State of Play

What's next for markets?

16 June 2022

History shows us that market panic can trigger strong human emotions often leading some investors to make poor decisions especially when investments are so volatile. Currently, with bond yields rising and shares falling in value[1] overwhelmed by a continuous flow of bad news, many investors might be asking – what next? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Annus Horribilis

In previous updates I have tried to tell some of the story of 2022, which based on the year thus far could best be described using a quote from Her Majesty the Queen's speech from 24 November 1992 as her 'Annus Horribilis'.[2] Whilst we are only half through 2022, it is fair to say that for almost all investors, so far it has been a bumpy ride. The most commonly asked question I get at the moment is whether it is going to get worse before it gets better and if so, when. So, I want to explore some of the driving factors that could influence markets to either become more pessimistic or investors to start believing that we are either at, or near the bottom, and seeing the turmoil as an investment opportunity. To do this, let's start by reflecting on how different investments have performed over the last six months and why.

Shares

Ever since the start of the year, the dominant driver affecting share prices has been rising inflation. As I have explained before, when prices rise sharply investors reassess the path for interest rates and then revaluate share prices based on expected changes to future revenue and profits because higher interest rates mean more expensive borrowing and slower economic demand. Central banks have a mandate with their respective policymakers to maintain stable prices to allow a smoother economic cycle of gradual growth and prosperity. These targets vary, but in the main, the acknowledged ideal inflation target is approximately 2%.

Inflation has reached a multi-decade high in almost all developed markets reaching 9% (based on the Consumer Price Index for April) in the UK according to the Office for National Statistics.[3] Not surprisingly, the Bank of England have raised rates at each of the last five Monetary Policy Committee (MPC) meetings[4] following the latest rate rise today, with further rises expected at the remaining meetings scheduled for this year. The US Federal Reserve has been even more aggressive in signposting the need for rate rises promising to tackle inflation no matter what, demonstrating their intent earlier this week with a rise of 0.75%, the largest increase since 1994.[5]

Why does this trigger falls in share prices? The price of any company share is broadly based on the dynamic of supply and demand. Investors, whether they be individuals, investment professionals or speculators, attempt to calculate the value of a company based on some important factors. This might be, market share, cash-flow, dividends paid, track record of the management or how much debt they owe when compared to their assets. It is complex and at times, to most individual investors, very difficult to assess accurately. All are trying to work out whether the current share price is considered cheap or expensive based on the available data and information. Most company share price values reflect not just the earnings and assets, but also future expected earnings and profits. This is expressed as a multiple of current earnings compared to the share price, described as the 'price to earnings ratio'. Typically, using this measure it is possible to look back over history and gauge how expensive a particular market, sector or company (like technology, industrials or healthcare) is.

Any changes in the prospects for a sector or a specific company force an investor to make a choice, either to stick with holding the shares in the expectations the price will rise, consider selling them if they think the outlook has deteriorated or buy more if these prospects have improved. This changes the number of buyers and sellers for a specific company. If there are more buyers than sellers, the price rises to reflect the size of this difference as investors have to pay a higher price to secure their purchase. If on the other hand, there are more sellers than buyers, those investors holding the shares are unable to find a buyer and are forced to discount the price to attract a buyer. In practice, due to modern technology this dynamic happens in a split second moving the price of a share one way or another. This year has mostly seen the latter, as share prices have fallen sharply reflecting the changing economic outlook and prospects for the constituent companies within the respective stock market.[1]

In terms of which stock markets have been hurt the most, the NASDAQ 100 which consists of more technology companies is down over 27% year-to-date whilst the broader US market index S&P 500 has fallen less at just shy of 22%.[1] This is in stark contrast to the largest companies in the UK market represented by the FTSE 100, which is almost flat when compared to the start of the year.[1] The UK's largest companies have benefited from a weak pound sterling which has fallen against an international basket of currencies based on a deteriorating economic outlook and a higher proportion of companies in the energy and commodity sectors, like mining.[1]

Bonds

In my update on 26 May I explained the story behind why bonds have performed so well for so long. Over more than 40 years, yields fell to almost zero thus helping investors to benefit from the rise in value of their fixed income investments.[1] Over the last 18 months yields have begun to rise in response to a change in expectations for future interest rates.[1] This has led to yields on all types of bonds, but especially government bonds to rise sharply.[1] When investors try to 'price-in' higher interest rates, in simple terms, they are trying to predict how high rates will go and importantly, how quickly. Often, 10 year government bonds provide a 'proxy' for what interest rates might be in 12 or 18 months' time.

This sharp rise in yields and respective fall in the value of bonds has coincided at the same time as the sell-off in shares as bonds have been unable to provide the diversification benefits normally expected in a portfolio over the longer-term. In terms of performance the UK bond market has been hit the hardest. From July 2020, when 10-year UK Government bond yields hit a record low of 0.1%, they have risen to 2.5% as at the time of writing.[1] The consequence is the value of the Bank of America (BofA ICE) UK All Gilt Index has fallen just shy of 16% year-to-date with the UK (BofA ICE) All Corporate Bond Index down just over 15% in value.[1] US high yield and US corporate bonds have fared better with falls of just under 5% and 7% respectively.[1]

Factors influencing the short-term outlook

The last few days have seen further falls in most major stock markets as US inflation data surprised markets by being higher than expected leading to fears that the cooling of inflation may take longer than hoped. Also, the UK economy shrank in April, again worse than forecast, with a drop of 0.3%.[1] The ongoing war in Ukraine continues to place pressures on the energy market, fuel prices and food supplies.[3] Whilst it is impossible to predict accurately how this will conclude and when, it appears hostilities will continue for some time making the task of tackling rising prices more challenging.

Central banks clearly play a significant role, both in terms of decision making and in the timing and communication of those decisions. Signposting to investors what to expect and why has become part and parcel of their role. The desired 'soft landing' where they increase interest rates just enough to cool demand without tipping economies into recession seems to become shorter and narrower with each passing day. My own observations are that I am not sure it is possible to 'land' softly given the challenges they face. Whilst supply side problems have started to resolve themselves it is a very slow process and may take some time to filter into prices and the data measures which guide monetary policy.

The other key influencing factors over the next few months will likely be driven by the ability of the market to accurately predict the path of future interest rates. If central banks stick to their promises and prioritise the task of reducing inflation back to their target, regardless of the economic consequences, interest rates will continue to rise pushing up bond yields with them. This has another knock-on effect for investors in shares. If low risk bond investments become even cheaper and over time offer much better income returns, then the compensation for taking more risk in shares should reflect in the return expectations for investors. However, if higher borrowing costs, lower economic and consumer demand lead to lower revenues and profits, share investors can expect lower returns than they have become used to since the financial crisis. This process of repricing risk assets has prompted the tough time experienced by investors in 2022.

The return to normalised interest rates and the unwinding of monetary policy was always destined to have wide financial ramifications, but the speed at which this transition would take and when it would start has always been hotly debated. In many respects, the global pandemic has triggered many changes in our lives, whether this be government policy, central bank decision making or even the way we work, rest and play. It appears to have also moved central banks to arguably throw too much money and support at an economic threat posed by the virus forcing too much money to chase a restricted supply of goods.

What happens next is unclear. Uncertainty is likely to remain until the path of both interest rates and the inevitable economic slowdown start to emerge. If markets have priced in too many rate rises and central banks manage to achieve an, albeit unlikely, soft landing, then bond yields should start to flatten and importantly the fall in share prices may start to reverse. The point at which this change happens is impossible to predict, but when it eventually happens, unless you possess a crystal ball, the only way to benefit from this recovery is to be invested. For new investors, the recent corrections may represent a buying opportunity assuming investing is right for their individual circumstances.

Clearly the turmoil this year has provided a vivid reminder of the concept of risk and return. It also challenges the conviction to stick to the long-term financial plan put in place to achieve certain goals. Having the courage to remain invested has arguably never been harder given the 24-hour news, social media and the continual bad news flow we have witnessed this year. If any investors have concerns about the suitability of their financial plan, then I would suggest seeking professional financial advice to support and guide you. Football is often described as a game of two halves. I hope 2022 proves to be exactly that and the second half provides the recovery I am sure all investors crave.

Learn more!

Investing can feel complex and overwhelming, but our educational insights can help you cut through the noise. Learn more about the Principles of Investing here.

Note: Data as at 15 June 2022.

[1] Investing.com, 15 June 2022
[2] The Royal Household, 24 November 1992
[3] Office for National Statistics, 12 May 2022
[4] Bank of England, 16 June 2022
[5] The Times, 15 June 2022