CAMBRIDGE
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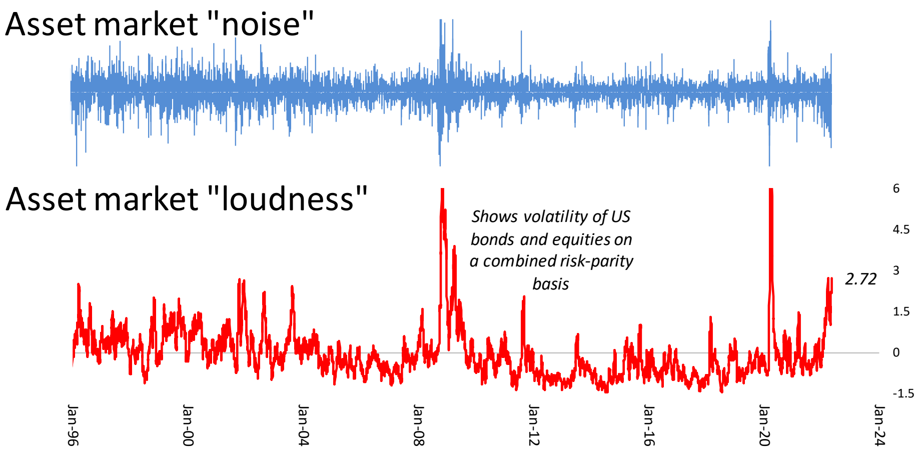
Market noise is almost deafening

The last week of April was like being on a roller coaster. We had rather hoped that the ride was almost over, but in fact it's only been getting wilder.

For the past five weeks, the asset markets have been displaying greater volatility. These charts are a way of demonstrating the phenomena we term asset market "noise and loudness." We have taken the daily changes of the US equity and bond market indices (the S&P 500 and the Bloomberg Barclays US Aggregate index which includes corporate bonds), and then sought to standardize each. This puts both markets on an equal risk basis. We have then looked at the combination to get an idea of the total market volatility. The daily changes observed are shown in blue and look very similar to a sound wave.



Source: Tatton IM, Bloomberg

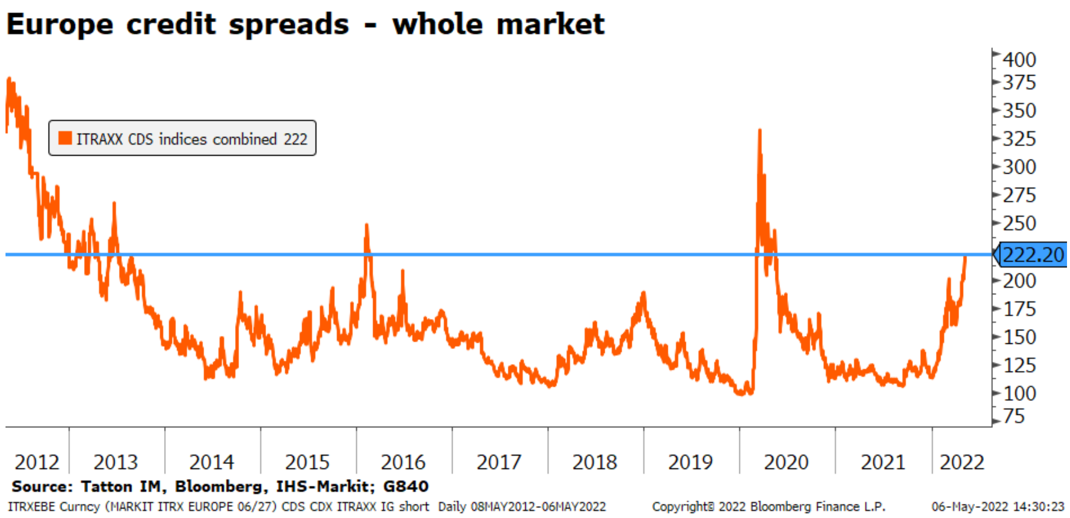
The red line shows how the "noise level" has risen – and the markets have only been getting louder. Currently, they are the loudest they've been in 25 years, with the exceptions of the global financial crisis of 2008 and the recent COVID-19 pandemic.

We have written about the concerted raising of interest rates on both sides of the Atlantic this week in the article below. These rate rises in the US and UK were expected (mostly), and yet both markets last Thursday were back on their rollercoaster ride. Equities managed a sharp rally and then gave up those gains, but they did manage to hold support levels within recent trading ranges. The S&P 500 was just below the 4100 level on Friday, as it was on Monday.

At the heart of broad asset market volatility is the fall in the bond markets. Usually, if equities are facing a risk-off period, bond yields tend to dip, meaning their prices head higher. However, the rise in inflation has up-ended usual equity-bond relationship. This time the rise in yields is driving equity markets lower. Central Banks are seeking to prevent asset markets from destabilising the real economy. To that end, they are trying to adjust domestic demand in line with reduced output levels from China and Russia, and have little idea of when those constraints will ease The Ukraine war, in particular, shows no signs of ending anytime soon.

As the Governor of the Bank of England Andrew Bailey said last Thursday, labour markets continue to remain tight in the UK and US (although for different reasons.) This is only adding to supply-side problems. For both the US and UK, the uncomfortable truth is that consumer confidence has to be influenced to persuade households to stop spending as much. History and precedent suggests that also we need companies to cut their costs. The Bank of England doesn't anticipate that happening before energy price rises due in October this year– their forecast is for UK household energy bills to rise another 40% at that point.

Ultimately, it is businesses that are being squeezed by the policy actions. They are more interest-rate sensitive than households. That squeeze is coming from policy rates rising which causes government bond yields to rise, and also from credit spreads rising. The Bank of England forecast for UK GDP to contract by 0.25% in 2023 implies a sharp rise in corporate distress and default.



In January, credit spreads were widening as companies sought to get hold of cheap funding. Investors were inundated with deals. We commented at the time that widening spreads were a relatively healthy signal. This time around spreads are widening without a single deal being done in the high yield markets. At current yields, companies think rates are too high and investors think they're too low for the risk.

At some point that will reverse. Investors have been very wary of both equities and corporate bonds for weeks now. Cash balances are building up and risk premia have risen rapidly. Right now, with volatility high in all markets, there is a deep incentive to remain on the sidelines, but institutional investors can't stay there forever. It would be better if markets stabilised and began a steady climb back up, but we could get sharp bear-squeezes as well.

There are few obvious catalysts for markets to rally, but we may get some help when Asia returns after the week of the spring holidays. China is in policy reversal mode and, although it has unfortunately recommitted to COVID zero-tolerance, Beijing is reopening tentatively.

Returning to the Bank of England, it has had communication difficulties for years now. Even though Thursday's messages were tough, they should be congratulated for their honesty and clarity.

April 2022: Monthly market returns review

April 2022 was not a strong month for global equities, which declined 3.5% for UK sterling investors as inflation pressures, rising yields and further discussions around interest rate hikes impacted returns.

In regional terms, the US equity market dropped 4.3%. Declines were even more apparent for the US technology sector, down 9%, as further potential rises in interest rates put pressure on valuations. After several months of predicting action, the Federal Reserve (Fed) is now delivering on its policy shift to tackle inflation. Analysts predict 0.5% rate increases from each of the Fed's next three meetings. A hawkish policy that Fed Chair Jerome Powell hinted was realistic and caused a reaction on bond markets; US 10-year yields rose by 0.56% in April, with global government bond yields rising also. Credit spreads also widened over the course of the month.

Emerging Market equities dropped 1% over the month. China's zero-COVID approach along with strict lockdown measures caused a slowdown in the economy, which was reflected in performance. Rising US yields continue to support the US dollar, which has risen by 7.3% this year- strengthening relative to the Yen by 11.1.% putting pressure on the Bank of Japan to change policy, which will increase if Japanese Bond yields move higher. Japanese equities also remained in negative territory, ending the month 4.4% down.

In Europe, with no sign of any resolution to the war in Ukraine, equity markets are still cautious, ending the month down 1.8%. The impact on energy markets remains acute as Europe grapples with Russian energy dependence and, despite a slight taper, European gas prices are up by 42% this year.

The UK, on the other hand, was the only major developed market that achieved positive returns in April, rising 0.8%. UK companies benefited from the commodity rally and banking sector movements on the back of the rising interest rates expectations. However, this highlights the disconnect between the UK economy and UK large cap stocks, consumer confidence in the UK and the eurozone has declined to levels consistent with a recession.

Emmanuel Macron's re-election as French President, by defeating his far-right opponent, had little material effect on markets, since it was widely predicted by polls, despite a narrowing margin of victory.

Risks to the recovery are increasing, in particular within Europe. Central bankers face substantial challenges as they look to tighten policy, to help bring inflation back down to target, without tipping their economies into recession.

Asset Class	Index	April	3 Months	12 months	2021	5-yr rolling annualised
Equities	FTSE 100 (UK)	0.8	2.5	12.3	18.4	4.9
	FTSE4Good 50 (UK Ethical Index)	0.7	2.1	9.3	13.0	2.1
	MSCI Europe ex-UK	-1.8	-4.0	-0.7	16.7	5.8
	S&P 500 (USA)	-4.3	-1.9	10.5	29.9	14.3
	NASDAQ (US Technology)	-9.0	-7.3	-1.9	23.3	16.4
	Nikkei 225 (Japan)	-4.4	-4.1	-4.5	2.6	7.1
	MSCI All Countries World	-3.5	-2.2	4.3	19.6	9.5
	MSCI Emerging Markets	-1.0	-4.3	-9.9	-1.6	4.3
Bonds	FTSE Gilts All Stocks	-2.8	-6.2	-8.3	-5.2	-0.1
	£-Sterling Corporate Bond Index	-3.1	-6.6	-9.2	-3.2	1.1
	Barclays Global Aggregate Bond Index	-0.9	-3.2	-3.7	-3.8	0.9
Commodities	Goldman Sachs Commodity Index	10.2	34.0	76.2	41.6	11.6
	Brent Crude Oil Price	7.3	28.3	77.0	51.5	15.5
	LBMA Spot Gold Price	4.4	14.3	19.4	-2.9	8.6
Inflation	UK Consumer Price Index (annual rate)	1.9	1.9	6.3	5.4	-
Cash rates	Libor 3 month GBP	0.0	0.1	0.1	0.0	0.5
Property	UK Commercial Property (IA Sector)*	2.0	2.1	10.1	7.4	2.9

Source: Morningstar Direct as at 30/04/22. * to end of previous month (31/03/22). All returns in GBP.

The outlook for oil

Global energy markets have seen quite the shakeup in recent years. After oil prices collapsed at the start of the pandemic, tighter supply and returning demand buoyed fuel prices for most of the last two years. Russia's invasion of Ukraine have given prices an extra spark this year, as commodity traders scrambled to adjust to the biggest energy disruption seen in a generation. Last week we saw yet another historic moment in global energy markets: The European Commission vowed to wean the continent off Russian oil imports entirely.

Last Wednesday, Commission president Ursula von der Leyen announced that almost all supplies of crude or refined Russian oil will be banned. Crude oil imports will be phased out within six months, while the use of refined products will cease by the end of the year. There are significant hurdles to the ban; Hungary vowed to reject the proposal unless it receives special allowances, while other Eastern European countries as reliant on Russian energy have their doubts too. But even with potential compromises, the ban will be the biggest change to global energy markets in living memory.

Oil prices have jumped in response. The international benchmark Brent crude rose 3.8% to around $109 per barrel on Wednesday. The US oil benchmark WTI rallied 5.3% to reach nearly the same level. US shale producers stand much to gain from the ban, as buyers of Russian oil switch suppliers. This narrowed the spread between the two indices. Brent prices increased again on Thursday, reaching around $112pb.

Taking a step back, those price rises are astonishingly small, considering the severity and extent of the EU's ban on oil. In historic terms, $112pb is a high price, but bear in mind it is not even the highest closing price seen in the last three weeks. Crude prices have floated in the $100-115pb range since the start of April. Shortly after the war began, intraday prices touched $130pb in March. "It's a very small move on a momentous decision," according to SEB's chief commodity analyst Bjarne Shieldrop.

Muted market reaction is partly a result of 'buy the rumour, sell the fact' behaviour. But at a deeper level, investors may also be concerned that demand is so weak that supply constraints have less of an impact. The global economy has slowed considerably this year, and the cost-of-living crisis is set to depress demand further in developed nations.

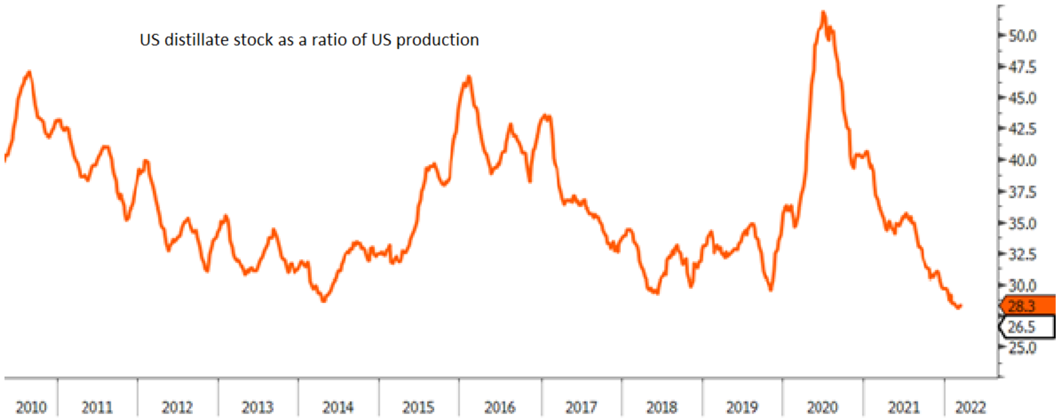
One of the biggest concerns, though, is the outlook for China's economy. The world's second largest economy is in a weak position, battling another covid outbreak and an ailing property market. Returning lockdowns pushed oil consumption down by over a million barrels per day in April, according to Standard Chartered. Some analysts predict that the total loss of demand could end up being between 3-4mn bpd – equalling the supply loss from Russian sanctions. We all know of course, once the lockdowns are over (and they are likely to be once the population is sufficiently inoculated), demand is certain to rebound sharply.

Analysts at Citigroup do expect shrinking Russian oil production to be more than offset by a confluence of factors: slowing demand from China, a drawdown of crude oil reserves and increased supply from other sources – such as Iran or non-OPEC+ members. Producers outside of Russia will see increased demand – and hence well-supported prices – yet overall prices have little room to climb higher. This is in line with Citi's forecast from a month ago, which did suggest a peak in crude prices, despite the EU's new ban.

These concerns weigh heavily against many of the predictions of a new commodity 'supercycle' which other commodity watchers have been predicting for some time. In the first quarter of 2022, hard and soft commodities linked to production in Russia saw massive gains – accounting for perhaps the majority of commodity price rises – and sparked by fears of structural change. With prices soaring around the world, some investors saw commodities as providing a well-argued inflation hedge. This worked quite well in the first quarter this year, but since has yielded more mixed results, also depending on the commodity sub-categories.

Diving deeper into the energy sector, there is an interesting trend going on in refined oil markets. Since the start of the Ukraine war, the price of refined diesel has increased faster than the underlying crude price. The diesel premium over crude has shot up in recent months – a fact made all the more astonishing when you consider the rally in crude itself. This is underpinned by a historic drop in diesel inventories. As the chart below shows, US diesel reserves slumped to their lowest level in over a decade recently.

US distillate stock ratio



Source: Tatton IM, Bloomberg, EIA: G842

Not only does Russia have a huge supply of oil, but its refineries are a vital part of global energy markets. Particularly so for Europe, which buys the vast majority of Russia's refined oil exports. Due to the impact of sanctions, Europe has had to secure its diesel from other sources – driving down US supplies.

This is not just a short-term problem. Individual refineries have limited capacity, and expanding production takes time and extensive investment. Taking Russian supply out of the market therefore has impacts at multiple stages, first at the source, then also downstream. Even if there is enough crude supply to meet global demand, it is an additional concern that the capacity available to process it might not be enough to meet final demand.

This a pivotal moment for commodities and inflation in general. Supply constraints upstream are one thing, but secondary effects can also bite further down the supply chain. The slowdown in China is a prime example of how this can affect the global economy: at the moment, lockdowns are weighing down on prices, and reducing demand for commodities. But this will also have the added effect of slowing Chinese manufacturing production, which will reduce the supply of finished goods in the months to come. This raises the prospect of repeat of the supply chain problems the global economy has been facing since the onset of the pandemic in 2020, with the only limiting factor being that supply chain constraints are currently not global anymore – most countries have sought to move on to an approach which views Covid as an endemic problem.

So far, the global inflation surge we've seen has been down to higher input prices. But even as that fades, prices of consumer goods can still spike from its after-effects. This is perhaps why central banks see high inflation as continuing for the rest of the year. A peak in commodity prices is a good sign, but it is a long way from sounding the all-clear.

A central bank mistake?

Central banks created financial headlines around the world last week with a succession of interest rate changes. The US Federal Reserve, which is generally viewed as the most important for the global economy, raised its benchmark Fed Funds Target Rate, which is now targeted to be in a range of 0.75-1%. Though markets expected as much from the Fed's latest meeting, the 0.5% rate hike does represent a significant milestone: it was the largest single increase in 22 years, and Fed Chair Jay Powell dropped heavy hints to strongly suggest that equivalent hikes will come at its next two meetings.

Of the world's major central banks, a total of nine institutions raised rates last week. Hong Kong generally tracks the US, so its hike was expected. The biggest policy shock of the week came from India, however. The Reserve Bank of India held a surprise meeting and announced a 0.4% interest rate rise on Wednesday, highlighting the need to tame prices as global inflation surges. Unlike many emerging markets, India avoided raising rates last year, with the RBI focused on aiding growth instead. But the significant supply disruption, caused by Russia's invasion of Ukraine, has forced its hand. The move shook the country's capital markets, sending stock prices and bond yields down.

Australia also provided a surprise by raising rates by 0.25% to 0.35%. It had been expected its Central Bank would wait, given the issues facing its major trading partner China.

Virtually all the world's major central banks are in tightening mode, as last week's policy announcements show (China is the exception). But the details of each move reflect different approaches to the global price shock. In a 'normal' environment, monetary policy curtails inflation by cooling an overheating economy. The problem is that the current inflation spike – the most severe in over four decades – is not the result of overheating, but a series of external supply shocks. This leaves policymakers with a difficult choice: destroy demand and ultimately bruise living standards – or maintain it and lose control of prices.

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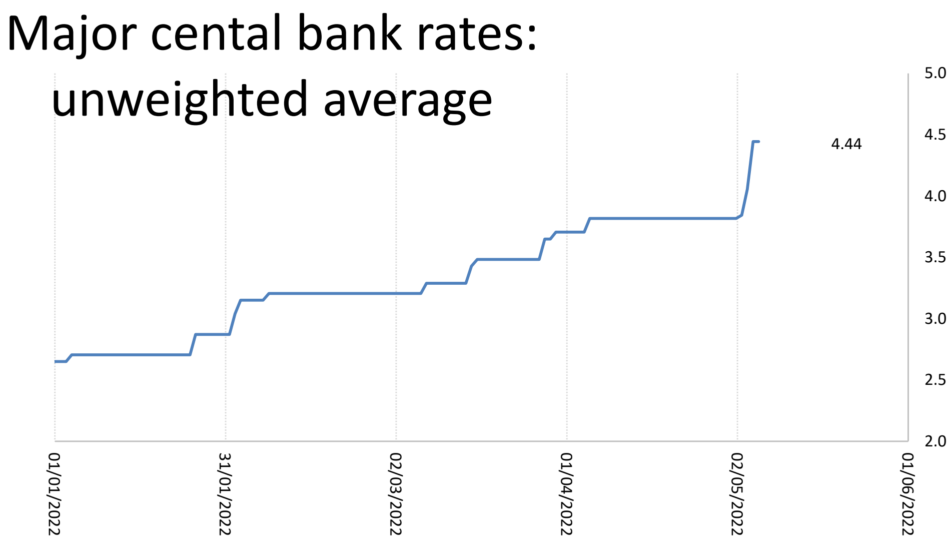

Source: Tatton IM, Blooomberg...

That brings into focus the Bank of England's decision last Thursday (May 5th 2022) to raise the policy (base) rate by 0.25% to 1%. The move was in line with expectations, the vote by the bank's Monetary Policy Committee (MPC) revealing. Three out of the nine MPC members dissented on the decision, instead calling for a 0.5% hike and a more aggressive approach to inflation. The MPC now expects inflation to hit 10% by the end of the year. Yet what seems like a firmly hawkish signal from the BoE was tempered substantially by its accompanying messaging.

This is the tension underlying recent discussion of Fed policy. Commentators have increasingly talked about a potential "policy mistake" this year – where a central bank raises rates significantly above the so-called neutral level, constraining demand and thereby causing a recession. The Fed's aggressive stance, coupled with a severe cost-of-living crisis, makes this a key concern.

However, last Wednesday's press release was considered a somewhat dovish sign. The 0.5% hike may be the largest in two decades, but investors were starting to suspect that even bigger hikes may be in store. Before the meeting, traders were increasingly betting that the Fed would raise rates by 0.75% later this year. But Jay Powell effectively ruled this out at his press conference, reiterating that he expected half-point hikes at each of the next two meetings.

Investors took the news well on the day. US stocks jumped nearly 3%, while bond yields dropped. It was seen as a sigh of relief from markets. Fears of a policy mistake were high after discussions of the neutral interest rate – what it ultimately is and whether the Fed will have to go further and faster to tame inflation.

Some economists such as Ken Rogoff, the ex-chief economist of the World Bank see the peak of short rates being much higher than now; he puts it as high as 5%. Fed officials still think the neutral rate is 2.5-3% as external global factors will slow inflation. The Fed's Powell restated his belief that reaching that neutral rate will be enough, though admitted it was "certainly" possible the Fed might have to go higher.

This position is understandable. Inflation becomes endemic when wages spiral higher with prices – but there is relatively little sign of that happening in the US. An overzealous approach to an external supply-side problem could damage consumers unnecessarily. But on the flipside, allowing inflation to run hotter for longer is precisely what can cause that spiral: if high inflation *expectations* become embedded, consumers will change their behaviour to add further inflation pressures. This is why many argue that neutral is not enough. According to former Fed official Seth Carpenter, now at Morgan Stanley: "The reality is that they will have to go past neutral in order to slow the economy,"

This is also the thinking at the BoE, made clear in comments made by both Andrew Bailey and Ben Broadbent. The bank's MPC made some dire warnings about the UK economy. Inflation is expected to hit 10% by the end of 2022, but GDP will contract the following year. In real (inflation-adjusted) terms, this means a potentially sharp contraction of the economy over the next 18 months. Despite that fall, three MPC members voted for a higher-than-expected rate rise, citing the potential for inflation expectations to become ingrained as a key concern.

In its effort to stabilise prices, the central bank has to finely balance the incentives to save or spend. Britons are feeling the tightest real income squeeze in a generation, which should in theory lessen spending. But if consumers feel their money will be worth less in a year's time, they have a greater incentive to frontload their spending, and a smaller incentive to save. The BoE are well aware that tighter policy might cause or exacerbate a recession – but it sees this as the only way to achieve price stability.

This debate calls into question what we really mean by a "policy mistake". The Fed has a mandate to fight inflation and bolster employment. The bank constrains employment to curtail inflation, but could end up undershooting its target on both counts. Even if Powell's team cause a recession and increase unemployment, inflation could remain at or above the 2% target.

The inescapable problem is the world economy does not have enough supply to meet current living standards (of course, the distribution of capital could change to benefit the worse off, but that is a political argument rather than an economic one). The pandemic and the war in Ukraine have slashed the world's current productive capacity, meaning that even in a low growth environment, demand outstrips supply. In this case, engineering a recession may be seen as necessary. For the central banks, it won't be their mistake.

Global Equity Markets

Market	Fri 15:50	% 1 Week*	1 W	Technical Short	Technical Medium
FTSE 100	7380	-1.7	-129	→	⬀
FTSE 250	19737	-4.3	-883	↘	↘
FTSE AS	4077	-2.1	-88	→	→
FTSE Small	6662	-2.4	-160	⬂	⬂
CAC	6239	-4.5	-295	↘	⬂
DAX	13638	-3.3	-460	↘	↘
Dow	32910	-0.2	-67	↘	⬂
S&P 500	4102	-0.7	-30	↘	⬂
Nasdaq	12283	-0.4	-52	↘	↘
Nikkei	27004	+1.6	+413	→	→
MSCI World	2784	-0.4	-11	↘	↘
CSI 300	3909	+3.3	+125	↘	↘
MSCI EM	1059	-1.6	-17	↘	↘

Top 5 Gainers

Company	%
Johnson Matthey	+23.1
BP	+9.9
Mondi	+8.8
Flutter Ents	+5.6
AVEVA	+4.9

Top 5 Decliners

Company	%
Segro	-18.8
Just Eat Takeaway.com N	-17.2
Hikma Pharma	-15.5
Ocado	-12.5
Croda Int'l	-10.7

Currencies

Pair	last	%1W
USD/GBP	1.235	-1.8
GBP/EUR	0.857	-2.1
USD/EUR	1.06	+0.4
JPY/USD	130.41	-0.5
CNY/USD	6.67	-0.9
Bitcoin/$	36,136	-5.7

Commodities

Cmdty	last	%1W
Oil	112.87	+3.2
Gold	1886.2	-0.6
Silver	22.50	-1.2
Copper	425.0	-3.3
Aluminium	2916.0	-5.7
Soft Cmdties	228.0	-1.6

Global Equity Market - Valuations

Market	Div YLD %	LTM PE	NTM PE	10Y AVG
FTSE 100	3.9	12.4	10.4	14.3
FTSE 250	3.2	11.3	13.5	16.3
FTSE AS	3.7	10.9	10.7	14.5
FTSE Small x Inv_Tsts	2.9	1.3	9.7	15.3
CAC	2.7	13.5	11.4	15.2
DAX	3.1	12.7	11.5	13.7
Dow	2.0	16.9	17.3	16.8
S&P 500	1.5	20.0	18.0	18.1
Nasdaq	0.8	22.0	25.5	24.0
Nikkei	2.0	14.6	14.9	17.8
MSCI World	2.0	16.9	16.4	17.0
CSI 300	2.0	13.4	12.1	12.7
MSCI EM	2.7	11.0	11.6	12.7

Fixed Income

Govt bond	%Yield	1 W CH
UK 10-Yr	1.99	+0.09
UK 15-Yr	2.23	+0.12
US 10-Yr	3.09	+0.16
French 10-Yr	1.67	+0.21
German 10-Yr	1.14	+0.20
Japanese 10-Yr	0.24	+0.01

UK Mortgage Rates

Mortgage Rates	Apr	Mar
Base Rate Tracker	1.50	1.50
2-yr Fixed Rate	2.11	1.91
3-yr Fixed Rate	2.03	1.90
5-yr Fixed Rate	2.12	1.94
10-yr Fixed Rate	2.44	2.34
Standard Variable	3.99	3.95

* The *% 1 week* relates to the weekly index closing, rather than our Friday p.m. snapshot values

** LTM = last 12 months' (trailing) earnings;
***NTM = Next 12 months estimated (forward) earnings

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9th May 2022

Please note: Data used within the Personal Finance Compass is sourced from Bloomberg/FactSet and is only valid for the publication date of this document.

The value of your investments can go down as well as up and you may get back less than you originally invested.

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