June 2022 | Investment perspectives

Weathering stormy investment conditions

In the face of soaring inflation, rising interest rates and disruption to global supply chains, it's been a bumpy ride for investors so far this year. Here we give our views on some of the questions investors have about markets at the moment and explain why it's important to maintain composure and look for opportunities.

Introduction

Just as the global economic outlook was beginning to improve following the pandemic, things have taken a turn for the worse. From the Russian invasion of Ukraine to surging inflation and rising interest rates, stock markets have fallen after a stream of negative news.

Despite the gloomy economic outlook, history shows that over the long term markets more than recover. In the short term, markets move around a lot, so it's important to stay invested for the long term so that you participate in any recovery.

1. Why is the FTSE 100 Index up and my portfolio down?

The UK's FTSE 100, which comprises the largest 100 companies listed in the UK, has been one of the strongest performing indices across the world this year (figure 1). Soaring fossil fuel prices, pushed higher by Russia's invasion of Ukraine, have helped the shares of the world's biggest energy companies outperform every other sector since the start of the year. This has led to companies such as Shell and BP seeing a major jump in earnings.

The increase in wholesale energy prices has fed through to customers who have seen their energy bills rocket, increasing the revenue for utility companies and boosting their market value. Shares in defence groups have also risen following an increase in demand for equipment as a result of the war in Ukraine. Broadly speaking, only these three sectors have delivered positive returns within those top 100 companies in the UK.

Let's turn to your portfolio, which is diversified and invested across global markets and asset classes to limit your exposure to individual markets and help reduce volatility – the normal ups and downs of the market. This means that your returns will reflect the performance of a range of underlying markets and assets.

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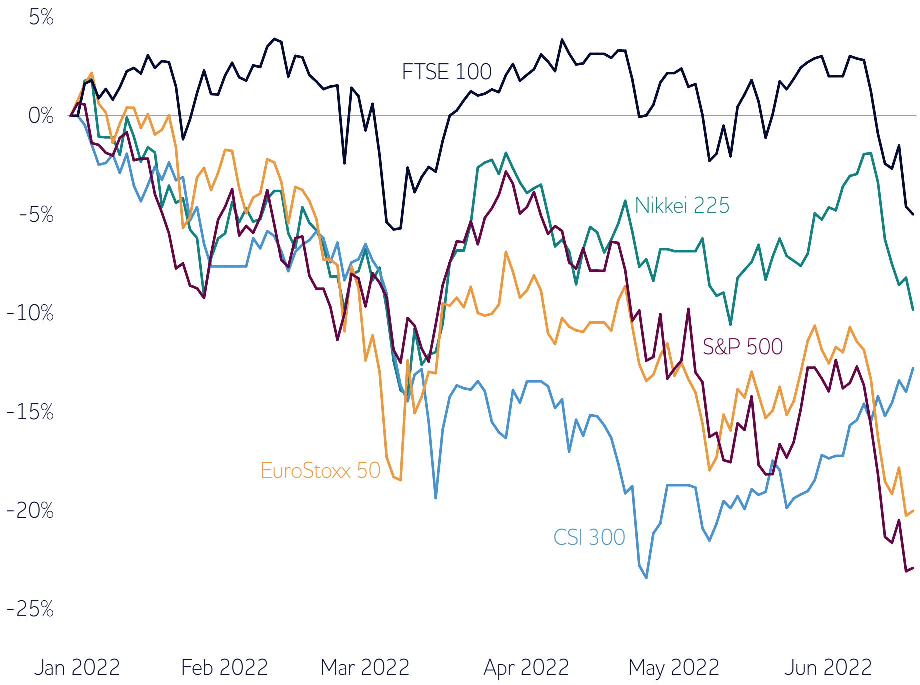
For example, in 2020, if you were an Adventurous, Balanced or Cautious client, your portfolio fell less than the FTSE 100 during the year. Perhaps more importantly, they all ended the year back in positive territory, while the FTSE 100 ended up dropping over 11% that year. Meanwhile, this year, as at the end of May, all these portfolios had fallen less than the US stock market.

This is why comparing your portfolio against a single market and looking at short-term performance is potentially unhelpful. How much your portfolio invests in the different markets or asset class is determined through the Openwork Partnership's long-term mix of asset classes for your risk profile (known as the strategic asset allocation). This strategic asset allocation takes a long-term view of how different asset classes are expected to behave and will take into account these short-term periods of negative performance.

Figure 1: How have stock markets performed in 2022 so far?

YTD performance (%)



Source: Bloomberg, shows price returns in local currency to 17 June 2022.

2. When will the market recover?

While we expect markets to recover over time, predicting how long it will take is not forecastable with any certainty. History shows us that often after bad years, you get positive years, so it's important to stay invested to make sure you don't miss out on the market turning around. For example, during the financial crisis in 2008 the S&P 500 (a proxy for the US stock market) dropped 37%, but the following year it was up 26%. Three years later the index had grown 48% and five years later it was up 126%.

Investment markets don't just rise continuously, and it is normal to expect periods where markets fall. Indeed, nobody knows exactly how markets will perform over the coming days, weeks or months. But one thing history has shown us is that there are likely to be more positive years than negative years. For example, since 2000, annual returns for the FTSE All Share Index (which comprises all the listed companies in the UK) have been positive in 13 years.

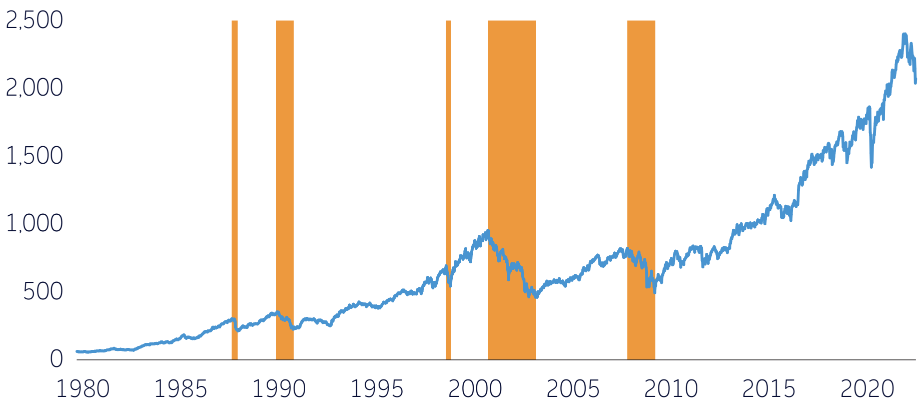
You may have read about the concepts of bear and bull markets. Bear markets are considered to have occurred when stock markets dip at least 20% or more from their recent highs over a period of at least two months. There have been five bear markets since 1980 (figure 2). The most recent one was between October 2007 and March 2009 during the financial crisis when the market saw a drop of 52%.

The good news is that in the long run, bear markets are almost invisible, as seen in the chart below (figure 2). While these can be extremely nerve-racking for investors at that moment in time, markets tend to recover and increase to higher levels. Keep in mind that every bear market has been followed by a bull market (when the price of a market rises at least 20%), so it's important to stay invested so you don't miss out on the market recoveries that follow bear markets.

Figure 2: Bear markets since 1980

Since 1980 there have been:

Declines of 20% or more, lasting at least two months.



Source: Bloomberg. Note: Analysis based on MSCI World Index in GBP from 31 December 1979 to 21 June 2022. Bear markets are characterised by a fall of over 20% over a period of more than two months. As such, the sharp but short-lasting correction seen in early 2020 during the first wave of Covid-19 is not included as a bear market.

3. Is this the end for bonds? They haven't provided any cushion this year.

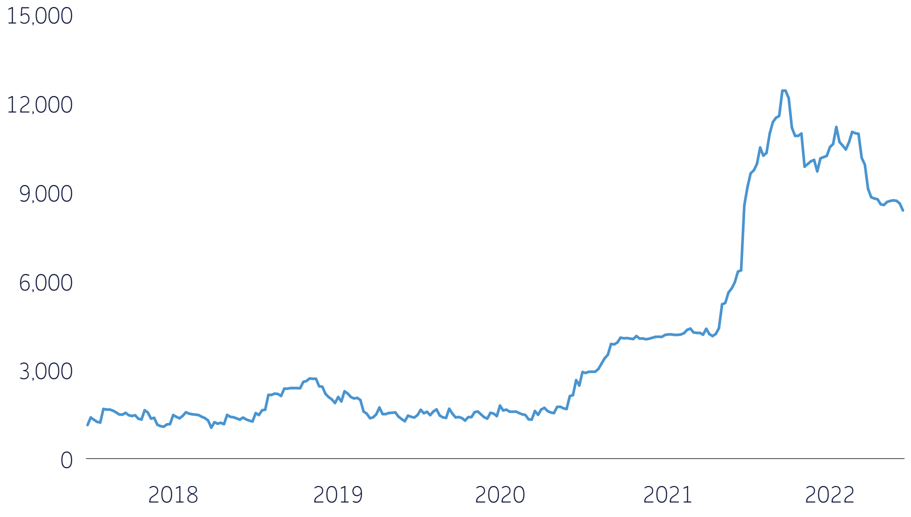
With rising inflation and interest rate hikes pushing bond prices lower it's been a challenging year for investors. Bonds are generally viewed as being lower risk than stocks and can also help generate a regular source of income.

However, supply chain disruptions caused by the Ukraine crisis and Omicron lockdowns in China have fuelled inflation which in turn has had a negative impact on bonds. This is because if prices are rising, the real value of both the annual income from bonds and the repayment of capital when the bonds mature are falling. Central banks are also raising interest rates to curb inflation, which presents a challenge to bond prices.

Despite inflation hitting multi-decade highs and central banks hiking interest rates to contain soaring prices, we see some signs for optimism. While markets are expecting aggressive interest rate hikes in the coming months, there are signs supply chain issues are gradually easing around the world, with most countries having now emerged from their Covid-induced restrictions. We believe moderating inflationary pressures will allow central banks to go slower with their hikes or even eventually start reducing interest rates over the next few years. This will help support bond prices, while a slowdown in economic growth should also help boost demand for high-quality bonds, such as those issued by the US and UK governments. As such, our outlook for bonds from here is fairly positive.

Figure 3: Container freight rates (in US dollars)

The cost of shipping containers from Shanghai to Los Angeles is falling, suggesting that supply chain issues are beginning to ease as China emerges from its strict zero-Covid lockdowns.



Source: Bloomberg

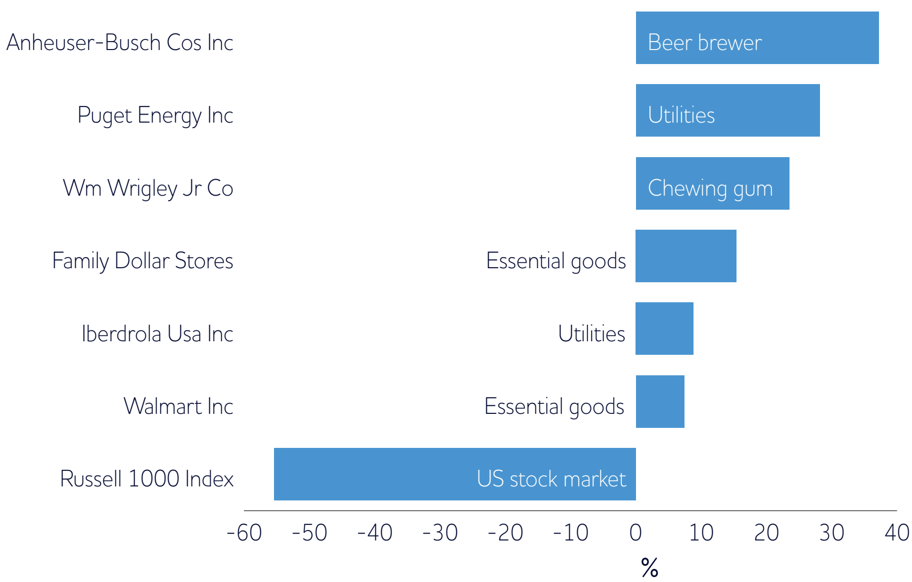
4. Is there anything to be optimistic about?

Whilst the outlook may look bleak, there are some things on the horizon that give us reason to be optimistic over the medium term:

1. As supply chain issues begin to unwind, inflationary pressures will moderate, which should in turn take the pressure off central banks to aggressively raise interest rates. This would benefit the bond market.
2. China has said that it will support its economy and its financial markets. Whilst we are yet to see this support in action, any measures that the government introduces to enhance economic growth will benefit economies throughout Asia and emerging markets and in turn world stock markets.
3. Sentiment among individual investors is at near all-time lows. This shows us that some of the difficult market conditions are behind us. Whilst we expect markets to remain somewhat volatile, we may be en route to a turning point, which we will likely see towards the end of 2022.
4. In poor economic conditions there are some types of companies, such as utilities, healthcare companies or producers of essential consumer goods, that can continue to deliver profits and positive returns for investors. For example, during the global financial crisis, even when the US stock market dropped over 50%, there were some companies who were able to deliver positive returns (figure 4). Omnis' investment managers manage our funds actively, can seek out these types of companies and position your funds appropriately.

Figure 4: How defensive sectors fared during the global financial crisis

During the global financial crisis, the US stock market dropped over 50%, yet there were still some types of companies from more 'defensive' sectors, such as utilities and providers of essential goods, that were able to deliver positive returns.



Source: Bloomberg. Chart shows returns from 12 October 2007 to 9 March 2009 in local currency.

5. Should I disinvest now and wait for markets to begin recovering?

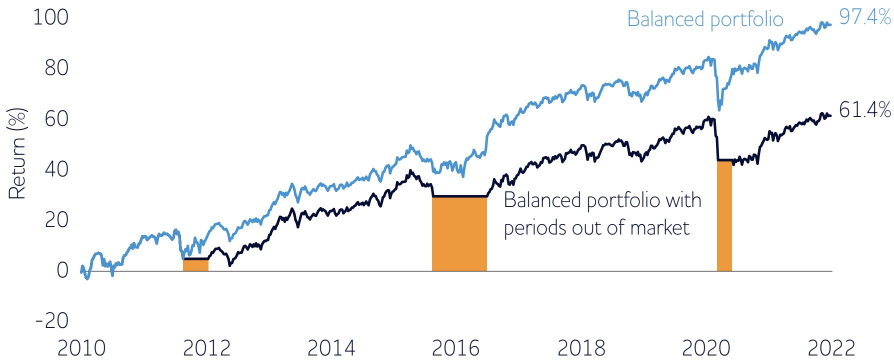
It's nearly impossible to time the market successfully, and it almost always pays to stay invested during periods of volatility. Having a diverse portfolio spread across a variety of markets, stocks, bonds and other assets can help soften the blow if one area suffers in uncertain times.

Although it may feel counterintuitive, it's important to stay calm and ride the ups and downs of your portfolio without making short-term decisions that could significantly impact the investment outcomes you achieve in the long run. Volatility is inevitable when investing in markets and it's helpful to know that the leading indices have generally delivered positive returns over the long term.

Missing out on recoveries can be costly for long-term investors, so it's important to stay invested. Figure five shows the impact of divesting when big market shocks occur in two identical balanced portfolios. In one portfolio the investor pulled out when the market fell 10% and only reinvested when the market had risen 10% from that point. In the other scenario, they stayed invested and had a return more than 35% higher.

Whenever possible you should remain focused on your long-term financial goals and stick to the plan you've agreed with your financial adviser. If you have any questions about your investments, your adviser will be able to reassure you and talk you through your options.

Figure 5: The cost of getting it wrong



Source: FE fundinfo. 1 January 2010 – 31 December 2021.
* Using Graphene C2 Balanced Index Equivalent for Balanced Portfolio. Assumes investments are withdrawn when market falls 10% and reinvested when market subsequently recovers 10%.

Find out more

As always, the best thing to do when you are feeling nervous about your portfolio is to stay calm and speak to your financial adviser who will be able to assess your portfolio against your long-term objectives.

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