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Global perspectives: Remaining neutral

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- **The Russian invasion of Ukraine has led to a significant increase in oil and agricultural commodity prices.** We are not expecting a rapid resolution to the fighting and believe sanctions on Russia are likely to be long-lasting. The war-related extent of the surge in oil prices to over $110 is over US$30 per barrel and is likely to have a meaningful impact on consumer spending.
- **Global markets have recovered to trade at pre-war levels after an initial sell-off.** US markets remain in overvalued territory. High valuations, slowing growth and tighter financial conditions are not conducive to strong equity market performance, in our view. European equity valuations are less stretched although there is relatively higher risk from sanctions on Russian energy supplies.
- **The US Federal Reserve (the US Fed) and European Central Bank (ECB) have recently indicated their priority for 2022 is inflation rather than growth.** There has been little weight given to the idea that high oil prices will act as a drag on the economy and as a result we are expecting a faster rate of monetary tightening and a slower pace of GDP growth.
- **Following the rebound in equity markets, we maintain our neutral outlook on equities.** The primary concern is the new-found fervour within the US Fed and the ECB to tighten monetary policy more rapidly despite the likely slowing of economic growth induced by the surge in energy prices. Furthermore, the apparently lowered intensity of fighting in Ukraine in recent days may represent a false dawn as Russia seeks to optimise its negotiating position, both with respect to Ukraine but also internationally applied sanctions.
- **We believe investors should become increasingly selective and seek exposure to sectors that benefit from higher interest rates and represent less cyclical earnings streams.** Given the outlook for interest rates we expect global bond yields to continue to push higher and remain underweight. However, the near inversion of the US yield curve suggests that the peak in US bond yields may occur relatively early in this rate tightening cycle.

Neutral on global equities, but only just

With global markets close to pre-Ukraine war highs, we remain neutral on global equities. Limited upward progress seems likely in an environment of increasingly hawkish rhetoric from the US Fed and ECB. Valuations for US equities, which account for approximately 50% of global market capitalisation, remain well above long-run average levels. We believe the war in Ukraine still represents a significant uncertainty, despite the apparent reduction in the intensity of the conflict in recent days.

The hawkish turn in central bank policy is something of a surprise given the resolutely doveish bias of the US Fed and ECB over the past decade and the likely drag on GDP growth from higher energy and food prices. There is now a US rate increase expected at each FOMC meeting for the rest of the year. This time, the US Fed appears to be quite serious about tightening financial conditions to squeeze out inflation.

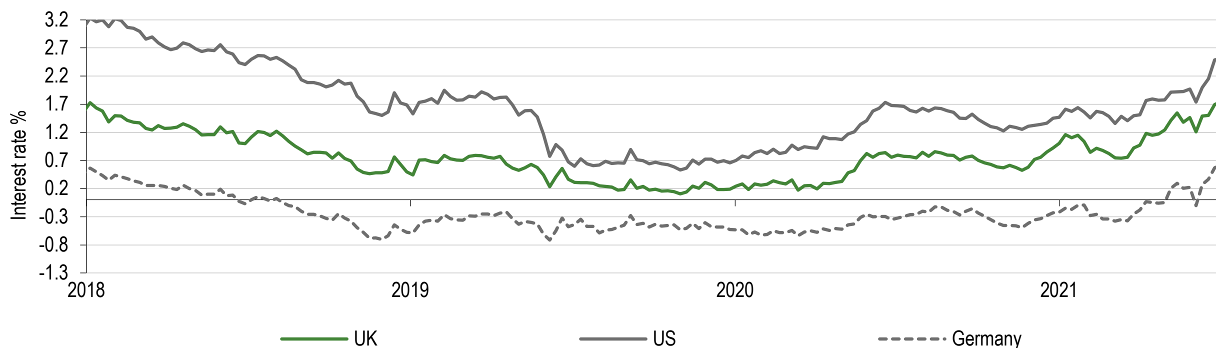
Both the US Fed and ECB are now in something of a self-imposed catch-up mode, having spent much of the prior 12 months asserting that the surge in inflation was transitory. In hindsight, the 'transitory' inflation argument has been shown to be wrong as policymakers have had to steadily increase inflation forecasts for year-end 2022.

In his most recent press comments, US Fed Chair Powell highlighted his determination to act 'expeditiously' to tighten policy to avoid embedding higher inflation expectations within the economy. The recent war-induced rise in global energy and food prices is clearly unhelpful in this regard, even if the United States is largely self-sufficient in energy. Headline inflation will clearly be higher and above central bank targets for rather longer than would have been expected in the absence of war in Europe.

In the UK, the Bank of England (BoE) is something of an outlier for now, raising interest rates by a further 0.25% but alluding to the possibility of an easier trajectory of rate increases as growth slows due to the economic impact of the war in Ukraine. For example, BoE Governor Bailey this week stated the magnitude of the energy shock will be higher than in any single year since the 1970s.

Increasingly hawkish central bank policy has resulted in rapidly increasing long-term government bond yields during Q122, Exhibit 1. Even the outbreak of war in Ukraine, which would normally be expected to be positive for government bonds as investors seek safe havens, has failed to stem the rise in yields. We note the US 10-year yield is now above levels prevailing in the pre-COVID-19 era.

Exhibit 1: Global 10-year yields soar as US Fed switches to hawkish track



Source: Refinitiv

Yet the implicit forward guidance in the dot-plots, contained within the US Fed's Statement of Economic Projections, that US rates will rise monotonically is only one part of the story. Judging

from the yield curve, investors do not expect the US Fed to be able to raise rates as quickly as policymakers currently indicate and we would concur with this assessment.

The recent increase in food and energy costs worldwide is likely to act as a significant drag on the economies of net oil consuming nations. Developed market GDP growth was in any case set to decline during H222 as the COVID-19 slowdown and recovery period falls out of the data. We note the spread between US two-year and 10-year rates is already close to zero, leaving the yield curve perilously close to inversion, which often signals a recession ahead. The combination of rapidly rising interest rates and a slowing economy at a time of surging energy and food prices is hardly an ideal environment for equities, in our view.

Exhibit 2: US two-year-10-year yield curve spread already close to zero – and at the start of the Fed tightening cycle

Source: Refinitiv

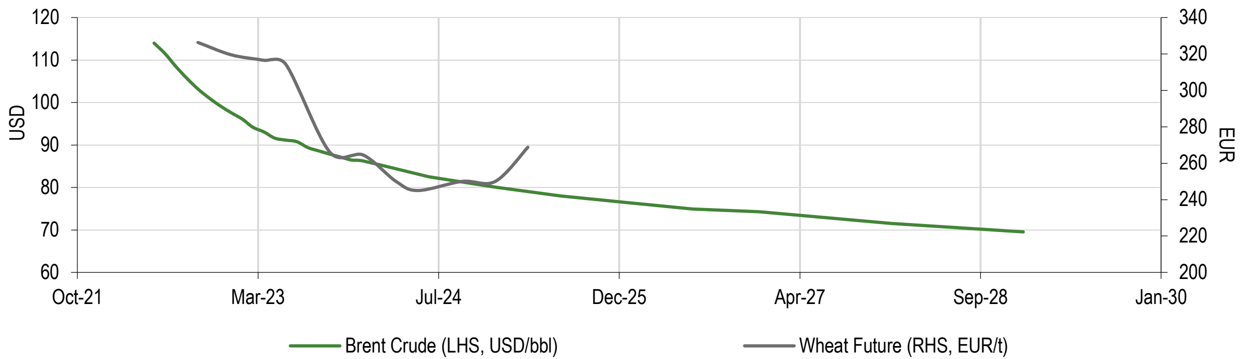
While interest rates are on a rising trend and GDP growth is set to moderate, for now global earnings estimates are still rising in aggregate, led by the energy and resources sectors, which have seen significant output price increases following the implementation of sanctions on Russia. However, we believe this is likely to be a one-off benefit concentrated in just a few sectors and which represents input cost pressure for the remainder of the stock market.

We believe almost all scenarios of the outcome of the war in Ukraine leave Russia isolated from the world economy for some time. This could possibly be until there has been a handover of power, which given the entrenched nature of Putin's administration may take years to occur. The Putin regime appears to have crossed the Rubicon into pariah status in the eyes of the US President, rather than a mere irritant engaging in an expansive hybrid foreign policy spanning military operations, influence campaigns and assassinations of opponents on foreign soil. In consequence, economic sanctions seem likely to be long-lived regardless of the ultimate outcome of the situation on the ground.

Potentially the only remaining uncertainty is whether China or India chooses to exploit the situation for their own economic and political advantages. In this regard, we note the humanitarian catastrophe in Europe resulting from the war to date seems to have had no public impact on the warmth of the Russia/China relationship, following the meeting of foreign ministers this week.

As a result of the likely durability of sanctions we believe oil and food prices are likely to remain elevated for the duration of 2022, which will maintain upward pressure on headline measures of inflation. Nevertheless, we are reminded of the aphorism that the solution to high oil prices is high oil prices.

Exhibit 3: Inverted wheat and oil futures markets suggest supply chain disruption will ease



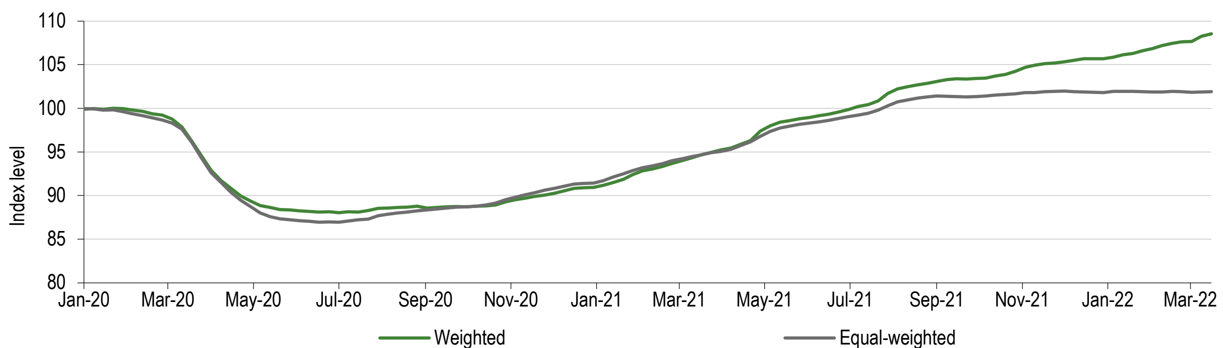
Source: Refinitiv

Both oil and wheat futures curves are strongly inverted, meaning that prices for delivery in the short term are much higher than prices for delivery further into the future. Oil for delivery in 2029 was moving higher prior to the outbreak of war, but is little changed since mid-February at only US$70. There is a similar story in wheat futures where prices for 2024 are up only 10% compared to spot prices, which have risen by over 40% during the same period.

We expect governments to move swiftly to reconfigure supply chains to avoid major disruption to either energy or food supplies as Russian volumes are reduced or eliminated entirely. We note the recent agreement between the US and EU for LNG supplies and early signs of a more favourable oil and gas investment climate around the UK. As hydrocarbon-based energy becomes more expensive we also expect further investment in renewable energy, which will permanently displace fossil-based fuel.

The EU has proposed relaxing environmental requirements for farmers to set aside land, increasing the acreage available for combinable food crops to compensate for both the loss of acreage and likely difficulties of exporting grain from Russia and Ukraine. Supply chain, energy and agricultural themes are likely to benefit from positive earnings momentum in the short term. Nevertheless, investors should be careful not to over-estimate the duration of the uplift from an essentially transient phenomenon which is likely to become played out within the next 12 months.

Exhibit 4: Global earnings revisions still positive but increasingly led by large-cap energy and resources



Source: Refinitiv, Edison calculations

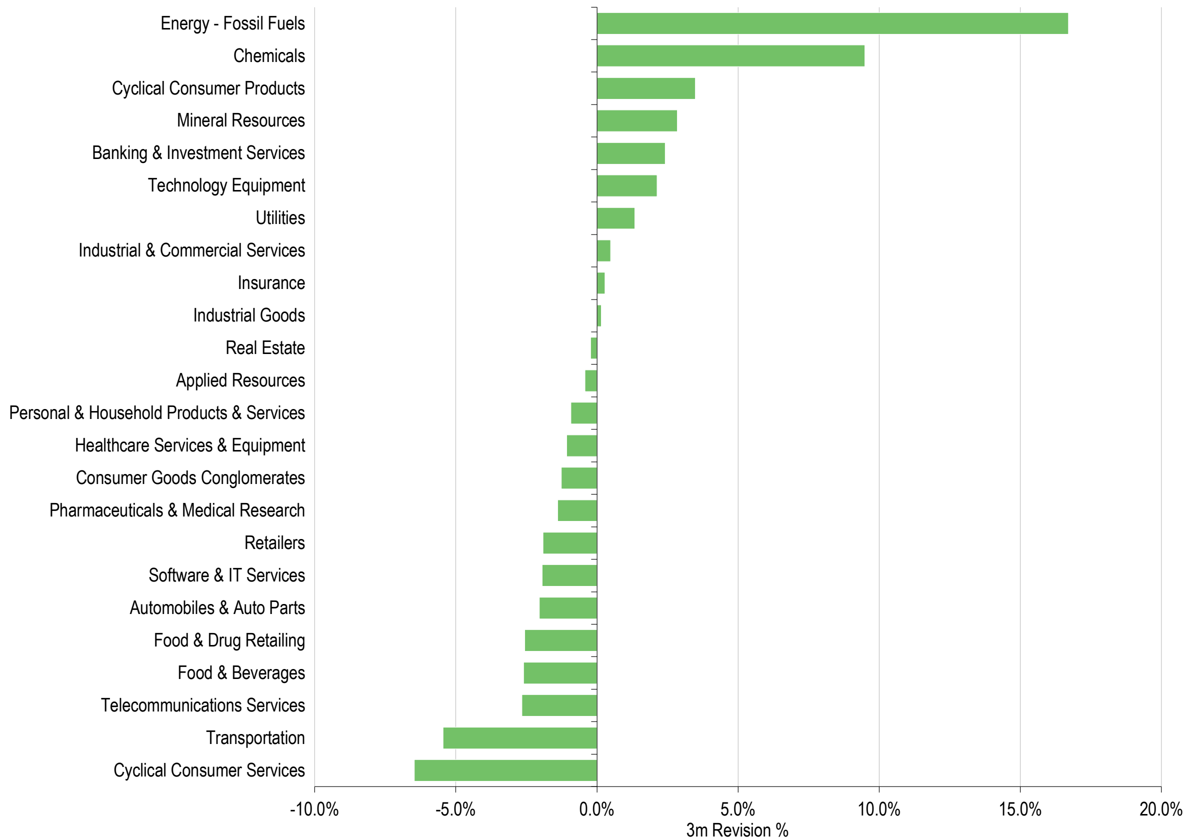
Earnings estimates rising with resource and energy demand

Rising energy and basic resources prices resulting from the recent supply shock are purely inflationary and in the medium term act as a drag on economic growth. However, for producers of these commodities this represents a period of increased profitability. Despite the uncertainties induced by the war in Ukraine and recent market volatility, global earnings estimates have been

rising in recent weeks. We believe this positive trend in earnings has been key to the market rebound, even as listed companies have shuttered or stopped supplies to Russia-based subsidiaries.

Nevertheless, the strong upward momentum in resource sector earnings prospects should not be allowed to mask the weaker earnings performance of the wider market. The COVID-19 earnings recovery appears to be complete as outside the energy and chemicals sector there has been little movement in earnings forecasts during Q122 on a global basis, Exhibit 5.

Exhibit 5: Outside energy sector mixed picture for profits forecasts during Q122



Source: Refinitiv, Edison Investment Research calculations

Conclusion

We maintain a neutral outlook on equities with some significant caveats following a hawkish turn in monetary policy. The ebbing of earnings momentum outside the energy sector during the quarter also suggests economic growth is moderating. Rising US interest rates and tighter than expected monetary policy in the eurozone is likely to prolong the period of underperformance for the most highly valued segments of the equity market, whether on a regional or sector basis, in our view.

Therefore, we continue to prefer traditional sectors such as banks, insurers, energy and telecoms over technology at this time. We add the defence sector to this list as commitments to increased defence spending are likely to outlast any ceasefire or apparent withdrawal of Russian forces.

US 10-year bond yields are likely to continue to move higher in the short run as interest rates rise, but the flattening of the yield curve suggests that the point where long-term rates stop rising in anticipation of a slowdown in growth is now approaching.

We view the likely progression of the Ukraine/Russia war as still uncertain at this stage, despite the remarkable resistance put up by Ukraine's defence forces. Nevertheless, global market prices have already adjusted to the supply chain challenges brought by the invasion, and investors have now had time to adjust portfolios accordingly. New investments in Russia will be off-limits to most institutional investors due to ongoing sanctions risk.

Whether the recent reduction in the intensity of the war signals a withdrawal or a regrouping of Russian forces is at this stage unknowable for those outside Putin's inner circle. It is only rational however to expect Russia to attempt to splinter the currently strong consensus on sanctions by feeling for exactly where the red lines are among individual European nations. We cannot exclude that the first example of this tactic could be the current round of peace negotiations and, in our view, investors positioning for a quick ceasefire may be disappointed.

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