Getting Over the Wall of Worry

Our weekly view on asset allocation.

07 March 2022

Tactical Caution as Markets Remain on Edge

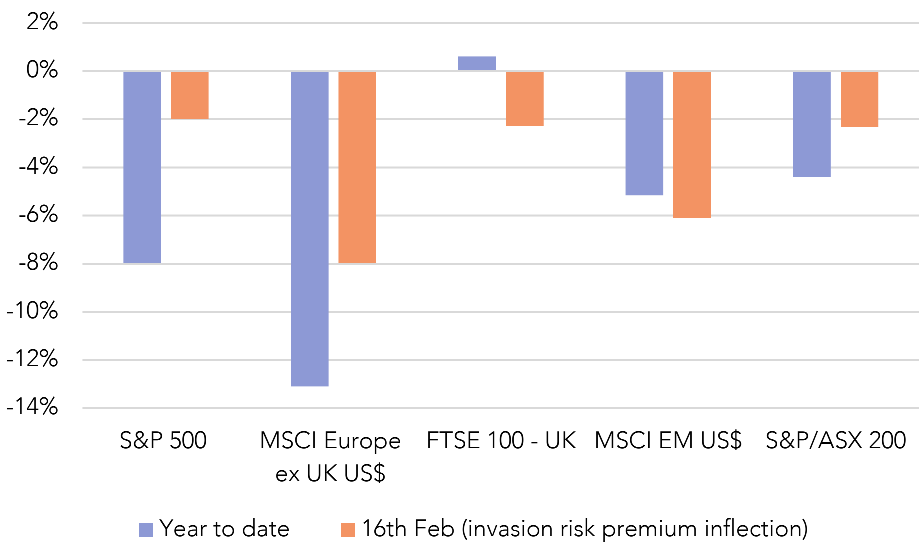
Markets remain on edge as Russia's invasion of Ukraine combined with ongoing concerns around inflation and the path of interest rates continue to create volatile conditions.

We expect markets will remain skittish in the near-term and we continue to exercise some tactical caution around risk assets.

While we have some tactical caution, we retain our constructive 12-month outlook for domestic (preferred) and global equities. Our positive 12-month view is premised on the prospect of an extension of the current phase of above-average growth for both the global and domestic economy. This should continue to support the global and domestic earnings cycle. In addition, global monetary policy remains highly accommodative. Policy is set to tighten but is far from neutral, let alone approaching restrictive levels. We see this as a supportive base for risk assets.

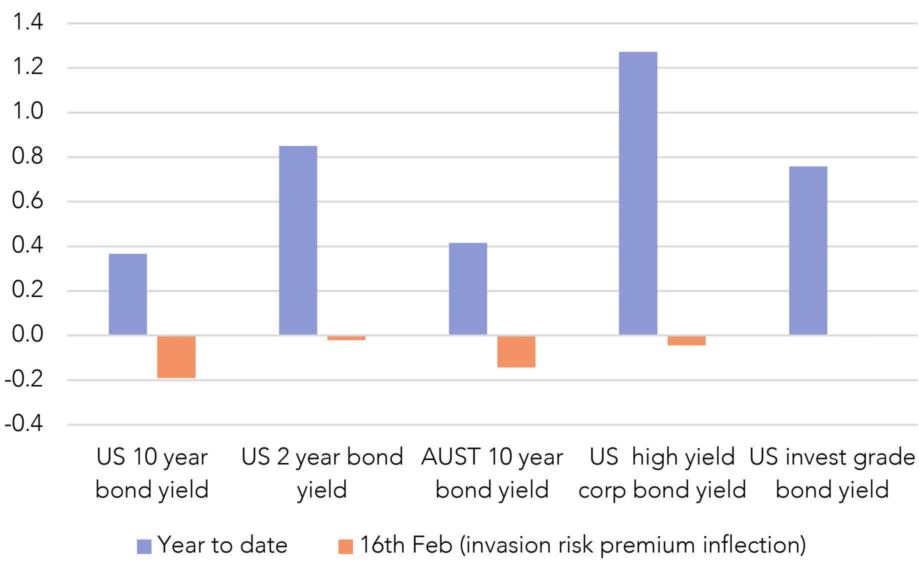
While our base case remains constructive, there is no question that the "wall of worry" has edged higher this year. Inflation has continued to pick up and looks stickier than envisaged just a few months ago. Russia's invasion of Ukraine has raised tail risks, particularly in relation to global energy markets. We delve into this wall of worry below.

Exhibit 1: Inflation and war worrying equities (equity market performance YTD to March 3)



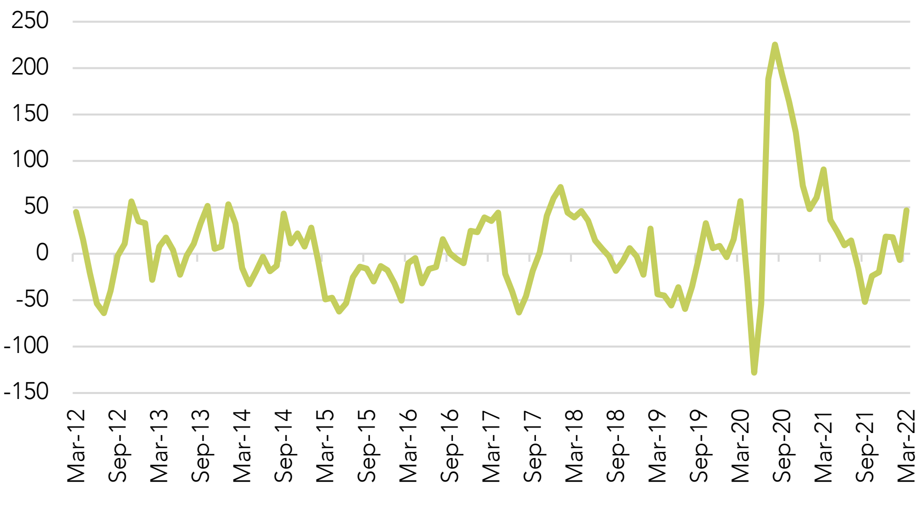
Source: Refinitiv, Wilsons.

Exhibit 2: Bond yields have moved higher year to date but lower recently on invasion fears (%)



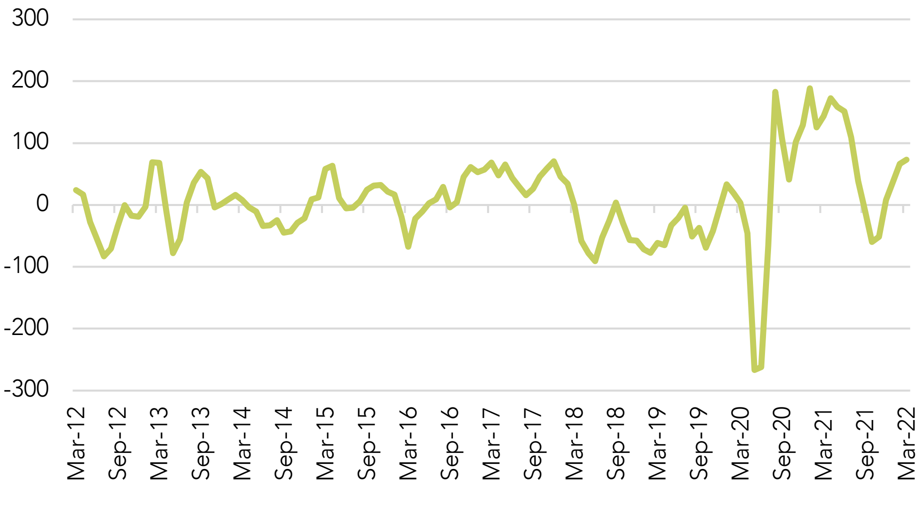
Source: Refinitiv, Wilsons.

Exhibit 3: US Economic data has surprised the consensus to the upside recently



Source: Refinitiv, Wilsons.

Exhibit 4: European economic data has surprised the consensus to the upside recently



Source: Refinitiv, Wilsons.

Exhibit 5: Equities have tended to bottom early in conflicts

Source: Refinitiv, Wilsons.

Russia Ukraine Crisis Unlikely to Derail the Global Expansion

As discussed last week, we expect the war in Ukraine to stay within its borders and therefore not have a significant impact on global growth or a major incremental impact on market risk premia. Russia has likely invaded Ukraine to prevent it from becoming a defence partner of the US and its Western European allies - NATO. Russia is not likely to attack NATO members who share a mutual defence treaty (Article 5 of the treaty). While a spill-over of conflict to another country is a risk that cannot be completely discounted, it is unlikely we feel.

Read Global Earnings Cycle Provides Support Amidst Uncertainty

The US and UK/EU have levied significant sanctions centred on the Russian banking/financial system. Although they have not halted Russian energy exports, which would risk a recession in the highly dependent European economy. Europe receives close to 40% of its gas supplies and 25% of its oil supplies from Russia – so Western leaders are unlikely to pull the energy sanctions lever.
We also think it is highly unlikely that Russia would significantly interrupt the flow of oil and gas exports to Europe, given its importance to the now constrained Russian economy.
Our base case is for only a very limited impact on global growth, with a more significant but still manageable impact on European growth.

The historical precedent stemming from most major conflicts is they typically do not have a long-lasting impact on asset market performance (see exhibits 5 and 6). On this basis, we may already have seen the lows in risk assets; however, a quick resolution in respect of this conflict appears unlikely. A prolonged conflict would extend tail risks in regards to a broadening war and/or a major disruption of energy supply. So, while the worst may be over for equity markets and energy market risk premiums, risk aversion is likely to stay somewhat elevated for some time.

Elevated energy prices are, of course, adding to near-term inflation pressures and will drag somewhat on medium-term growth (particularly Europe). However, prices are not elevated enough to shift our constructive core view of the global growth cycle and therefore equities. The current $111 Brent oil price is high, but current levels are unlikely to induce a recession. The Organization of the Petroleum Exporting Countries (OPEC) does have spare capacity to ease any further pressure if required.

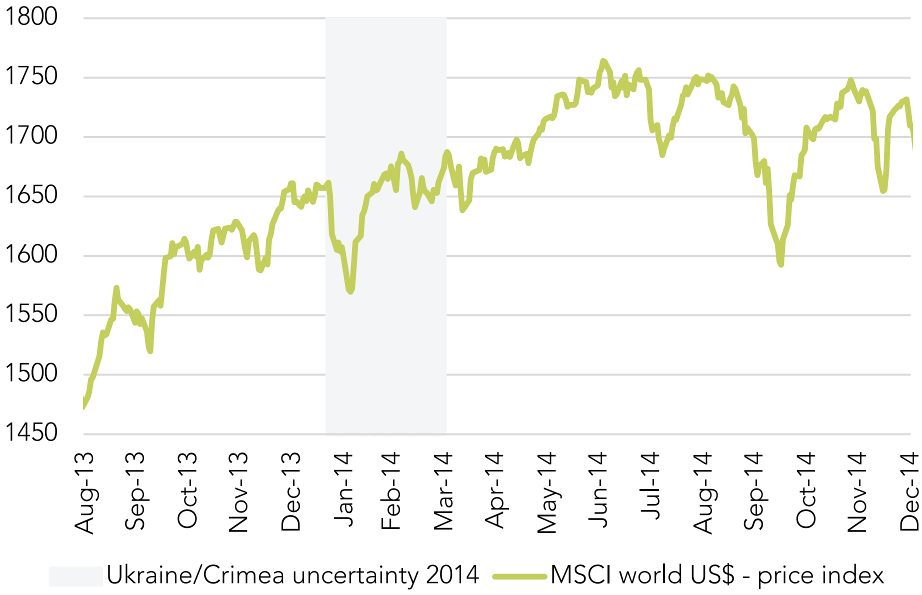
Inflation Still the Main Worry for Markets

The outlook for inflation and interest rates still appears to be the main risk factor for equities at this juncture. While the inflation pulse is global, pressures appear most acute in the US. The response of the US Federal reserve will be critical for global asset markets.

The Russian invasion of Ukraine has seen the US rates market reduce the expected pace of Fed rate hikes and take the chance of a 50bps start to the tightening cycle in March to virtually zero. This was ratified by comments by Fed Chairman Jerome Powell this past week.

The flattening of the US yield curve has also been a focus in recent weeks, though it remains "upward sloping" at just under 40 basis points. The US yield curve has a better track record of predicting recessions than most indicators (or most economists); however, we see some flattening as a normal part of the market's anticipation of a rate rise cycle. Importantly, a 30-40 basis point slope (2-year v 10 years) should be seen as a normal slope in a regime of low interest rates. In our view there is no real signal coming from the US yield curve at present despite some alarmist commentary from some quarters. We will continue to watch closely. Credit markets remain relatively well behaved. Spreads have widened from ultra-low levels but are not excessive. All-in US corporate borrowing costs have edged down a touch since the Russian invasion (See exhibit 2 and 8).

Exhibit 6: This war could be more protracted than recent conflicts



*Riots in Ukraine in Jan-Feb 2014, Russian Soldiers in on Feb 27 2014

Source: Refinitiv, Wilsons.

Exhibit 7: The oil price (Brent) has jumped on Russia's invasion of Ukraine

Source: Refinitiv, Wilsons.

Exhibit 8: US high yield corporate credit spreads have widened this year but are still around "normal" levels

Source: Refinitiv, Wilsons.

Our read on the US economy at present is that it is expanding at a very robust clip, and we expect it can withstand multiple rate hikes over the coming year. Market pricing of 6-7 rate hikes in the space of the next 12 months is still looking too aggressive in our view. Conversely, we still think market expectations for the terminal or peak cash rate in the US are too low (currently 2%), but this debate will likely play out over the next 2-3 years, not in the next 12 months.

We expect there will be enough fading in inflation pressures over the coming year to keep the Fed on a moderate tightening path. Equities should be able to move higher into a gradual tightening cycle over the next 12 months as they have in many previous cycles.

Of course, the risk of a more aggressive Fed tightening cycle remains a risk. The path of inflation over the rest of the year will frame market expectations in this respect. The next inflation reading due in mid-March is likely to take US inflation to a new peak. We expect moderation as the year progresses as supply chains and consumption patterns normalise. Still, the risk of stubbornly high inflation causing renewed concerns around the path of interest rates bears watching. US wages will also be important to watch for the potential to feed back into the underlying inflation pulse. Wage inflation has picked up in the US, but it is quite concentrated in low wage jobs rather than being in a broad-based spiral. Once again, we are alert to signs of a broader wages pulse.

Cautiously Constructive

Investors have a significant wall of worry to confront at present. This is nothing new in the grand scheme of market dynamics, although uncertainty is undoubtedly higher than average at present.

Importantly, equities are still supported by a strong global and domestic economy. The Russia Ukraine conflict has not as yet caused enough economic and financial stress to sway us from an upbeat view on global growth.

Inflation and the path of the Fed is still the key risk factor, though for now, monetary policy remains in a very supportive position. Our assessment is that the Fed will proceed relatively gradually, and the US economy is more than strong enough to cope. However, we remain alert to the risk that inflation proves stickier than we and the markets currently anticipate.

Investment implications

We remain overweight equities with a skew to Australia aided by a constructive view on commodities and the A$. We continue to favour the UK with the US and Europe now line ball. Fixed interest remains uninspiring though Australian bonds are likely approaching fair value. We continue to like floating rate private credit and continue to hold gold as an inflation and tail risk hedge.

Disclaimer and Disclosures

Recommendation structure and other definitions

Definitions at www.wilsonsadvisory.com.au/disclosures.

Disclaimer

All figures and data presented in this research are accurate at the date of the report, unless otherwise stated.

This document has been prepared by Wilsons Advisory and Stockbroking Limited (AFSL 238375, ABN 68 010 529 665) ("Wilsons") and its authors without consultation with any third parties, nor is Wilsons authorised to provide any information or make any representation or warranty on behalf of such parties. Any opinions contained in this document are subject to change and do not necessarily reflect the views of Wilsons. This document has not been prepared or reviewed by Wilsons' Research Department and does not constitute investment research. Wilsons makes no representation or warranty, express or implied, as to the accuracy or completeness of the information and opinions contained therein, and no reliance should be placed on this document in making any investment decision Any projections contained in this communication are estimates only. Such projections are subject to market influences and contingent upon matters outside the control of Wilsons and therefore may not be realised in the future. Past performance is not an indication of future performance.

In preparing the information in this document Wilsons did not take into consideration the investment objectives, financial situation or particular needs of any particular investor. Any advice contained in this document is general advice only. Before making any investment decision, you should consider your own investment needs and objectives and should seek financial advice. You should consider the Product Disclosure Statement or prospectus in deciding whether to acquire a product. The Product Disclosure Statement or Prospectus is available through your financial adviser.

Wilsons Corporate Finance Limited ACN 057 547 323, AFSL 238 383 may have participated in some capacity with regard to capital raisings for some of the companies mentioned in this article. To manage any conflicts of interest with Wilsons Research, full disclosure on any relevant corporate transaction may be found on our website.

Wilsons contact

david.cassidy@wilsonsadvisory.com.au | +61 2 8247 3149

john.lockton@wilsonsadvisory.com.au | +61 2 8247 3118

rob.crookston@wilsonsadvisory.com.au | +61 2 8247 3101

www.wilsonsadvisory.com.au