. Interest rate	4.1%	4.5%	3.8%	-0.2%	-0.6%

Within equities – favour US and UK, blending structural growth, quality and value dimensions

We continue to allocate across global markets, blending managers and strategies with diversifying characteristics and styles.

The largest regional allocation within our equity portfolios has been the US market over recent years, and this remains a high conviction market bias. The US economy retains a relative advantage over European and developing counterparts (chart 8). This is expected to sustain the fundamental drivers of US outperformance that we have witnessed in recent years.

Chart 8¹⁰: US equities retain a growth advantage



As the cycle matures and inflationary risks shift up, strategies with defensive characteristics are critical. These strategies typically emphasise companies with stable yet moderate earnings growth driven by 'non-cyclical' demand. Healthcare is a favoured sector in this category, which we access through a dedicated strategy as well as through core active managers.

The UK is another region which we favour relative to global markets, having increased allocations over the past year. Whilst the impact is less severe than continental Europe, the UK economy is also likely to slow in the coming quarters as energy costs eat into disposable income. However, it is well known that market and economic performance can diverge.

The UK large cap market is a good example of one which is emerging as a leader against the backdrop of an evolving economic and geopolitical backdrop.

Notably, the FTSE 100 index offers access to 'old economy' industries and sectors – industrials, energy and materials in particular, with a global revenue profile (chart 9). After years in the doldrums, and trading on competitive valuations, such 'commodity beneficiaries' are in high demand. Large consumer staple businesses, such as in the household and food retailing space, are also prominent allocations and have many of the defensive characteristics that appeal in this environment.

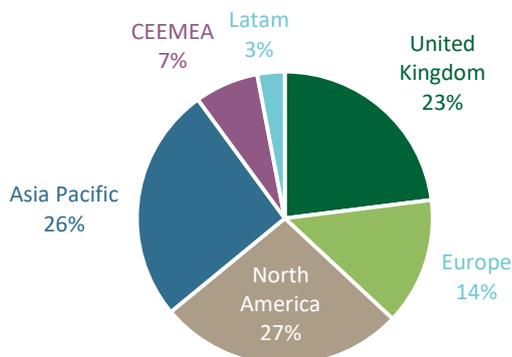
⁹ Source: Oxford Economics, March 2022

¹⁰ Source: BCA Global Research, MSCI, March 2022



Chart 9¹¹: FTSE 100 – UK by name, global by nature

Geographical sales exposure of FTSE 100 index



Within fixed income – favour investment grade credit and China bonds, having exited local currency Emerging Market debt

The outlook for emerging markets looked challenging even before the Russian invasion of Ukraine. In particular, several emerging market central banks face pressure to raise interest rates to control elevated inflation without the economic momentum to tolerate tighter financial conditions.

This is most acutely felt in the local currency debt space. Early in the year we exited our holding, despite our long held view that emerging market local currencies are undervalued versus the US dollar. In an environment where central banks in the developed world are turning increasingly hawkish, and the market is recalibrating interest rate expectation, we do not see fertile ground for a recovery across emerging market local currencies.

Having held a dedicated strategy in emerging market local currency debt in recent years we exited the position in early February.

Across our fixed income holdings we remain very underweight both from an absolute allocation as well as from an interest rate sensitivity perspective. We prefer to hold corporate debt over developed market sovereign bonds. Corporate debt typically has lower interest rate sensitivity than sovereign bonds, and offers a higher yield, depending on the credit quality.

The credit worthiness of corporate bonds, both in the Investment Grade (higher credit quality) and High Yield (lower credit quality) space is robust, as evidenced by improving debt metrics and a very benign default cycle outlook and we are comfortable allocating capital here.

We have also retained our exposure to the China Government bond market which has continued to act as a diversifier in the portfolio, whilst also benefitting from the favourable movements in the Chinese exchange rate.

Hold physical gold as a hedge against the unknown

We introduced physical gold to multi-asset portfolios in April 2020, recognising the heightened economic uncertainty. Gold typically performs well during periods of market stress, as well as rising inflation expectations. Both conditions are prevalent today. Gold has proven to be a valuable diversifier in recent months and we retain an allocation as an insurance against unintended outcomes that might follow.

Summary

We retain optimism on the prospects for equities and credit as core allocations within our portfolios. However the economic and geopolitical environment has become more uncertain, with considerable regional divergence expected. Volatile markets are a likely consequence. Our long term, global philosophy supports continued engagement with risk assets, although we are operating with a heightened level of vigilance for signs of deterioration that would warrant a more defensive stance.

Stonehage Fleming Investment Management
April 2022

¹¹ Source: Goldman Sachs Global Research, March 2022



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