Handelsbanken
Asset Management

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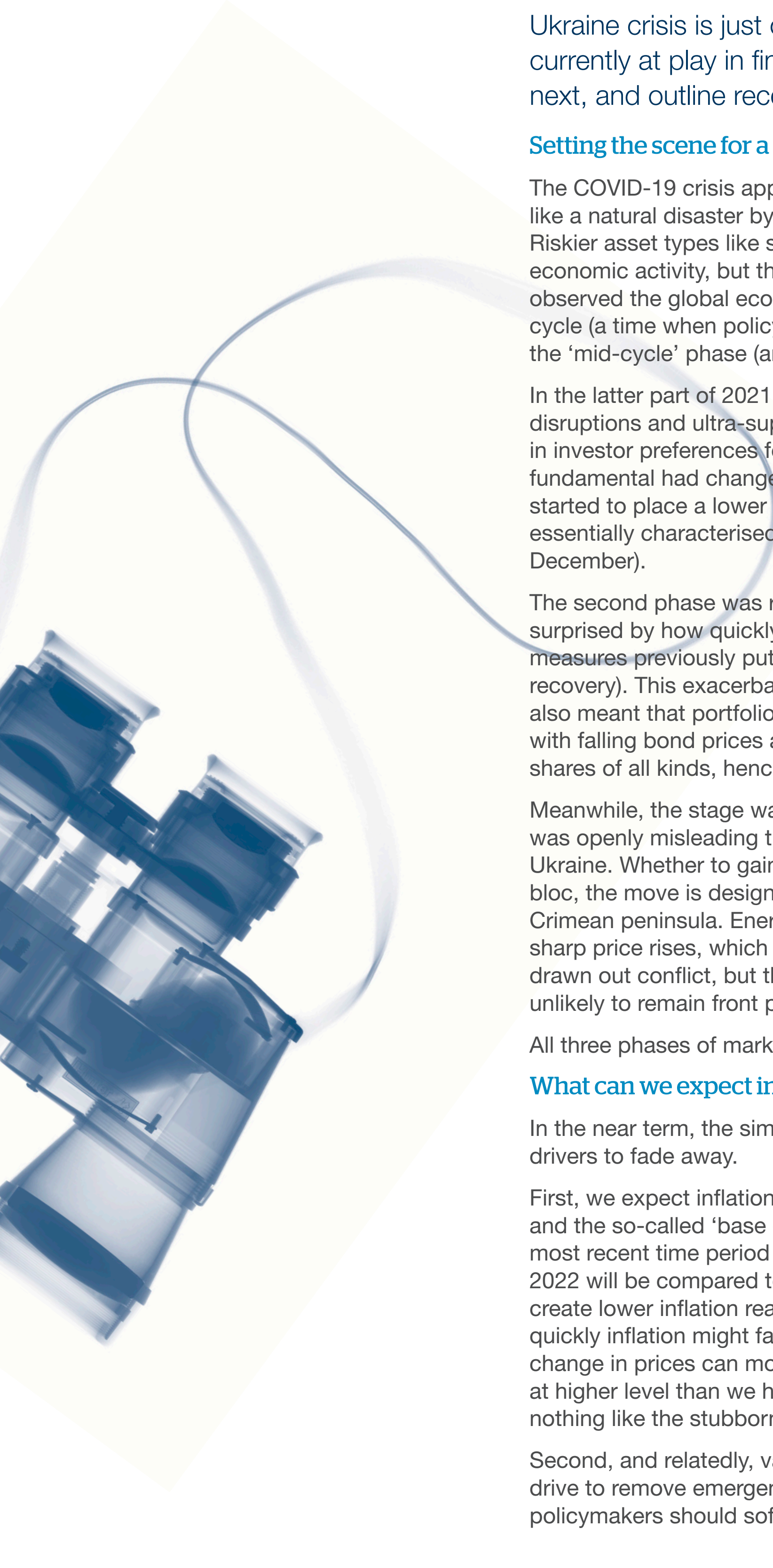
Investment Insight

Has financial market volatility picked up for more than one reason?



Financial market volatility has picked up in recent months, and the Russia-Ukraine crisis is just one part of the picture. Below, we discuss the factors currently at play in financial markets, consider what investors could expect next, and outline recent adjustments in our investment strategies.

Setting the scene for a perfect storm of volatility

The COVID-19 crisis appeared to come out of nowhere, and was essentially treated like a natural disaster by both financial markets and policymakers around the world. Riskier asset types like shares swiftly accounted (in their prices) for the sudden stop in economic activity, but then swiftly bounced back. For most of the period since, we've observed the global economy moving from the 'early-cycle' phase of its perpetual cycle (a time when policymakers intervene to set the scene for economic recovery), to the 'mid-cycle' phase (an expansionary period, when new growth can be harnessed).

In the latter part of 2021, the prospect of economic re-opening, supply chain disruptions and ultra-supportive central banks manifested in a sharp rotation in investor preferences for styles and sectors within the stock market. Nothing fundamental had changed for many of the stock market's prior winners, but investors started to place a lower relative value on these assets. This relative 'de-rating' essentially characterised the first phase of the recent volatility markets (November and December).

The second phase was related to a shift in central bank rhetoric, with markets surprised by how quickly policymakers planned to unwind the emergency support measures previously put in place (ultimately a healthy sign recognising economic recovery). This exacerbated the aforementioned rotation in investor preferences, but also meant that portfolios with a significant allocation to government bonds struggled with falling bond prices and rising bond yields. Moreover, it caused indigestion for shares of all kinds, hence most market indices experienced declines.

Meanwhile, the stage was being set for a third phase of market volatility. Russia was openly misleading the world whilst preparing for an unprovoked invasion of the Ukraine. Whether to gain control of natural resources or to just threaten the European bloc, the move is designed to finish what it started in 2014 with the annexation of the Crimean peninsula. Energy and soft commodities (like agricultural products) have seen sharp price rises, which will have ripple effects around the world. It may also be a long drawn out conflict, but the media often has a short attention span, and the conflict is unlikely to remain front page news forever if so.

All three phases of market volatility have caused disruption to all kinds of investors.

What can we expect in the near term?

In the near term, the simple answer is that we expect the majority of recent negative drivers to fade away.

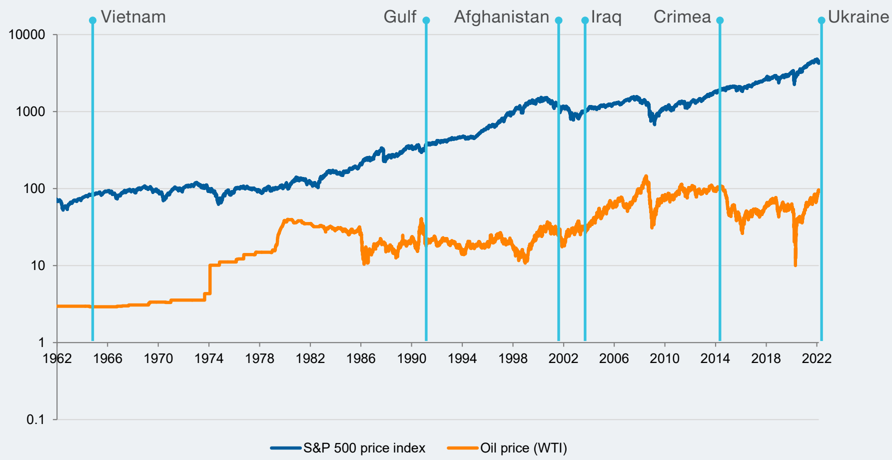
First, we expect inflation fears to begin to abate, as supply chain disruptions improve and the so-called 'base effect' kick in. Inflation is measured by comparing prices in the most recent time period to prices in a previous time period. This means that prices in 2022 will be compared to the elevated prices seen in 2021, which should automatically create lower inflation readings ahead. In the meantime, the market is focused on how quickly inflation might fall and at what level it will settle. Our belief is that the rate of change in prices can moderate quite quickly, and that while inflation is likely to settle at higher level than we have grown used to since the global financial crisis, it will look nothing like the stubbornly high levels reached in the 1970s.

Second, and relatedly, various central banks may be approaching the peak of their drive to remove emergency support levels. By this, we mean that the rhetoric used by policymakers should soften, and this should calm nerves that early moves from central banks won't push us straight into another recession. In other words, the indigestion affecting markets relating to this issue should be transitory.

Third, Russia's actions, though generally agreed to be utterly unjustifiable, could become something else we get used to living with. From a financial markets perspective, we have to accept the uncomfortable truth that – if history is any guide – then 'invasions' quite often present good buying opportunities for investors. Remember the adage 'buy the rumour, then sell the news'? There has been talk of a Russian invasion for several months, and financial markets may have already 'priced in' these events to a large degree.

A history of invasions, stock markets and the oil price

S&P 500 Index (representing the US stock market) and West Texas Intermediate (representing the oil price)



Source: Macrobond.

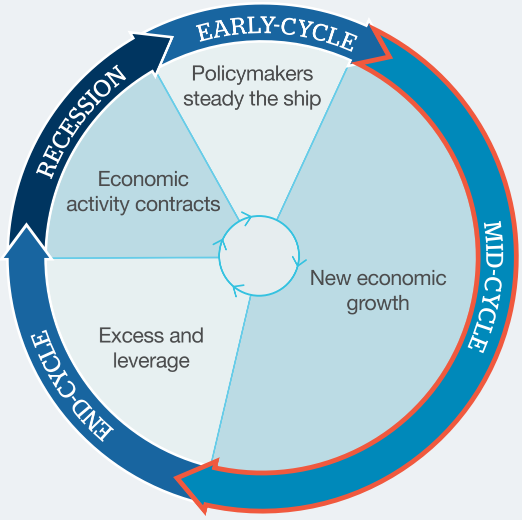
This chart uses a logarithmic scale to address skews towards large values in the data.

How about further down the line?

Over the medium term, we are focused on the ongoing economic cycle. Our analysis shows that the mid-cycle phase remains alive and well. Though not necessarily as long in duration terms as the post-2008 period, this does offer some runway to reward investors, particularly in a world where the real returns on cash continues to deteriorate.

Unpicking the four stages of the global economic cycle

(Sometimes termed the 'global business cycle')



Source:
Handelsbanken Asset Management

Contact

To find out more about the Handelsbanken strategies, visit wealthandasset.handelsbanken.co.uk or contact your local representative.

Talk of recession is premature in our view, but we will be prepared to cross that bridge when we come to it. For now, we are happy to hold risk levels at a neutral level versus our longer-term average across most of our strategies. This reflects the fact that the economic cycle is far from over, but that asset valuations no longer look cheap. Our attitude to recent market volatility leans more towards it being an opportunity than a long-term threat.

Have we changed anything in our investment strategies?

In the meantime, we have been busy examining our positions and re-appraising the tilts at work in our strategies. Our trading activities can be summarised in two waves.

First, we have slightly reduced our underweight duration position in UK government bonds. In essence, this means that our bond positions are now more sensitive to interest rate rises. While this might seem counterintuitive, as central banks have already signalled higher interest rates ahead, bond yields have already been rising in response to these signals. We believe that yields still have further to rise, but we also think that much of the journey ahead for interest rates has already been accounted for in bond prices. As a result, we have taken the decision to be opportunistic and adjust our bond positions early.

Second, after careful analysis of our stock market holdings, we are dialling back some of our strategy tilts and active positions. As nominal economic growth is less scarce than in the post-2008 environment of very limited economic growth, the market may feel that premium valuations for the 'steady-eddy' growth-oriented shares are no longer justified. Thus, more exposure to typically cheaper, less growth-focused 'value' shares makes intuitive sense to us. This will involve tempering our exposure to some of our active stock market managers, as their style of investing may continue to struggle in the near term given the backdrop described above. Portfolio management is often about risk management, which is why we're aiming to recalibrate these tilts and positions.

Our investment strategies are designed to achieve our clients' aspirations over the long term, riding out short-term volatility such as the environment we are currently experiencing. This is not the first time our investment strategies have seen volatile markets, and it won't be the last, but we continue to believe that well diversified, global, multi asset class portfolios will be rewarded over the long term. Spending time in the markets is much more optimal than trying to time markets to perfection.

The Investment Team

Registered Head Office: No.1 Kingsway, London, WC2B 6AN. Registered in England No: 4132340. www.wealthandasset.handelsbanken.co.uk
Telephone: 020 7045 2600