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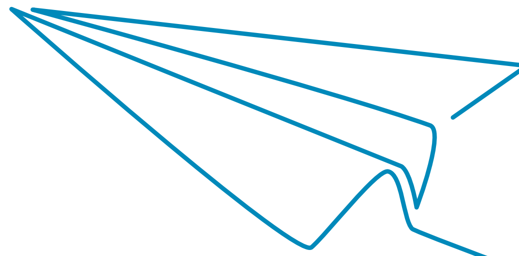
Handelsbanken
Wealth & Asset Management



Strategy Review

Take a closer look at the landscape for financial markets, and what this means for our investment strategies

Key takeaways

Central banks in the US and UK have raised interest rates, aiming to slow down economic activity to tackle inflation

Financial markets continue their volatile run, digesting a shift in central bank rhetoric and action

Inflation remains elevated, thanks to high levels of employment, buoyant housing markets and ongoing supply chain constraints

Nevertheless, US consumers – who are critical to the health of the US economy – remain in relatively good shape

The war in Ukraine is visible in financial markets primarily in the energy and agricultural sectors

The world's leading central banks are in the process of shifting their policies away from the ultra-supportive stances they have held in recent years (featuring extremely low interest rates and central bank purchases of financial assets). They are now beginning to move to a more neutral stance, meaning higher interest rates and a reduction (or end to) asset purchase programmes.

Financial markets have been adjusting to this change with discomfort. In bond markets, investors are reflecting expectations of higher interest rates by pushing bond yields higher (bond prices, which move inversely to bond yields, have therefore been falling). In stock markets, investors are reassessing the relative winners and losers, and share prices are trading at cheaper valuations. Such episodes of financial market indigestion are normal during periods of central bank adjustment, but they can still feel unsettling.

What are central banks doing about inflation?

Since our last *Strategy Review* in March, the US Federal Reserve Bank (Fed) has increased its benchmark interest rate to a range of 0.75%-1% (from its previous range of 0.25%-0.75%). This was in-line with market expectations, and marked the largest rate rise since 2000. The Fed has also outlined a programme in which it will eventually reduce its bond holdings by $95 billion each month. In the UK, the Bank of England has increased interest rates from 0.75% to 1.0%, in a move accompanied by very downbeat commentary around the outlook for UK economic growth.

In taking these steps, central banks hope to deliberately slow down economic activity, and thus control inflation. For the time being, inflation is elevated due to supply chain constraints (which central banks can do little about) as well as high levels of employment and buoyant housing markets.

Will inflation stop consumers in their tracks?

We are now seeing signs that upwards pricing pressures have begun to peak. We expect data to show that US inflation peaked last quarter, though we do not know how slowly it will fall from this point, or at what level it will settle. For the time being, the cost of living crisis is very real.

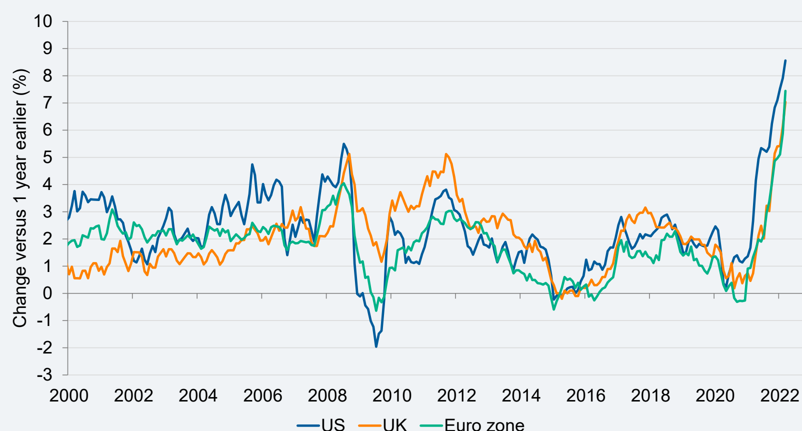
Even as COVID-19 concerns continue to take a back seat, consumer confidence in most regions around the world has fallen due to higher prices and cost of living concerns. Nevertheless, consumer spending can still support economic activity ahead, least not due to the cash saved by many consumers during the height of the pandemic.

In the US, spending by consumers accounts for a significant portion (more than two thirds) of economic activity. As a result, the health of the all-important US consumer often determines the health of the wider US economy, and indeed the world economy. Fortunately, from our current vantage point, we believe that consumption in the US can continue to stand its ground, despite the current inflationary pressures. Economic data tells us that (overall) US consumers still have savings and growing incomes, and that household finances broadly remain in good shape. Indeed, US household cash now exceeds household debt for the first time in three decades.

Globally, while saving rates do appear to be beginning to fall, they remain higher than at similar points in the past, particularly in the UK and Europe. This is good news for potential consumer spending, and by extension for the economy.

Inflation may be at its peak, but we do not know how far (or how quickly) pricing pressures will fall from here

Headline inflation in the US, UK and Eurozone



Source: Macrobond

What about the war in Ukraine?

Meanwhile, never far from the headlines or our minds, the terrible conflict in Ukraine is now entering its third month. As President Putin would evidently like to be able to claim a victory for Russia, near term de-escalation looks sadly unlikely.

As asset managers, it is our uncomfortable duty amid this human tragedy to also consider the financial market impact of the conflict. So far, financial markets have been focused on the impact of the conflict on global supply chains, with the energy and agricultural sectors particularly vulnerable.

Energy is a bigger concern for Europe than the US, given the latter's energy self-sufficiency. European reliance on Russian energy is reducing, but remains an area of weakness in this international power struggle. For now, like the rest of the world, we can only watch, wait and hope for a resolution to the conflict.

Under the bonnet in our investment strategies

We know that it can be very difficult to hold one's nerve when financial markets are unsettled. Against this backdrop, we continue to focus on our long-term investment aims, and remain watchful for the emergence of attractive investment opportunities.

Within our investment strategies, we have previously reduced some of our stock market risk, and recently tactically adjusted our stock market holdings to reflect the evolving market backdrop.

Modifying our exposure to 'value' areas of the stock market

In today's environment of fairly broad-based inflation, we expect a greater range of cheaper company shares to exhibit above-average earnings growth. This outlook has led us to reposition our core strategies slightly, increasing our positions in cheaper, 'value' shares.

Much of this repositioning has been funded from reductions in our holdings of smaller company shares. We will still have an overweight allocation to smaller businesses versus our long-term average, but to a more appropriate magnitude given our view on the current outlook.

Retaining conviction in long-term 'growth' themes

In making the above set of adjustments, we maintain our stock market positions in what we perceive as longer-term investment themes, where structural trends remain in place.

In practice, this means that our strategies have long-held positions in some key growth-orientated areas of the stock market, like healthcare and technology. Despite intermittent political and regulatory disruptions, we value the stability and persistence of this growth.

We also like emerging markets, partly for their growth potential, but also (and perhaps more importantly) as a way of harnessing the rise in global economic activity.

Maintaining our creative drivers of financial returns

Alongside our investment positions in traditional areas of financial markets like bonds and shares, we are always on the lookout for creative return drivers – assets whose performance is largely unconnected to either traditional financial markets or natural economic fluctuations.

In keeping with this, our strategies currently hold positions in 'alternative' asset types like music royalties, social housing and renewable energy.

While these asset types are subject to their own unique risks, they also offer something different, and can help to smooth financial returns within our strategies over time.

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