IMPERIUM CAPITAL

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Taking the (not so) long view

Global Matters Weekly

21 February 2022

– **Robert White, CFA**

The latest elevated CPI print of +7.5% has spooked investors this year, triggering volatility in both bond and equity markets. In trying times, it sometimes helps to take the long view. In a recent paper the Bank of England has taken this advice to the extreme, looking back 800 years to the 14th century to calculate the average global GDP-weighted inflation rate of just +1.51%[1]. Unfortunately, 800 years is not a particularly sensible investment horizon for most people, but there are plenty of other more relevant periods for us to examine when considering the importance of current economic events.

We "only" need to go as far back as 1982 to find a period where inflation in the US has been at the levels we see today, and of course back then the US economy was in a very different place. First off, unemployment was +10.7% by the end of that year with manufacturing, construction and auto industries hit particularly hard. Today unemployment appears under control at +4.0%, and much of the job uncertainty has been in leisure and hospitality sectors due to Covid-19.

Inflation was also coming down from a much higher point in 1980 when it peaked at +14.8%. Price stability was in fact not explicitly part of the Fed's mandate until the Reform Act of 1977, and Volker's appointment as Fed Chairman in August 1979 signalled a change of course for monetary policy. Under Volker, the Federal Reserve raised interest rates as high as +20% in 1981, and by 1982 they were on their way down as the worst of the inflation prints were already in the past. Today we are in a much easier environment with interest rates at +0.25%, and we are just at the start of a hiking cycle. While no one expects rates to reach the highs of the early 1980s, there is uncertainty ahead as to just how far the Fed will go.

What about markets? The early 1980s were famous for "Volker's Bear" as the steep increase in rates resulted in a long-term bear market decline from November 1980 to February 1982. Today equities have bounced strongly from their most recent bear market in 2020, but we have seen some volatility this year as the S&P 500 was down +5.2% in January. Such periods can feel painful for investors, for a number of reasons.

> **"While investors cannot control their natural behavioural instincts, we should focus on what we can control. "**

The first reason comes down to human psychology. Prospect theory is a field of behavioural economics which scientifically describes how individuals assess their losses and gains asymmetrically; the pain we experience from a loss is greater than the pleasure we derive from an equivalent gain. This doesn't seem to make sense if we behave completely rationally, however it can be understood anecdotally as many of us can relate to the pain of having something we value taken away from us. The truth of this fact is not merely anecdotal; Kahneman and Tversky formalised this principle scientifically, and the former won a Nobel prize for his work[2].

Secondly, the decline in January has come in a period of relative calm for markets, and so has felt particularly sharp. Over the last decade, the S&P 500 has averaged +15.4% return per annum with a standard deviation of +13.2%. Again, we can look further back at history to compare these numbers. Since 1927, the average return has been lower than the last decade at +9.7%, while the standard deviation (a common measure of risk) has been higher at +18.7%.

While investors cannot control their natural behavioural instincts, nor the overall direction of markets, we should focus on what we can control. The best way to deal with market volatility is to hold investments over the long term and to diversify risk optimally across a range of asset classes, regions, styles and companies. This is what we do on a daily basis for our clients, making the journey as smooth as possible through these tough periods.

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1 *https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2020/eight-centuries-of-global-real-interest-rates-r-g-and-the-suprasecular-decline-1311-2018*

2 *Kahneman, D., & Tversky, A. (1979). Prospect theory: An analysis of decision under risk. Econometrica, 47, 263-291.*

All other sources taken from Bloomberg Finance, L.P.

The **Marketplace**

- Global equities fell -1.8% last week
- The ongoing geopolitical tensions and the move to price in additional rate hikes led to further declines in equities
- Brent crude returned -1.0% over the week to $93.5 a barrel
- Gold returned 2.1% to $1898.4 per ounce

Market **Focus**

US

- US equities fell -1.5% last week
- January's month-on-month PPI reading came in at 1.0% vs +0.5% expected, the fastest monthly pace in eight months
- Empire State Manufacturing Survey's Prices Received Index reached a record high of 54.1 in February, and prices paid also held roughly steady at 76.6 vs 76.7 prior
- US weekly initial jobless claims for the week ending 12th February came in at 248k vs 218k expected
- Retail sales expanded by 3.8% vs expectations of 2.0%, their fastest monthly gain since last March
- Industrial production grew by 1.4% month-on-month in January vs 0.5% expected
- Existing home sales were faster than expected with 6.5m sales vs expectations of 6.1m
- The Philadelphia Fed's manufacturing business outlook survey fell to 16.0 vs 20.0 expected
- The New York Fed's Survey of Consumer Expectations for January saw a decline in short and medium-term inflation expectations.

Europe

- European equities returned -1.9% last week
- The German ZEW survey for February came in slightly below expectations but was an improvement on January's readings. The headline expectations component rose to a 7-month high of 54.3 and the current situation index improved to -8.1 from -10.2 the month prior.

UK

- UK equities fell -1.7% last week
- January's CPI release came in at a post-1992 high of 5.5%
- Core CPI was similarly above expectations at 4.4%
- Job vacancies hit a record high of 1.298m in the three months to January. The number of payrolled employees in January was also up 108k and the unemployment rate was in line with expectations at 4.1% for the three months to December.

Asia/Rest of The World

- The benchmark Global Emerging Markets index returned -0.7% last week
- Japanese equities fell -1.9% over the week
- Chinese equities returned -1.6% last week
- Japan's economy expanded at an annualised rate of 5.4% quarter-on-quarter (vs 6.0% estimated). The nation's economy grew by 1.7% in 2021, recording its first expansion in three years
- Japanese exports grew by less than expected to 9.6% year-on-year (vs 17.1% expected) due to slowing demand coupled with global supply constraints
- Japan's CPI reading for January came in at 0.5% year-on-year, down from 0.8% in December
- China's CPI came in at 0.9% year-on-year vs 1.0% expected, whilst PPI fell to 9.1% vs 9.5% expected
- The PBOC injected 100bn yuan (net) into the banking system via its medium-term lending facility to counter the economic slowdown.

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Asset Class/Region	Currency	Currency returns			
		Week ending 18 Feb. 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	-1.5%	-1.8%	-8.6%	12.2%
United Kingdom	GBP	-1.7%	0.8%	2.8%	19.7%
Continental Europe	EUR	-1.9%	-1.2%	-6.9%	12.6%
Japan	JPY	-1.9%	2.5%	-3.4%	1.2%
Asia Pacific (ex Japan)	USD	-0.6%	3.9%	-1.3%	-13.7%
Australia	AUD	0.3%	3.5%	-2.8%	8.7%
Global	USD	-1.8%	-0.7%	-7.6%	7.9%
Emerging markets equities					
Emerging Europe	USD	-4.8%	-0.2%	-7.7%	3.2%
Emerging Asia	USD	-0.7%	3.3%	-1.7%	-17.1%
Emerging Latin America	USD	-0.2%	6.2%	11.8%	5.6%
BRICs	USD	-1.2%	3.4%	-0.7%	-21.8%
China	USD	-1.6%	4.3%	-1.2%	-33.9%
MENA countries	USD	1.3%	2.3%	8.6%	35.0%
South Africa	USD	1.1%	9.8%	12.9%	4.4%
India	USD	0.4%	1.6%	-0.5%	12.5%
Global emerging markets	USD	-0.7%	3.5%	0.1%	-11.7%
Bonds					
US Treasuries	USD	0.0%	-1.2%	-2.9%	-3.1%
US Treasuries (inflation protected)	USD	0.1%	-1.4%	-3.8%	3.0%
US Corporate (investment grade)	USD	-0.9%	-2.4%	-5.7%	-4.7%
US High Yield	USD	-0.3%	-1.5%	-4.3%	-0.5%
UK Gilts	GBP	1.8%	-1.4%	-4.4%	-4.4%
UK Corporate (investment grade)	GBP	0.9%	-2.3%	-4.9%	-5.3%
Euro Government Bonds	EUR	0.5%	-2.6%	-3.3%	-4.8%
Euro Corporate (investment grade)	EUR	0.2%	-2.2%	-3.2%	-3.7%
Euro High Yield	EUR	-0.2%	-2.2%	-3.4%	-1.5%
Japanese Government	JPY	-0.3%	-1.1%	-1.8%	-1.4%
Australian Government	AUD	-0.2%	-1.8%	-3.2%	-4.6%
Global Government Bonds	USD	0.1%	-1.0%	-3.0%	-6.6%
Global Bonds	USD	-0.1%	-1.3%	-3.5%	-6.7%
Global Convertible Bonds	USD	-1.3%	0.3%	-5.5%	-13.1%
Emerging Market Bonds	USD	-0.4%	-1.8%	-5.7%	-7.5%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 18 Feb. 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	-0.9%	-2.6%	-10.4%	22.1%
Australian Property Securities	AUD	3.0%	3.6%	-7.5%	21.2%
Asia Property Securities	USD	0.0%	3.4%	4.1%	-3.7%
Global Property Securities	USD	-0.5%	-0.4%	-6.4%	12.7%
Currencies					
Euro	USD	-0.7%	1.5%	-0.6%	-6.3%
UK Pound Sterling	USD	-0.1%	1.4%	0.4%	-2.7%
Japanese Yen	USD	0.7%	0.1%	0.0%	-8.2%
Australian Dollar	USD	-0.2%	2.6%	-1.5%	-7.6%
South African Rand	USD	-0.5%	3.2%	5.2%	-3.3%
Swiss Franc	USD	0.5%	1.1%	-1.1%	-2.7%
Chinese Yuan	USD	0.5%	0.6%	0.5%	2.6%
Commodities & Alternatives					
Commodities	USD	0.9%	4.4%	13.2%	41.0%
Agricultural Commodities	USD	0.3%	3.7%	7.3%	33.3%
Oil	USD	-1.0%	3.9%	20.3%	46.3%
Gold	USD	2.1%	6.0%	3.8%	6.9%
Hedge funds	USD	-0.2%	0.6%	-1.2%	0.2%

Source: Bloomberg. Past performance is not indicative of future returns

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