INVESTMENTS • ADVICE • PLANNING

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Caves Quarterly
Q1 2022 Round Up

Ukraine Crisis

During the first quarter of 2022, we have witnessed a terrible development in geopolitics with Russia's brutal invasion of Ukraine. We are shocked and deeply saddened by events in Eastern Europe and although our quarterly review serves to comment on the impact on financial markets, we acknowledge first and foremost that this is a humanitarian crisis with life changing consequences and suffering for millions of people.

Whilst Russia is not a large part of the global economy (c.2% of global GDP), the Ukraine crisis has created significant economic issues; Russia supplies around 40% of the EU's natural gas and is responsible for approximately 11% of global oil exports. It is also a major producer of aluminium and wheat, which Ukraine also grows. Immediate risks include a spike in energy and food prices, the crippling of the Russian financial system following international sanctions and further disruption to global supply chains.

The intentions of Russia's president, Vladimir Putin, are notoriously difficult to comprehend and February's invasion has cast a dark shadow over the longer-term outlook. Geopolitical uncertainty has created an unstable environment for risk assets, whereby intraday market volatility has been dramatic and is expected to remain elevated for some time.

The start of the war and the resulting supply-side shocks are causing headaches for global Central Bankers, who are now forced to choose between trying to support growth or tame high inflation.

Strong corporate balance sheets combined with the release of pent-up consumer demand should, however, go some way towards offsetting the negative effects of monetary tightening and avoiding a global recession this year.

Global Equities

The UK's FTSE All-Share Index was broadly flat over the 3-month period. Having started the year with strong momentum, the UK economy looks set to slow from April onwards, as consumer confidence dips and household disposable incomes are exposed to rising borrowing costs, increased national insurance contributions and a 54% hike in the energy price cap on household gas and electricity bills. Despite the growing list of economic headwinds, our domestic market held up well relative to global peers, buoyed by its exposure to outperforming sectors in mining, energy, and banks, which have been the key beneficiaries of record high commodity prices and rising interest rates.

Over in the U.S., volatility at the index level has been amplified by large price swings and mixed corporate results from the FAANG technology stocks. The S&P500 index recorded its worst January since 2009 and entered correction territory - defined as a sell off of 10% or more – in February. A rapidly improving labour market and persistent inflationary pressures have forced the U.S. Federal Reserve (Fed) to adopt a more hawkish stance towards monetary policy. This shift to higher interest rates against a backdrop of waning corporate earnings hit equity markets hard in the first quarter, particularly growth focused companies that have revenue streams more weighted towards the future. This equity style rotation is reflected in the performance of the S&P500 and NASDAQ indices, which declined 5% and 9% respectively since the end of December.

European equities endured a difficult period, as indicated by the Euro Stoxx 50 index, which moved 9% lower over three months. The eurozone was primed for a strong post-pandemic recovery and exposure to financials and cyclically sensitive sectors such as energy, materials and industrials looked set to benefit regional equity markets.

The outbreak of war, however, has left Europe highly vulnerable to economic deceleration, given the aforementioned reliance on natural gas and oil imports from Russia. Despite several countries approving measures to absorb higher energy bills for households, consumer confidence has already dipped across the continent.

China's Hang Seng index registered a negative return of 6% in the three months to the end of March. The government's zero-tolerance approach to Covid-19 outbreaks continues to hamper the world's second largest economy, with recent lockdowns in technology and financial hubs, Shenzhen and Shanghai, exacerbating global supply chain constraints. Equities sold off aggressively through March until China's top financial policy committee said local governments should "actively introduce policies that would benefit markets". Confirmation of a 5.5% growth target for 2022 also helped to restore confidence, supporting a rebound in equity indices towards the end of March.

The disruption to Chinese manufacturing activity is having a negative impact on the Japanese economy, with the country also exposed to higher prices in food and energy imports following the invasion of Ukraine. The Nikkei 225 index surrendered 3% over the period.

Commercial Property

The commercial property sector made good progress in the first quarter, as Net Asset Valuations (NAVs) trended higher across London-listed Real Estate Investment Trusts (REITs).

The easing of lockdown measures and recent strength in the labour market has led to a renewed sense of confidence towards UK real estate, with opportunistic investors getting amongst inflation-linked assets and seeking out value in REITs with large share price discounts to NAV.

The removal of work from home guidance is seeing the reoccupation of office buildings and traditional retail is expected to recover during 2022, supported by improved consumer demand. Industrials/logistics continue to benefit from record high speculative development, tight supply, and low vacancy rates.

Alternatives

Russia's role as a major energy and raw material producer pushed prices for oil, natural gas, and some agricultural commodities to extreme levels as tensions escalated in Eastern Europe.

Having started the period below $80, the price of Brent oil ended the month of March at $108 per barrel, sliding back from a near 14-year high of $139 touched during the early stages of the conflict.

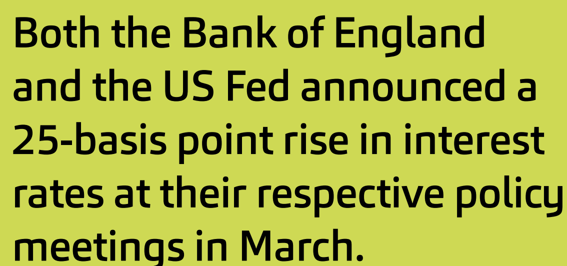
Equity market volatility, rising inflation and the war in Ukraine was a powerful combination for gold outperformance in recent months, with investors rushing into the precious metal for its reputation as a safe haven asset in times of uncertainty. Having traded at $2,074 in March (just shy of its August 2020 record of $2,085), gold ended the period at $1,950 an ounce.

Fixed Interest

Fixed income securities are flagging possible danger ahead, with the 2-year and 10-year Treasury yields inverting for the first time since 2019.

An inverted yield curve occurs when rates for longer-term bonds are lower than those for shorter-term maturities and, historically, has been a good indicator of an impending recession. Corporate credit markets, however, remain steady with expectations for issuer default low following debt refinancing and balance sheet strengthening through the pandemic.

Both the Bank of England and the US Fed announced a 25-basis point rise in interest rates at their respective policy meetings in March. Whilst anticipated, the Fed also signalled there may be six additional increases throughout the calendar year and comments made later in the month suggested they are willing to risk economic growth and potentially a recession in the fight against inflation. This unexpected hawkish pivot, along with robust wage growth and falling unemployment data in the U.S. saw bonds sell off sharply across the first quarter of 2022, with yields rising sharply as a result. The US 10-Year Treasury Note and the UK 10-Year Gilt yield closed out the first quarter at 2.35% and 1.61% correspondingly.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Outlook

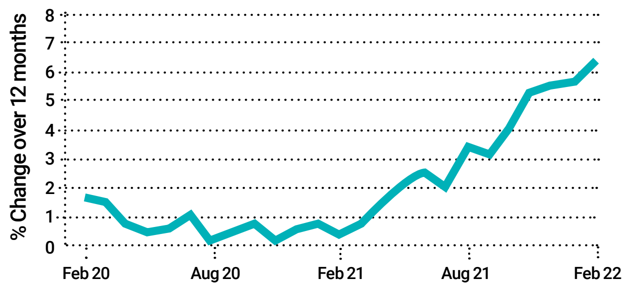
Our outlook for 2022 was broadly constructive, in line with expectations for ongoing policy support, a moderation to multi-decade high inflation levels and above-trend global growth.

Just as the economic effects of the pandemic appeared to be fading, the Russia-Ukraine crisis has applied new pressures to a global economy that was already susceptible to issues with disrupted supply chains and soaring inflation.

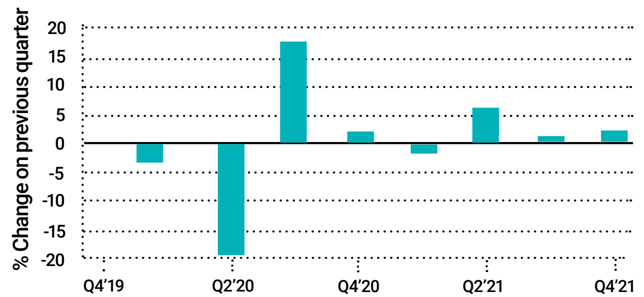
Whilst the timing and nature of the eventual conclusion of hostilities in Ukraine are impossible to predict, we hope that the worst of the conflict is now behind us. In an environment whereby political and economic uncertainty remains high, investors should remain braced for bouts of high volatility until normal economic activity resumes and geopolitical risks subside. As ever, we advocate a balanced approach to portfolio construction and believe this is best achieved through a focus on quality and asset class diversification.

A year in numbers

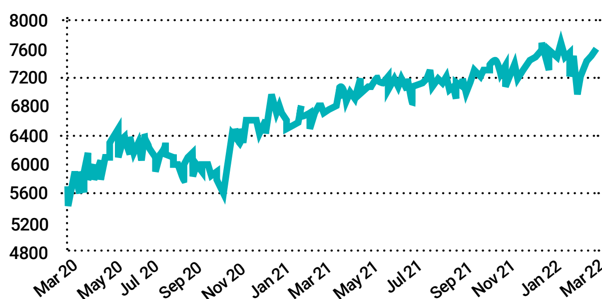
UK Consumer Prices Index (CPI)



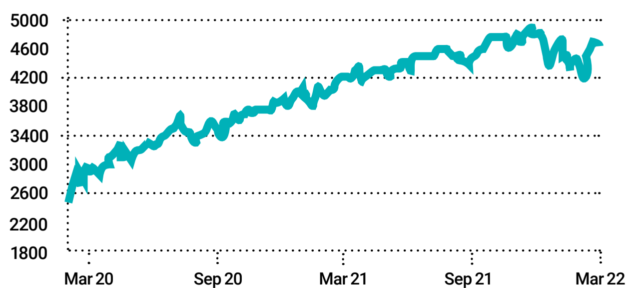
UK Gross Domestic Product



FTSE 100 Index



S&P 500 Index



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