Psigma
Investment Management

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Brief View from Psigma

Regime Change and Volatility in 2022

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Introduction

Given the significant bout of market volatility and extreme downside pressure in certain investments this year, we thought a brief update would be useful. The start of the year has seen falls across most asset markets, with the combined world stock market down 4.6% and the UK government bond index losing 3.9% in January. We have also seen a major reversal in the fortunes of the recent leaders and laggards, with the previously omnipotent US market shedding 4.5% in January, with the much-loved Technology sector down much further, whilst the UK FTSE All Share "only" lost a much more respectable 0.3%.

Volatility is an investor's friend, not their enemy

Whilst volatility is "nerve-wracking" for investors, this is all part of a normal market cycle. What we saw last year, both in terms of the extraordinary confidence from investors and a managed market calm by central bankers, was abnormal. Our key message has always been to treat volatility "as a friend and not an enemy" and this philosophy will be key in 2022. We have been using the recent turbulence in markets as an opportunity to recalibrate our investment strategy and increase exposure to certain investments that have been unfairly treated.

The "Pandemic Trade" is now over

What we are now seeing across global asset markets is what we forecast towards the end of last year, which was detailed in our recent "Five Themes for 2022" update. It became clear in mid-2021 that markets had become increasingly dislocated from the reality of a near future that heralded slower economic growth, reduced potency of corporate profits growth, elevated inflationary pressures and, clearly most importantly for now, a marked change in both central bank attitudes and the environment for liquidity. Admittedly, what we didn't expect was that markets would carry on partying like it was 2020 in the last few months of last year, with some unexpected performance from specific investments. Maybe that was the "last hurrah" of the pandemic trade, but whatever it was, it appears over now. Previously favoured "growth" shares and government bonds have been hit woefully hard at the start of this nascent new year, with the darlings of yesteryear down materially. At the same time, there has been no solace in the supposedly protective high-quality bonds and the widely held duration-sensitive instruments, with new cycle highs in bond yields, new cycle lows in bond prices and some concerning performance. We are pleased to report that we have been positioned for these dynamics and have been able to protect against the worst of the losses experienced across major bond markets.

Central Banks bare their teeth

The causes of this onset of market troubles are the Central Banks and the growing concern over inflation. Over the last few weeks, we have seen a clear determination from Central Banks on both sides of the Atlantic to raise interest rates and act aggressively to curtail inflationary pressures. This is a major change. As a guide, the UK Monetary Policy Committee is now expected to raise interest rates another five times further, following on from the two recent increases, implying that UK interest rates will end the year at 1.75%. The significantly more important US Federal Reserve is forecast to act similarly.

A "regime change" dawns across markets

The ramifications for investors from this new-found determination from Central Banks are severe and imply a market "regime change", as we have been suggesting. Notably, parts of global asset markets that have been hugely inflated due to the loose monetary policy and investor complacency have been hit especially hard at the start of this year and the Central Banks have not softened their tone. Indeed, they have become even more resolute in their rhetoric. The question that we and all other investors should be asking ourselves is, how much market pain Central Banks are willing to take? Will they, as they have on every previous occasion since the Financial Crisis of 2008, back away if markets continue their recent declines? We can't answer this question definitively, but the difference here is inflation and the miserable impact it is having on the lower earners in society, as Central Bankers and politicians are finally admitting. Maybe, just maybe, the Central Banks will not ride to the rescue of investors this time.

Opportunities presented for investors

Schizophrenic financial markets, shifting central bank policies, inflation concerns and slowing growth were all central to the projections we made about 2022 during the second half of last year, and are all things we have tried to position for. We would expect this bout of volatility to persist, even if some of the hardest hit investments are starting to look attractive, and there will be major reversal days in both directions. We are about to add some selective positions in UK corporate bonds that have already reacted efficiently to the likelihood of future UK interest rate increases, offering attractive yields for nimble investors.

For those asking whether we have seen sufficient pain in equity markets already, we would suggest that a few weeks of volatility (albeit with some truly eye-opening negativity in the former market favourites) is not sufficient to offset the excesses that have built in some markets in the last few years. Our expectation is that we can continue to see pain in the areas of asset markets that have been inflated by the promise of never-ending central bank and government support, as well as zero interest rates. Some specific areas, such as renewable energy companies and other environmental themes, have already reached levels where we are comfortable increasing our allocations to a favoured long-term theme.

UK equities finally outperform

We must be clear and say that we are not overtly bearish on financial markets, but we are respectful of the fact that we believe that the "game has changed", at least in the short term. We continue to hold that the core view that we have held for the last six months of "most concerned about markets since at least 2018 and most optimistic on specific investments since 2015" remains true. Some of our clients have asked about the differential between UK equities and global investments in 2022 so far, and we would suggest that this is down to the idiosyncratic nature of the UK equity market. The UK equity market has a high weighting in banks and energy companies, which have performed well in 2022, a complete contrast to 2020 when the UK equity market was down 10% and global investments and standard Balanced portfolios made positive returns. Our portfolios are global in nature and the UK equity market is not a useful guide to how our portfolios might be performing, although we are pleased to see the UK market performing better. It has been a long time since outperformance from the UK market has been observed and there is a decent chance that this change in fortune might persist for longer.

Conclusion

To conclude, our key message is that this is not a time for panic. The overall behaviour in markets that we are experiencing is what we have been expecting. This market volatility will afford us refreshed opportunities for our clients' portfolios. Taking a "Balanced" and "Diversified" approach remains sensible. Plenty of tantalising areas for making clients' positive returns exist, but it could be that the end of 2021 finally brought an end to the impressively rewarding strategy of just owning anything, and that 2022 and the period ahead is a time for differentiation. This makes us very excited.

Please ask if you have any further questions and thank you for your ongoing support.

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For further insights from our CIO Tom Becket check out the Psigma Voice, our communication platform providing you with a variety of investment and market commentary.

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