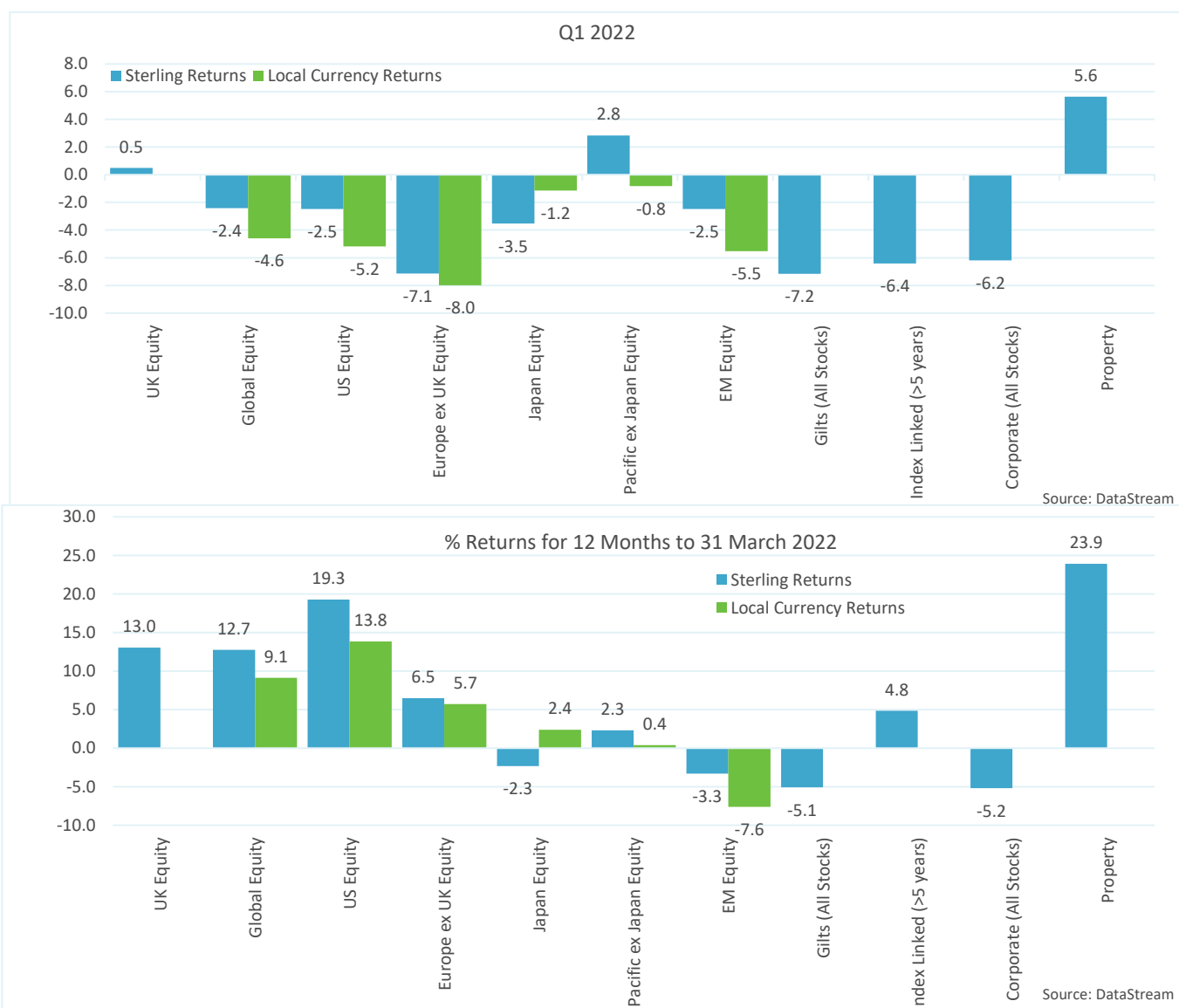


Market commentary Q1 2022

Economic background

- Russia and Ukraine represent a small share of global GDP and trade but produce a disproportionate share of key global commodity exports.
- Physical disruptions and sanctions have triggered broad commodity price rises which, alongside existing inflationary pressures, are increasing input costs and weighing on consumer's real incomes.
- The rapid spread of Omicron in China, which has led to large-scale lockdowns, has also been a factor, weighing on Chinese domestic demand and compounding existing supply chain issues.
- Global growth has been revised down from a relatively robust pace, but forecasts still point to relatively strong growth over the next couple of years, by the standards we've seen since the global financial crisis.

Market returns to 31 March 2022



Equity markets

Global equities have largely rebounded from the initial sell-off following Russia's invasion of Ukraine, but high inflation, expectations of monetary tightening, geopolitical tensions, and slowing earnings momentum have all contributed to a -4.6% year-to-date global equity return (local currency).

The UK was the only region to deliver a positive return, benefiting from above-average exposure to energy, metals, and miners. Europe fell to the bottom of the performance rankings, whilst Emerging Markets fell further as new COVID-19 lockdowns and broader geopolitical concerns weighed on Chinese markets.

Earnings growth in 2022 will inevitably slow sharply from an expected 54% in 2021. But demand and revenue growth remain strong and there is evidence that businesses expect to be able to pass on most of their higher costs. Business surveys highlight the share of firms raising, or planning to raise, average selling prices at record highs. Consensus forecasts show earnings growing by almost 10% this year, reflecting only a modest margin squeeze.

Nevertheless, there are risks, and the inflationary backdrop may favour sectors that benefit from more inelastic demand and greater industry concentration, both of which are key in maintaining pricing power and margins.

Bond markets

Investment-grade spreads largely reversed the sharp rises following the invasion of Ukraine towards the end of the quarter but remain considerably higher than the start of the year amid rates volatility, diminishing policy support, and inflation concerns.

Global investment-grade credit spreads have risen 0.3% p.a. since end-Dec to 1.3% p.a. Corporate fundamentals are in decent shape, particularly interest coverage given the scale of refinancing in recent years at extremely low rates. However, high current and forecast inflation, and its corrosive effect on nominal fixed income coupons, sees us retain a degree of caution.

Normalisation of monetary policy and rising cost of living may lead to some deterioration in collateral performance, though high inflation is offset, to some extent, by decent wage growth and strong house price rises, resulting in benign defaults and arrears and higher potential recovery values.

Property

The property market appears to have reasonably strong fundamental and technical foundations to support further recovery.

Nominal property rents, in aggregate, have been rising for the past year, though rental growth continues to fall short of inflation. The most recent RICS Commercial Property Survey showed that respondents expect further rent increases as availability reduces.

The investment market is in good health, supported by overseas demand and a resurgence in the number of domestic buyers – transaction volumes reached their highest quarterly volume since 2015 at the end of 2021. Within the market, there is still significant sectoral divergence, with strong industrial fundamentals masking weaker sectors, such as retail.

InflationWatch

Since the pandemic, inflation has risen further and for longer than most market participants expected in many countries including the UK. Strong demand, ongoing supply chain constraints and rampant energy and commodity price inflation continue to push prices higher. How high will inflation go, and will it persist? Has the era of respectable growth rates and low inflation finally come to an end?

We have introduced “InflationWatch” to help clients assess the outlook for inflation, and we plan to publish it quarterly. This provides:

- An update on the latest position on inflation
- Consensus forecasts on future inflation rates
- Our view on whether the risks to the consensus view are tilted to the upside or downside.

We focus on the UK and the outlook over the next 2-3 years. Our primary measure of inflation is the change, year-on-year, in the headline Consumer Price Index (“CPI”).

Inflation in a modern, open economy is determined by a complex set of macroeconomic factors including aggregate demand, input costs, inflation expectations and monetary policy stance.

Current Situation¹



- Headline UK CPI reached 7.0% in March 2022, the highest level since inflation targets were introduced in October 1992
- Latest consensus forecast is that inflation will moderate to 3.6% year-on-year by mid-2023 and then gradually fall back towards the 2% target over the next 5 years.

¹ Source: Reuters DataStream, consensus forecasts

Outlook indicators²

Driver		Metric	Latest	-3m	median/neutral
Inflation		UK headline CPI, % y-o-y	7.0	5.4	2.0
		UK core CPI, % y-o-y	5.7	4.2	1.7
Aggregate demand		UK GDP growth, % y-o-y	6.7	6.8	2.2
Input costs	Goods	UK PPI, % y-o-y	11.8	9.4	2.3
	Energy	Gas prices, £/MMBTU, % y-o-y	460.8	118.0	4.6
	Energy	Oil prices \$/barrel, % y-o-y	69.2	51.1	4.3
	Labour	UK unemployment rate (%)	3.8	4.1	5.5
	Labour	Average weekly earnings, 3-month average, % y-o-y	4	3.8	3.0
	Labour	UK vacancies (index, average = 100)	199.4	191.6	96.9
	Exchange rates	UK £ effective trade-weighted index, % y-o-y	-1.0	4.4	0.0
Expectations	Consensus forecast	UK headline CPI in 2-years' time, % y-o-y	2.8	2.2	2.0
	Consensus forecast	UK GDP growth in 2-years, % y-o-y	1.4	2.4	2.2
	Market-implied inflation	UK 5y spot inflation in 5y time, % p.a.	4.0	2.8	2.3
	Inflation surprises	UK Citigroup inflation surprises, > 0 = upside surprise	85.0	88.2	4.1
Monetary policy	Money supply	UK M4 ex-IOFC (12m growth rate %)	3.9	2.6	2.0
	Current interest rates	Base rate % p.a.	0.75	0.3	2.0
	Market-implied interest rates	UK overnight index swaps, % p.a. in 24 months	2.2	1.3	2.0

The dashboard above shows the latest reading for each indicator, and the reading 3 months ago, and compares them with the long-term median, or assessed neutral, value. The tone of the colour indicates the strength of the signal. A darker tone indicates either a stronger inflationary or disinflationary signal, depending on whether red or blue, respectively.

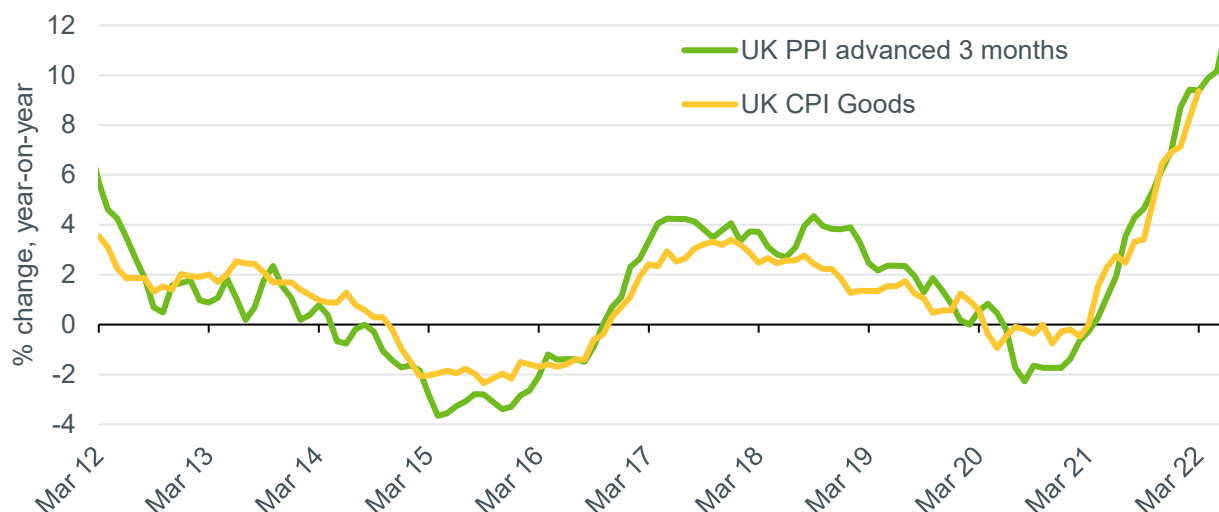
Highlights:

- GDP growth remains higher than its long-term average as the recovery from the pandemic continues; this could be inflationary if there is no surplus capacity in the economy. However, growth forecasts are expected to moderate sharply, and fall below long-term median levels by the end of 2023.
- Producer price inflation ("PPI") is well above its long-term average which points to more upward pressure on consumer prices if companies pass on increases in their costs.
- Increases in wholesale energy costs, which are close to all-time highs, are unparalleled outside the gyrations and base effects of the pandemic in 2021. These increases have been driven by strong growth, as well as sanctions and potential disruption of the supply of Russian oil and gas. The UK economy is less energy intensive than it once was but increases in energy costs will raise headline inflation measures.
- The unemployment rate is close to its all-time minimum. Earnings growth has fallen back from its recent peak of 7.3% in June 2021 but remains above its long-term average. Low unemployment, above-target wage growth and vacancies at extremely elevated levels, point to inflationary capacity constraints.
- Expectations of higher inflation can be self-fulfilling. Consensus forecasts are that inflation will moderate from current levels but still remain above target at the end of 2023. Longer-term market-implied inflation has risen sharply over the past 3 months and is pricing inflation nearly double the central banks' target.

² Reuters DataStream, Bloomberg, Bank of England, Consensus Economics

- Growth in the money supply remains above longer-term levels and there remains a significant “overhang” from rapid expansion in the monetary base in 2020; this is typically inflationary.
- Base rates have risen three times in recent months and the markets expect monetary policy to tighten further to combat higher inflation, with market-implied rates rising to restrictive levels over the next 2 years.

Focus Chart: UK producer prices index and CPI goods³



- PPI advanced by 3 months is closely correlated with CPI for goods which suggests PPI is a good leading indicator of consumer price inflation. As noted above, PPI is currently much higher than its long-term average.

Our View

- Inflation is expected to remain high in the near-term before moderating sharply in 2023 and then gradually return to target over the next few years.
- We believe near-term inflation risks are skewed to the upside due to supply chain issues, increasing energy, raw material and input costs, and tight labour markets, all of which are inflationary. In which case, interest rates may need to rise further in the short-term than the market expects to bring inflation under control.
- However, high energy prices and inflation are weighing on real disposable incomes and monetary policy is rapidly turning less accommodative, both of which are seeing aggregate demand forecasts revised downwards. We believe inflation may therefore fall faster in the medium-term than currently forecast.
- Deflationary factors such as demographics, technological innovation and globalisation are expected to drive inflation down to its target level. However, we believe the probability of a switch to a period of higher inflation has increased.

³ Source: Bloomberg, Reuters DataStream