ROCQ CAPITAL

First Quarter 2022

Russia's invasion of Ukraine in late February prompted significant volatility in financial markets across all asset classes, which was exacerbated by the announcement of unprecedented sanctions on Russia by Western governments. While the direct impact on individual Western companies is likely to be small, given limited operations in and exposure to the region, investors' risk appetite was significantly hit by this and the early developments in the conflict such as the possibility of nuclear weapons being deployed. Equity markets, already weak in January and February, fell dramatically before staging something of a comeback towards the end of March which improved performance for the quarter as a whole. The MSCI World index was down 2.7% in Sterling terms, as developed markets outperformed emerging markets (MSCI EM -4.5%). Europe, with the highest direct and indirect exposure to the effects of the conflict, was weaker than the US, which is more remote on account of its energy self-sufficiency as well as its geography. The Eurostoxx 50 index fell by 9.0% in GBP terms, compared to -2.1% for the US S&P 500.

The impact on commodity markets is likely to be longer-lasting, given Russia's position as a large exporter of oil, gas, minerals and metals with continental Europe a key customer. Ukraine and Russia also stand out as important parts of the food supply chain, particularly as producers of wheat and fertilisers. In a highly volatile and at times chaotic quarter for commodities, crude oil gained over 30%, natural gas 50% and the broad CRB commodities index rose by almost 10%. Inflation, already rising to levels not seen since the 1980s, will be put under further upward pressure by these developments. In the US, inflation reached 7.9% in February, having been only 1.7% a year earlier, and in the UK the level is 6.2% compared to 0.4% in early 2021.

This highlights the difficulty facing policymakers already grappling with rising price levels. Central banks have begun to raise interest rates tentatively and are broadly expected to continue doing so for the rest of the year. Amongst developed economies this is particularly an issue for the US and UK, where global supply chain disruptions from Covid are interacting with strong demand on account of tight labour markets. For example, US economic growth ended 2021 at a 7.1% annualised rate and the UK's figure was 7.4%, while employment reports continue to paint a buoyant picture of expanding employment and rising wages.

The Bank of England raised rates in February and March, while the US Federal Reserve (Fed) began its hiking cycle in March and the European Central Bank (ECB) moved forward its plans to do the same later in the year. Quantitative easing programmes are also expected to be wound down at a faster pace than might have been predicted a few months ago. This marked a sharp shift in tone and action across the board, and caused significant weakness in markets during January and February. Governments must also walk a tightrope; having been hoping to rein in spending after the support programmes delivered to mitigate the effects of Covid and lockdowns, they now face calls to support those struggling with the cost of household energy bills.

This has impacted fixed income markets, which have been unusually volatile and had a weak quarter. With inflation rising, the low fixed coupons available – particularly in government bonds – are less attractive. UK 2 year yields doubled from 0.7% to 1.4% and 10 year yields rose from just under 1% to 1.6% as investors sold bonds heavily; similar moves were afoot in other fixed income markets, and the ICE BoA Global Broad Market Index lost 6.5% making it the weakest quarter in recent memory. In addition, the shape of the yield curve became a focus as short term yields rose relative to longer term ones. This can be an indication of weakening economic growth ahead, though with bond markets heavily influenced by central bank purchase programmes over recent years it is unclear if this signal is as meaningful as it used to be.

While there are still disruptions from Covid in most economies via absenteeism and supply chains that are not yet back to normal, as a risk factor in financial markets it has subsided and has naturally been dwarfed by concerns about Ukraine. One exception to this is China, which in March announced a series of lockdowns including in its key technology and export region of Shenzhen. The country's 'zero Covid' approach is likely to be significantly watered down, though vaccination levels for more vulnerable citizens probably need to be raised first.

Outlook

As a result of the Ukrainian conflict, a higher degree of uncertainty in markets seems assured and we feel the need to operate accordingly with an appropriately diversified portfolio, lower exposure to fixed income instruments than a year ago and a small tilt towards investments more sensitive to commodity prices, where appropriate. There will almost certainly be a negative impact on global growth via higher inflation of an unknown magnitude, with the economic hit to be bigger in Europe and therefore more likely to influence the ECB than the Fed. Inflation also appears slightly less entrenched in Europe than in the US, which has stronger wage growth and more risk of second-round effects. Other things equal, this would be negative for European assets on a relative basis and our portfolio composition reflects this, with relatively low exposure to European equity markets.

Central banks are indicating their resolve to tackle inflation quickly, and are likely to continue with this stance until they see either inflation starting to fall – which may be the result of supply chain pressures easing – or they become concerned that growth could be significantly negatively affected.

Geopolitical risk, energy security and supply chain security are likely to be a renewed focus throughout the world, for governments and the private sector. These are long-term themes, already in train within supply chains due to the vulnerabilities exposed by Covid lockdowns, and are likely to accelerate given the developments in the Ukraine conflict. The energy security issue may prompt a further push into renewables and other domestically-based solutions, possibly including nuclear, though this transition will be bumpy and still crucially reliant on fossil fuels as a bridge. There will be significant opportunities in this space over the coming years and despite the near-term headwinds facing financial markets there remain interesting themes for us to have exposure to as we assess the path ahead for the global economy.