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Handelsbanken
Wealth & Asset Management

Strategy Update

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

Key takeaways

Near-term noise is unsettling financial markets, but central banks must stay the course with interest rate rises

We are watchful for tactical opportunities arising from the market unrest, but our long-term investment approach remains the same

Inflation appears to have peaked in the US, but the war is not yet won and policymakers likely have further to go

We have held risk levels steady within our investment strategies, believing that these are appropriate for the economic and market environment

Adding to our bond market positions over the past year has proven helpful for short-term performance

It's been a noisy few weeks for financial markets, from nerves about central bank plans to high profile casualties in the banking sector on both sides of the Atlantic. You can read more about some of the events upsetting markets in our latest *Market Update*, but suffice to say that a repeat of the 2008 financial crisis is not our base case in the current environment.

Primarily, we believe that the recent problems ensnaring a specific selection of banks stem from the ripple effects of major policy changes at the world's leading central banks. After years of ultra-low and even negative interest rates, central bankers are now attempting to move to a more 'normalised' regime. Interest rates are therefore likely to settle at a higher level than the ultra-low levels to which the banking sector had apparently grown a little too accustomed.

What do recent banking casualties mean for our investment approach?

We are always aware that market weakness can create possibilities for nimble investors, and we remain alert to any potentially attractive opportunities that could arise amid the current turbulence. But while we are watchful for any tactical opportunities that might emerge in the near term, the reality is that short-term market news does not dictate our strategic approach to investing. We are long-term investors, aiming to build resilient investment strategies which are able to ride out the noise and weather a range of market conditions over the long run.

However, that doesn't mean that we don't pay attention to near-term events beyond tactical opportunities, especially if we think these instances could create longer-term changes in direction for key policymakers like central banks. At present, our view is that central banks are winning the war on inflation, slowing down economic activity by raising interest rates and removing economic support programmes. But this war is not yet won, as highlighted by the most recent (high) data on consumer prices in the US.

As a result, we are watching closely for any signs of central banks becoming too distracted by the rather fluid events in the banking sector, lest they should overreact and soften their approach prematurely. From the current vantage point, we believe it would ultimately prove more beneficial for the global economy (and financial markets) if central banks were to continue pushing interest rates higher for now, in order to rein in inflation definitively.

Where are interest rates and inflation headed next?

As ever, we are especially alert to the actions of central banks, and in particular (as the central bank for the world's leading economy) the actions of the US Federal Reserve Bank (Fed).

It's our view that the Fed will stop raising interest rates within the next few months, and will likely hold rates at these elevated levels until a material change takes place in economic data. At the moment, economic data in some areas (such as survey data covering the private sector) looks surprisingly upbeat given the extent of central bank action over the past year. However, we know that central bank policies show up in the real economy with a lag, usually taking a little time to feed through into economic outcomes. As a result, we would be surprised to see durability in these upbeat economic readings.

We're also closely watching inflation, which has shown signs of reaching or passing its peak in most major economies. The factors behind this include supply chains continuing to return to normal, and more limited inflationary pressures from energy costs: the initial spike in energy prices is starting to fall out of 'year-on-year' data, meaning that it will hold less sway over inflation figures. Europe's energy shock is also rapidly reversing.

Nevertheless, we are not out of the woods yet, and a misstep from central banks at this point could be very painful for the global economy. Wages and rental costs appear to be taking much longer to normalise, and employment markets remain markedly buoyant. Policymakers are likely to be meticulously following economic data readings in these areas for signs of meaningful slowing.

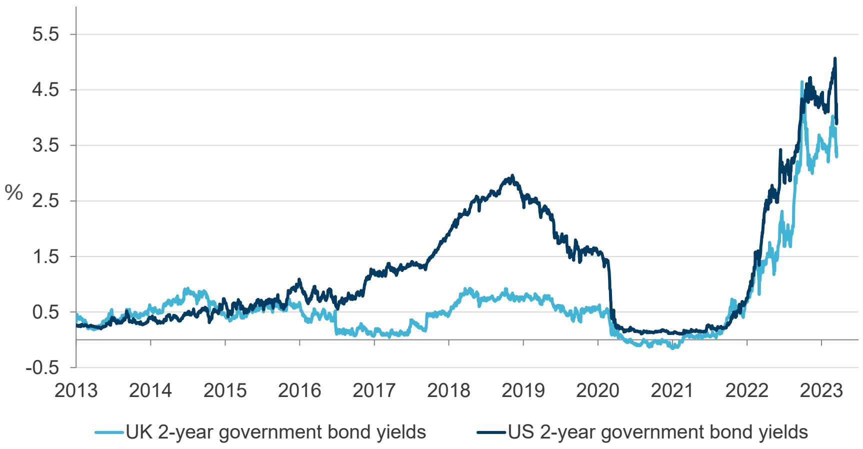
Under the bonnet in our investment strategies

We have not materially altered the risk levels within our investment strategies since our last *Strategy Update*, believing these levels to be appropriate for the current economic and market landscape.

In recent months, we have been increasing our allocation to bonds within our multi asset strategies, and accordingly reducing our allocation to shares. Given how much bond yields had risen (and how much bond prices, which move in the opposite direction to yields, had fallen) over the past year, it was always our belief that this would prove to be positive for our strategies in times of market volatility. It has been pleasing to see this materialise amid the latest bout of market turbulence. Certainly, our strategies have not been immune to market weakness, but our comparatively reduced position in shares has also helped on a relative basis.

Bond yields had risen sharply over the past year, but have come down as bond prices have risen during the recent market turbulence

UK and US 2-year government bond yields (%)



Source: Macrobond

Adjustments to our bond positions have begun to bear fruit

Over the past year, we have increased our allocation to bonds within our multi asset strategies, as yields rising (and prices falling) made bond valuations suddenly look much more attractive for the first time in many years.

We have focused primarily on the government bond sector, and while the journey has not been smooth, these positions have helped to cushion performance for our strategies during the recent market turbulence. Bond yields have fallen sharply, and bond prices have risen, which is good news for our bond holdings.

Stock market prices still need to account for further challenges

We retain our reduced position in shares versus our long-term average, believing that stock markets still need to continue 'repricing' to account for a less attractive outlook for corporate earnings and the effects of higher interest rates.

Tactical opportunities are emerging in areas of the UK property sector

Within our allocation to 'alternative' asset types (beyond traditional bond and stock markets), we have seen tactical opportunities emerging in UK real estate investment trusts (REITs). We believe that a number of options in this area of the market look under-priced versus their underlying property assets.

Where we have moved to take advantage of these perceived opportunities, we have funded purchases from elsewhere in our alternative asset holdings. This means that the overall mix of asset types within our strategies has been held steady.