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Markets: Volatility does not mean negativity

By George Herman

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Financial markets have been gripped by fears of a recession, brought on by anxiety around interest-rate hikes by the global central banks.

Source: Supplied. George Herman, chief investment officer at Citadel.

A long-term investment strategy is about finding the right path for the changing environment, whether that be a war or 'cost-of-living crisis'. Political change often leads to policy change, affecting how people, commodities and exchange rates move thus directly impacting financial markets.

Volatility does not mean negativity – it is movement as relative changes in valuations adjust and nothing more. It brings as many opportunities as risks at stock-, sector-, country- and currency levels.

No financial advisor has answers for the world's issues, but what they should have answers for is where the financial markets are pricing the risks of the future and how to set out the right investment solutions to handle different scenarios.

But how did we get here?

Equities

At the end of 2021, global equity markets went on a bull run celebrating the release of the post-pandemic world with a lot of optimism as seen in the 30% increase in equity markets for 2021.

In January 2022, when the Federal Reserve (Fed) indicated that monetary policy would be tightened this year and acknowledged the issue of inflation, global equities immediately took a step back.

When the Russia-Ukraine war broke out, global equities took another step back, but SA equities continued to benefit off high commodity prices.

As the world acclimatised to the war, in June 2022 sudden inflation and interest-rate fears knocked global equities even lower, now down 20% since January 2022.

The slower growth also affects SA equities that have started feeling the heat. However, SA equities and all asset classes except global bonds, are still positive when looking at an 18-month perspective.

Global bonds suffered heavily as interest rates normalised.

Commodities

Commodities drastically increased by 80% between February 2022 and June 2022 because of the Russia-Ukraine war. Energy commodities doubled in the 14-months prior to the end of February 2022.

Industrial and agricultural commodities also went through the roof in the first quarter of 2022.

Commodity markets began rolling over and cooling down in June 2022 when scarcity was no longer the issue, rather a decreasing consumer demand off the back of a slower global economy.

Inflation and interest rates

The falling commodity prices fed into inflation being the financial narrative for 2022.

The Fed started the process of hiking interest rates at the beginning of this year, and we’re now up 150 basis points (bps) for the year, with another 150 bps priced into the market for the rest of this year.

For perspective on how high the current US inflation of 8.5% is, we look at the average over the past 30 years which sits at 2.5%.

Many are asking whether inflation has peaked, but expectations for the next inflation print due on 13 July 2022 sits even higher at around 9% – and this is where we expect it to peak as the sharp turnarounds seen in commodity prices will start alleviating some inflation pressure.

The world is trying to normalise now that it’s no longer on stimulus.

Bonds

The main contributor of unhinging risk markets was US bonds. US Treasury and bond yields jumped, in fact doubled from 1.75% to 3.50% in the first quarter of 2022.

This sent shockwaves through the markets, since this dislodges the valuations of all assets promising future payments.

This created volatility and the need to rebalance asset classes among each other and the reassessing of long-term risk and growth. In the first half of 2022, we witnessed the largest drawdown in US Treasury's history and by quite some margin.

What is unique is that usually bonds and equities are inversely related, and whenever equities sell down bonds go stronger, but not this year. Bonds are down and so are equities so both sides of the portfolio are taking strain, a unique situation, but not a permanent one.

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Where to from here?

The narrative is now no longer about interest rates and inflation because it looks likely to be under control. The narrative now is around growth and the fear of recession.

The important factor for financial markets will be the point when the Fed acknowledges that its own actions will hurt economic growth to such an extent that it will have to stop hiking or even start cutting interest rates (a pivot).

Recession

The most important assessment for the year has been whether we are going into a recession and every short-term US macroeconomic figure shows lower and lower growth momentum.

Technically, the US could already be in a recession, but it doesn't affect the long-term dynamics of the market.

As soon as the economy slows, inflation goes higher, as food and fuel costs increase, consumer confidence gets dented.

Now, its plunging to the lowest level in several decades. This obviously affects consumption behaviour and the strength of the global economy. With commodities starting to turn, headline inflation should peak soon.

Market valuations and level of earnings

The average level of volatility we are currently experiencing is literally double from what we experienced for the period of 2012 through to 2017, and is still gaining momentum. The market is waiting for the next move of earnings and there is scope for earnings to cool down from here.

Historic equity drawdowns in recessionary and non-recessionary periods indicate that the median decline for the world during non-recessionary periods is on average 11% and during recession it is 33%.

Currently, we are sitting between the two at 22%.

Global equity markets are well adjusted to the new interest-rate environment and are now waiting on equity market earnings for further direction.

In conclusion, our philosophy at Citadel is that the future is uncertain and will surprise, which is why we assess, scenario-plan and manage our fund structures accordingly.

ABOUT THE AUTHOR

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