

Quarterly Markets Review

Q1 2022

A look back at markets in Q1, which was dominated by Russia's shocking invasion of Ukraine as well as rising inflationary pressures.

The quarter in summary:

Russia's invasion of Ukraine in late February caused a global shock. The grave human implications fed through into markets, with equities declining and bond yields rising (meaning prices fell). Commodity prices soared given Russia is a key producer of several important commodities including oil, gas, and wheat. This contributed to a further surge in inflation as well as supply chain disruption. Elsewhere, Chinese equities were negatively affected by renewed Covid-19 outbreaks, leading to new lockdowns in some major cities.

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US

US stocks declined in Q1. Russia's invasion of Ukraine drew widespread condemnation and elicited a range of strict sanctions from the US and its allies. President Biden targeted what he termed "the main artery of Russia's economy" by banning Russian oil imports.

Sanctions also struck at the Russian financial system. Assets of the Russian central bank were frozen, while coordinated steps were taken with numerous allies to seeking to deny Russia access to the global financial system. Some of Russia's wealthiest people have also been hit with asset freezes and seizures, while a slew of major international corporations have withdrawn from the country. Numerous other sanctions have been instated.

The invasion amplified existing concerns over inflation pressures, particularly through food and energy, although US economic data otherwise remained stable. The US unemployment rate dropped from 3.8% in February to 3.6% in March. Wages continue to rise, but have not yet matched the rate of headline inflation. The annual US inflation rate, as measured by the consumer price index, hit 7.9% in February.

The Federal Reserve (Fed) raised interest rates by 0.25%, with calls from within for more aggressive tightening. Further hikes are expected through the rest of 2022.

Energy and utility companies were amongst the strongest performers in relative terms over the month, outperforming a falling market with modest gains. Technology, communication services and consumer discretionary were amongst the weakest sectors.

Eurozone

Eurozone shares fell sharply in the quarter. The region has close economic ties with Ukraine and Russia, particularly when it comes to reliance on Russian oil and gas.

The invasion led to a spike in energy prices and caused some fears about security of supply. Germany suspended the approval of the Nord Stream 2 gas pipeline from Russia. The European Commission announced a plan – RePowerEU – designed to diversify sources of gas and speed up the roll-out of renewable energy. However, in the meantime there are fears that the high energy prices will weigh on both business and consumer demand, hitting economic activity.

Over the quarter, energy was the only sector to register a positive return. The steepest declines came from the consumer discretionary and information technology sectors. Worries over consumer spending led to declines for stocks such as retailers, while the war in Ukraine also exacerbated supply chain disruption, hitting the availability of parts for a wide range of products.

In response to rising inflation, the European Central Bank (ECB) outlined plans to end bond purchases by the end of September. ECB President Christine Lagarde indicated that a first interest rate rise could potentially come this year, saying rates would rise “some time” after asset purchases had concluded. Data showed annual eurozone inflation at 7.5% in March, up from 5.9% in February.

The ongoing war in Ukraine and rising inflation led to a small pullback in forward-looking measures of economic activity. The flash eurozone composite purchasing managers’ index (PMI) slipped to 54.5 in March from 55.5 in February, though a level over 50 still represents expansion. (The PMI indices, produced by IHS Markit, are based on survey data from companies in the manufacturing and services sectors.)

UK

UK equities were resilient as investors began to price in the additional inflationary shock of Russia’s invasion of Ukraine. Large cap equities tracked by the FTSE 100 index rose over the quarter, driven by the oil, mining, healthcare and banking sectors. Strength in the banks reflected rising interest rate expectations. The Bank of England moved to hike rates ahead of other developed market central banks.

As the quarter progressed, some of the more traditionally defensive sectors advanced up the leader board. Intermittent fears of a global recession, however, drove periodic sell-offs in some of these “safer” stocks too. Market volatility rose given the additional uncertainty related to the Russia/Ukraine conflict.

The Bank of England increased its official rate by a combined 50 basis points (bps) with a further two consecutive 25 bps hikes on top of December’s 0.15% increase. Consumer focused areas underperformed, as did traditionally economically sensitive one. Those parts of the market offering high future growth potential also lagged. These factors combined drove a poor performance from UK small and mid cap equities.

According to the Office for Budget Responsibility (OBR), UK consumer price inflation is set to peak at close to 9% this year. The OBR published its new forecast for the Consumer Prices Index (CPI) alongside the Spring Statement at the end of the quarter. It now expects CPI to hit 8.7% in Q4 2022 (previous forecasts had been to peak at 4.4% in the second quarter of 2022) before falling back in Q1 2023. Chancellor Rishi Sunak announced additional measures alongside the Spring Statement designed to support the UK consumer.

Japan

After weakness in January and February, the Japanese stock market rose in March to end the first quarter just slightly below its end 2021 level. This was despite the change in outlook for US interest rates, the outbreak of war in Europe and sharply higher energy prices.

From the start of the year, the tone for the equity market was set by the release of minutes from the US Federal Reserve meeting, and the associated change in expectations for US interest rates. This helped to accelerate a change in market dynamics. In Japan, this was especially evident in the outperformance of value-style stocks at the expense of growth. Much of this relative gain in value stocks was concentrated in financial-related sectors including banks and insurance

Geopolitical events then dominated equity market behaviour from February onwards. Despite the geographical proximity, Russia is a relatively small trading partner for Japan, accounting for around 1% of exports and 2% of imports. The balance is skewed by the import of energy from Russia, especially LNG, while exports are predominantly in auto-related areas and most auto makers are now moving to suspend these links.

The yen weakened sharply against all major currencies in March, reaching a six-year low against the US dollar. Although expected interest rate differentials have widened this year, the scale and timing of the yen's weakness is unusual given the currency's perceived role as a safe-haven asset at times of uncertainty.

In the last week of March, the Bank of Japan conducted fixed-rate bond purchase operations for several consecutive days. This unprecedented move was the clearest possible statement of the Bank's intention to keep bond yields within the current target range of +/- 25bps.

Asia (ex Japan)

Asia ex. Japan equities experienced sharp declines in the first quarter of 2022 amid a volatile and challenging market environment as Russia launched an invasion of neighbouring Ukraine.

Share prices in China were sharply lower in the quarter while shares in Hong Kong and Taiwan also fell. The number of Covid-19 cases in Hong Kong and China spiked to their highest level in more than two years during the quarter despite the Chinese government pursuing one of the world's strictest virus elimination policies. The city of Shanghai, China's financial capital with a population of 25 million people, went into a partial lockdown at the end of the quarter in a bid to curb a surge in Omicron Covid-19 cases, prompting fears that other parts of the country could also go into lockdown.

Share prices in South Korea were also sharply lower in the first three months of 2022 as the Covid-19 pandemic continues to affect economic activity in many parts of the Asia-Pacific region. However, despite the index falling sharply, there were pockets of growth such as Indonesia, which achieved solid gains in share prices during the quarter. Thailand, Malaysia and the Philippines also moved higher, although gains were more muted.

Emerging markets

Emerging market (EM) equities were firmly down in Q1 as geopolitical tensions took centre stage following Russia's launch of a full-scale invasion of Ukraine. The US and its Western allies responded with a raft of sanctions. Commodity prices moved higher in response to the war, raising concerns over the impact on inflation, policy tightening and the outlook for growth.

Egypt, a major wheat importer, was the weakest market in the MSCI EM index, due in part to a 14% currency devaluation relative to the US dollar. China lagged by a wide margin as daily new cases of Covid-19 spiked, and lockdowns were imposed in several cities, including Shanghai. Regulatory concerns relating to US-listed Chinese stocks also contributed to market volatility. Poland, Hungary and South Korea also underperformed.

Conversely, the Latin American markets all generated strong gains, led higher by Brazil. Other EM net commodity exporters posted sizeable gains, including Kuwait, Qatar, the UAE, Saudi Arabia and

South Africa. Russia was removed from the MSCI Emerging Markets Index on 9 March, at a price that is effectively zero.

Global bonds

Financial markets were volatile over the quarter. Headlines were dominated by the horrific war in Ukraine and the terrible humanitarian crisis continuing to unfold. There was a short-lived rotation toward safe haven assets as the war began, but investors appeared to focus overall on inflationary pressure that is high and still rising.

Government bond yields rose sharply (bond prices and yields move in opposite directions). Central banks were surprisingly hawkish and markets priced in a faster pace of monetary normalisation. The extent of yield moves differed across markets. The US Treasury market is in the midst of one of its worst sell-offs on record, but moves were less pronounced in core Europe and the UK.

The Fed's rhetoric turned more hawkish and "lift-off" came as expected in March, with the Fed implementing a 25 basis point rate hike. Investors expect several more, at a swift pace, in 2022. The US 10-year Treasury yield increased from 1.51% to 2.35%, with the 2-year yield rising from 0.73% to 2.33%.

The UK 10-year yield rose from 0.97% to 1.61%, the 2-year from 0.68% to 1.36%. The Bank of England (BoE) raised rates a second time in February, in spite of concerns about the UK outlook and particularly cost of living pressures on households.

The European Central Bank (ECB) unexpectedly pivoted to a more hawkish stance in February. Comments from President Lagarde indicated rate rises were no longer ruled out for 2022 and the ECB confirmed a faster reduction in asset purchases.

The German 10-year yield increased from -0.18% to 0.55% and the 2-year yield from -0.64% to -0.07%. Concerns over potential tightening and monetary normalisation impacted Italian yields particularly, with the 10-year rising from 1.18% to 2.04%.

Corporate bonds saw significantly negative returns and wider spreads, underperforming government bonds. High yield spreads widened more than investment grade, although they saw less negative total returns due to income. Investment grade bonds are the highest quality bonds as determined by a credit rating agency; high yield bonds are more speculative, with a credit rating below investment grade.

Emerging market (EM) bond returns were negative. Local currency bonds were slightly more resilient than hard currency. Among EM currencies, Latin America performed well, the Brazilian real notably, but Asia and central and eastern Europe fell.

Convertible bonds, as measured by the Refinitiv Global Focus Index, suffered disproportionately and shed 6.4% in US dollar terms compared to -5.2% for the MSCI World. Selective IT names within the universe of convertible bond issuers saw a strong rebound. The new issuance market remained subdued as market volatility was high and companies were unwilling to issue convertible bonds at low stock prices.

Commodities

The S&P GSCI Index achieved a strong return in the first quarter of 2022, driven by sharply higher prices for energy and wheat following Russia's invasion of Ukraine. Energy was the best performing component of the index, with strong price gains for gas oil, natural gas and heating oil amid rising global demand for energy and fears of supply curbs as a result of the Ukraine crisis.

Within the agriculture component, wheat, Kansas wheat and corn all recorded sharp price gains on fears that supplies could be hit by the conflict (Russia and Ukraine account for around 30% of global wheat exports). Within industrial metals, the price of nickel was sharply higher in the quarter. Aluminium and zinc prices were also significantly ahead in the period. With precious metals, gold and silver achieved small gains over the quarter.

The value of investments and the income from them may go down as well as up and investors may not get back the amounts originally invested.

Overview

Total returns (net) % - to end Q1 2022

Equities	3 months			12 months		
	USD	EUR	GBP	USD	EUR	GBP
MSCI World	-5.2	-3.1	-2.4	10.1	16.3	15.4
MSCI World Value	-0.7	1.5	2.2	10.6	16.8	15.9
MSCI World Growth	-9.6	-7.7	-7.1	9.2	15.4	14.5
MSCI World Smaller Companies	-6.5	-4.4	-3.8	-1.1	4.5	3.6
MSCI Emerging Markets	-7.0	-4.9	-4.3	-11.4	-6.4	-7.1
MSCI AC Asia ex Japan	-8.0	-6.0	-5.4	-14.6	-9.8	-10.6
S&P500	-4.6	-2.5	-1.9	15.7	22.2	21.2
MSCI EMU	-11.1	-9.2	-8.6	-3.6	1.8	1.0
FTSE Europe ex UK	-9.7	-7.7	-7.1	1.7	7.4	6.5
FTSE All-Share	-2.3	-0.2	0.5	7.9	13.9	13.0
TOPIX*	-6.2	-4.2	-3.5	-7.2	-1.9	-2.7

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Government bonds	3 months			12 months		
	USD	EUR	GBP	USD	EUR	GBP
JPM GBI US All Mats	-5.2	-3.1	-2.5	-3.2	2.3	1.4
JPM GBI UK All Mats	-10.0	-8.0	-7.4	-9.6	-4.6	-5.3
JPM GBI Japan All Mats**	-6.7	-4.6	-4.0	-10.2	-5.1	-5.9
JPM GBI Germany All Traded	-7.0	-4.9	-4.3	-10.2	-5.2	-5.9
Corporate bonds	USD	EUR	GBP	USD	EUR	GBP
BofA ML Global Broad Market Corporate	-7.5	-5.5	-4.9	-6.2	-0.9	-1.7
BofA ML US Corporate Master	-7.7	-5.7	-5.1	-4.3	1.1	0.3
BofA ML EMU Corporate ex T1 (5-10Y)	-9.0	-7.0	-6.4	-12.3	-7.4	-8.2
BofA ML £ Non-Gilts	-8.8	-6.8	-6.2	-9.4	-4.3	-5.1
Non-investment grade bonds	USD	EUR	GBP	USD	EUR	GBP
BofA ML Global High Yield	-6.0	-3.9	-3.3	-4.7	0.7	-0.1
BofA ML Euro High Yield	-2.2	0.0	0.6	-4.9	0.5	-0.3

Source: Thomson Reuters DataStream.

Local currency returns in Q1 2022: *-1.2%, **-1.7%.

Past performance is not a guide to future performance and may not be repeated.

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