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General Economic Overview – Quarter 1 2022

It would be impossible to ignore the factors that have driven asset prices this quarter. The two key elements have been the changing views on inflation and the Russian invasion of Ukraine. In the case of the latter, most western governments are supportive of the situation that the Ukrainian people find themselves in after the invasion by their Russian neighbours. Naturally this event led to a significant increase in volatility across both bond and equity markets, however after over a month of conflict, markets have made something of a recovery and volatility has fallen from the peaks seen following the initial invasion. Compared to the last quarter asset prices have seen significant movement but have finished with the S&P 500 down by around 2% (in sterling) year to date, which is probably better than expected.

2022 started in a reasonably positive manner with the only major concern being that of inflation and how the central banks would be able to negotiate a soft landing. Inflation data was coming in higher than expected and sticking around longer than expected leading to predictions of much faster tightening in western economies. The expectation of US rate rises went from around three in November 2021 to six / seven in the last month. In March we saw the first rate rise since 2018 from the Federal Reserve with confirmation that the unwinding of the balance sheet could commence as soon as May – the emphasis moving to taming inflation rather than supporting growth. With inflation at a 40-year high and the Fed's preferred measure of wage growth at its highest level on record the risk does seem to be skewed to the upside for monetary tightening. The Bank of England also raised rates on the 17th March by 0.25% to 0.75%. Inflation is expected to rise to 8% in Q2 and possibly higher with the impact of the invasion of Ukraine. The Bank of England were however less hawkish than the Fed on further rate rises with consumer confidence declining and the squeeze on household incomes much larger than a month ago.

With the concerns over inflation being linked closely to supply related issues, based on high consumer demand post pandemic, the invasion of Ukraine could not have come at more difficult time. This added level of uncertainty has ramped up the concerns that inflation will jump even higher because of shortages created in certain key sectors. The price of oil for example is currently around $100 a barrel (March 2022) but for a short period was close to $140. This type of volatility for commodities is bound to have an effect on consumer confidence and prices in the shorter term. Energy prices are already likely to go significantly higher this year and this recent crisis may well see a second round of increases. In Russia, the situation has created a significant problem for the economy with interest rates set by the central bank now at 20% and panic buying a feature in many regions. An initial rush to take out currency from banks has been mitigated by central bank action to raise rates. Inflation is high as the sanctions bite, particularly for businesses that import goods. There is the acceptance however that the initial inflationary hike might actually lead to less interest rate rises than currently predicted by the Fed and the Bank of England. The B of E has certainly become more dovish in its rhetoric and equity markets recovered towards the end of March partly in the belief that fewer rate rises will be needed because of a faster economic slowdown.

The threat to the global economy extends to the political landscape as those countries which are seen as allies to Russia, such as China and India, have yet to really commit full support, risking international condemnation as well as possible sanctions. China has an interesting position as it wants to continue to keep its geographical corridor open with Russia for energy supply in case other routes are cut off, but it also needs to trade with the West. India has similar energy requirements. Whilst the rest of Europe also has energy requirements, the threats raised by the crisis in Ukraine have raised the importance of a diversified supply which recent globalisation has tended to ignore. A move to more renewable sources

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will be the cornerstone for this but it takes significant time to switch this onto the grid, particularly in the case of nuclear energy. All of this has pushed commodity prices to 20 year highs.

There are no good outcomes from war, but most wars do end with a negotiated peace of some kind. How much this conflict continues to affect global growth will depend a lot on the time it takes to resolve. A long, drawn-out war will have a negative effect on global growth and probably speed up any recession that may be forthcoming from the already difficult inflationary conditions we face. It will make a central bank error more likely and a soft landing less likely.

Equity Markets

The first quarter of the year has not been great for investors, but it could have been much worse – a loss of around 2% on the S&P 500 is probably not too bad given the political situation at the moment. The theme at the beginning of the year was inflation and this has of course shifted to the implications of the war in Ukraine and the effect of sanctions and supply chains, especially in the energy sectors. This has meant very different levels of performance for sectors as the quarter has moved on. Ahead of the Ukraine crisis, energy stocks had been performing well, with the UK stock market performing more strongly than many others because of its old industry and energy bias. The US was weakening, as the technology sectors were badly hit, with the threat of inflation getting out of control and rates having to rise faster than expected resulting in a higher discount rate and reducing future profit expectations.

It is likely that the increase in volatility caused by the crisis in Ukraine will be present in markets for the time being. Confidence is very important for risk investors and the current levels of uncertainty will make investors more nervous and more reactionary to any negative news. Whilst the war continues, and sanctions are in place, economic data will be difficult to fully interpret as the cause may be temporary, but it may also have longer term ramifications which markets will incorporate in valuations. The longer the war goes on the more the uncertainty will continue. The world's largest economy, the US, is somewhat insulated from this but it is still influenced by energy prices which are on the increase. Returns from commodities have been strong, particularly oil and gas, but also gold and other rare metals such as nickel, with Russia a core global source. This is reflected in higher valuations for these companies across markets.

UK

The Chancellor Rishi Sunak finds himself in another difficult position as we saw from the Spring Statement. The UK finances were stronger than expected at the end of 2021 allowing for some additional flexibility for tax reforms, but the Ukraine crisis has changed this with the forecasts from the OBR for UK growth coming down to 4% from 6.5% for the year to October 2022. Inflation is now expected to peak at closer to 10% rather than 5% as predicted last October. This is likely to create a big squeeze on household incomes, the largest impact being from the increase in energy prices. The so termed 'cost of living crisis' will now take precedence with many calling for the increase in National Insurance due in April to be scrapped until this is over. There is no simple fix without increasing spending or lowering tax receipts which the Chancellor may yet be forced to do. The recent statement which lowered some costs, such as taking 5p off petrol duty, was seen as tinkering and not really having any significant impact for most of the population.

The annual rate of inflation has come in at 6.2% which creates a dilemma for the central bank (and indeed most western central banks) which is trying to tame prices without cutting off growth. Rates were raised in March by 0.25% for the third time in recent months but raising rates is not a subtle tool

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and increasing them too far could cut off growth in the future if the effects of the Ukraine invasion become greater and last for longer, particularly in Europe which would affect the UK due to its close economic links. Prior to the Russian invasion, the UK economic picture was looking quite strong – GDP grew 0.8% month-on-month in seasonally adjusted terms in January, which contrasted December's 0.2% decrease. January's figure marked the best result since June 2021 and came on the back of upturns in the services and manufacturing sectors. The unemployment rate registered 3.9%, down 0.2 percentage points from the previous rolling quarter. Experimental data for February showed that employment rose by 275,000 from January. Like many economies the shift of growth has moved from goods to services, as this sector recovers, and the PMI data backs this transition as areas such as hospitality and travel benefit.

US

The US continues to be more isolated from other economic regions and so has been less affected by the Ukraine crisis, given its more independent economy. Whilst energy prices have increased, they have not risen anywhere near as much as in Europe for example. The US are aware that this situation could worsen and as we have moved through the quarter there has been further intervention with President Biden announcing supply increases from the US strategic oil reserve to reduce supply pressure.

Inflation remains the main concern for policymakers as it hit 7.9% in February and there is a strong belief from Wall Street economists that the Fed may well raise rates by half a percent (double the previous 0.25% increases) at one or more of its forthcoming meetings to combat this. By contrast, economic growth is easing as the latest wave of Covid-19 cases and elevated inflationary pressures drag on economic sentiment. The unemployment rate ticked up in January and consumer confidence continued to fall in February, which should be stunting household spending although the latest data for consumer spending in January 2022 remained quite robust. The Chicago Fed National Activity Index also showed the strongest output expansion since October 2021. In the last week in March we saw a recession signal flag red as the two year treasury note rose above the ten year (albeit briefly) for the first time since August 2019. This yield curve inversion is seen by many as a negative signal about the economy's long term growth prospects and has preceded every US recession over the last 50 years. This time around it might not be such a reliable signal as yields have been manipulated by the huge bond buying programmes of QE.

Since the beginning of the year one of the features of the US equity market has been the levels of volatility and this has resulted in a change that has seen an increasing level of share buybacks. Companies have taken advantage of weaker prices (with shares falling 25-30%) to strengthen their position by propping up demand for their stock and increasing earnings per share by reducing the number of shares in circulation. The overall resilience of the S&P 500 has surprised many economists, although there may be delayed reasons for this that have yet to fully work themselves through the system.

The US is in a stronger position than many other regions with fiscal and monetary stimulus boosting consumer spending and confidence.

Europe

The centre of attention for most European politicians has been the events in Ukraine over the last few weeks, but prior to that it was the same battle with inflation that was present in other western economies. The ECB has been at the centre of much of the inflation debate and has been steadfastly dovish whilst other central banks have moved hawkish this year. This has changed recently, and

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although raising rates seems some way off, the language and actions have seen a shift. Different economies in Europe are moving at different speeds on interest rates – the UK has raised rates and more recently the Norwegian central bank also raised rates as its economy is booming at the moment.

Growth was always set to slow down this year after the pandemic recovery but looser restrictions, tighter labour markets and accumulated savings, coupled with EU fund disbursements and loose fiscal and monetary policies, could maintain activity. However, sustained inflation, prolonged global supply shortages, Russia's invasion of Ukraine and high public debts all cloud the outlook.

The invasion was clearly an unknown, but it has a greater chance of reducing European competitiveness because of its more immediate geographical effect. The most likely fallout is for the manufacturing sector, particularly German businesses which are more exposed and European PMIs may well fall below 50 which signals a recessionary environment in the short term. The war in Ukraine is on the European doorstep and raises the treat of a stagflationary shock raising prices and squeezing household incomes. The OECD has predicted a 1.4% point hit to Europe's economy in 2022 based on the effects so far. The effect on confidence is difficult to interpret but with 3 million refugees entering European countries (most notably Poland) the Union has a lot to deal with outside of just energy supplies. The ability for Europe to increase sanctions in areas like oil and gas is limited with Olaf Scholz, the German Chancellor, not prepared to move on this at the moment. The US is aiming to aid Europe by increasing supply from other sources, but this is not an immediate solution.

Asia & Emerging Markets

Asia was the first region into the initial pandemic and the first to come out of it and many countries benefitted from the strength of demand for manufactured goods in 2021 and going into 2022. This was especially true of China and to a lesser extent Vietnam. The latest Covid-19 variants have been more damaging to Asia compared to the rest of the world as in many countries vaccination rates lag the west and also the efficacy of the Chinese vaccines on both Delta and Omicron are weak. This has resulted in China now imposing more restrictions than western countries and this is affecting not just manufacturing sectors (which are key exporters to the west) but also the domestically orientated service sector. China and Hong Kong are both closed to visitors and the domestic population aren't able to travel internationally. China offshore equities (not the 'A' share market) were hard hit in the initial fallout from Ukraine with investors fearing the possibility of sanctions. This, combined with slowdown fears for the wider economy related to the property sector, has weighed on the market.

Within Asia the overall economic recovery has been mixed. India had shown signs of entering a prolonged economic upswing until the Ukraine invasion prompted a surge in the oil price which has impacted on the Indian market as the country is a major oil importer. Southeast Asia remains a strong long-term consumption story with economic performance stronger for commodity exporting countries such as Indonesia and Malaysia.

The 'Common Prosperity' agenda is driving a long-term rebalancing in the Chinese economy and will create both winners and losers, so there will remain opportunities for active managers to deliver positive returns. There does need to be an emphasis on businesses which are ESG focussed and show responsibility to all stakeholders. The authorities in China explicitly wanted to see a cooling in property prices even if this caused short-term economic pain, believing owning or not owning property was a driver of inequality in the country. There is also a focus on reducing emissions which in the short term has hit economic activity in certain industries.

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China is focussed on its 'Dual Circulation' strategy which is a refinement of the Made in China 2025 agenda, and this has an objective for the country of the creation of globally competitive domestic champions in key strategic sectors, whilst increasing the level of domestic consumption in the economy. This aims to reduce reliance on global macro forces (and western countries) with the aim of China becoming its own growth driver. If the economy does slow more than expected China remains the one major economy which did not resort to QE and it has the potential to further cut interest rates from current levels. China will now concentrate on the quality rather than the quantity of economic growth which perhaps surprisingly could provide an increase in profits for many companies as it will reduce the oversupply issues which hit margins even when GDP growth was averaging 10%.

India has benefitted from its post Delta variant economic recovery and has weathered the Omicron variant. The reform measures enacted by the Modi administration, such as the nationwide goods and services tax and the incentives to manufacturing businesses, are also helping sentiment towards India, where the long-term growth runway remains intact. Compared to its North Asian neighbours, India should benefit from the under penetration of many basic goods and services such as autos, retail and healthcare. The country's current account vulnerability had improved significantly, aided by the phasing out of expensive and wasteful fuel subsidies, but there are concerns once again about the current account after the surge in the oil price which has hit the currency in the short term.

Amongst the other Asian markets, the ASEAN region is no longer the market darling it once was, and valuations no longer trade at premium levels. As the effects of Covid-19 on their economies pass over time it seems safe to assume the long-term positive trend in domestic consumption will resume. As a result, whilst in the short-term, oil importers could see vulnerabilities highlighted there are now attractive opportunities for longer term investors. Indonesia continues to have favourable demographics and is a beneficiary of higher commodity prices. Malaysia too is a commodity exporter which should protect the currency against devaluation pressure. The Philippines has some attractive long-term opportunities and is no longer amongst the most highly valued in Asia. Many Asian countries continue to have competitively priced labour markets which have the potential to attract inward investment. Within Singapore many of the listed banks have exposure to the ASEAN region and should benefit from rising US interest rates and bond yields.

Within Latin America, Brazil has been a volatile market as rising inflation resulted in significant increases in interest rates in 2021 and the first quarter of 2022 which slowed the economic recovery. There remain concerns about the election due later this year with polls suggesting the return of a left-wing government under former President Lula. However, the market has recognised Brazil is a significant beneficiary of the Ukraine crisis as a commodity, and especially a food commodity, exporter and its currency has rallied significantly during the first quarter.

Chile has suffered from political turbulence and the election of a left-wing regime in a country which had previously shown high levels of political and economic stability, although it has not been able to shake off the regional problem of high levels of inequality which helps explain the election outcome. The country is an exporter of copper, a key component of the green energy revolution.

Within the emerging market region, it is important Covid-19 vaccination rates keep up with the developed world and also that they have a formula which can deal with newer variants such as Delta, Omicron and any other evolving mutations. This should allow scope for a further economic reopening and catch up over time although Ukraine-driven supply side shortages will reduce growth and increase inflation. Food inflation is always a risk and can be a cause of social instability and unrest.

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As well as the situation in Ukraine, a further risk to the region remains faster than consensus US monetary tightening which, if combined with a very strong US dollar, generally results in stock market and economic weakness. Overall, the region has raised interest rates ahead of the developed world in response to rising inflation and this should be a relative positive over the remainder of 2022.

Japan

The quarter started less favourably for the Japanese economy with Covid-19 cases on the rise and reaching record levels in early February, leading authorities to extend quasi state of emergency measures in a number of key prefectures. As a result, consumer sentiment turned more pessimistic during January and February, and the composite PMI tumbled back into contractionary territory in the quarter amid weaker domestic demand. More recently this has improved as cases have fallen and approval has been given to the most recent record JPY 108 trillion yen budget from the government to support households as energy and food costs escalate. Unlike other countries, the Bank of Japan has indicated that it will continue to support bond buying even as the yen has come under heavy pressure. The bank wants to keep a lid on medium term borrowing costs, in line with their yield curve control policy (YCC) where it keeps debt yields in a fixed range. The yen has fallen against the dollar because of this policy as the gap between bond yields with the US has widened. A cheaper yen means higher import costs and although that is good for Japanese exporters, the government also has a goal to limit the fall in the yen and may have to intervene in currency markets if it were to fall further. Following the recent lockdown there is an expectation that the economic growth picture will pick up as pent-up consumer demand is released, although rising inflation and higher energy prices will possibly dampen this picture.

There are also some other positive signs. Japan's newly created University Endowment Fund has caused some positive momentum for equity markets this quarter. It is starting with yen 5 trillion of AUM, with a near-term target of yen 10 trillion which would make it larger than the Harvard and Yale endowments combined. The reference portfolio has 65% in equities and 35% in bonds. If it were to follow the GPIF (government pension fund) model, that would suggest a holding of yen 2-3 trillion in domestic equities. Whilst not massive compared to the whole market, it is significant as it signals a confidence in equity market investment.

Overall the Japanese government faces a difficult task of managing the domestic economy as it comes out of the pandemic later than other countries at a time of rising global interest rates and slowing global growth and is also impacted by the Ukraine crisis.

Fixed Interest

The problems facing fixed interest investors are much the same as we reported last quarter although they have had a small reprieve as investors fled to areas of safety at the beginning of the Ukraine crisis. This saw yields fall back as investors sought to protect capital. The initial phase of the conflict is however over, and yields have started to rise again especially as interest rates rise in western markets with the US and the UK both raising rates in March 2022. Even without the Ukraine crisis, investors were facing the highest inflation figures in decades and well above central bank targets. The dilemma for central banks is how to tackle rising prices without choking off growth. Stagflation has been previously dismissed as a threat, but the effects of the events in Ukraine have brought this back into scope as an outcome under current economic forces.

Bond funds have all struggled year to date, with many of the most popular down around 5-7%. The main cause has been yields rising around 1% since the start of the year. Few parts of the bond market have

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been spared from the falling bond prices with this turmoil coming after US Federal Reserve chairman Jerome Powell's statements suggesting he wanted to return US monetary policy to a neutral stance quicker than previously thought. The Bloomberg Global Aggregate Index, a broad market-cap weighted index made up of government and corporate bonds, is down more than 7% year-to-date.

The message so far from the Fed and the ECB is that they will focus on inflation rather than growth which might mean they don't rush to support markets at the first sign of an economic downturn. Certainly, US bond yields at the short end have charged higher in recent months, rising to 1.92 from 0.8 at the beginning of the year. In Europe, short-term borrowing costs fell as the reliance on Russian energy supplies saw defensive assets in demand, and although they have now risen again the likelihood of higher rates in the short term is small. Supply led inflation requires a different strategy as higher short-term prices could dampen longer term inflation expectations as growth slows. The gap between long term rates and short-term rates is small leading to what is termed a flat yield curve which can signal that growth is about to slow. In recent days (up to the end of March) this has eventually led to an inverted curve, with short term rates being higher than long term rates, which can indicate a recession with central banks potentially having to cut rates (this is a long way off). The issue for central banks is the increased potential for a policy mistake in this environment.

Another threat in this situation is that of default from the Russian government and Russian companies. Russian debt is estimated to be $490bn according to the central bank of Russia. Of that $40bn is in dollar bonds which have plunged in value. Another $40bn is in rouble denominated debt and the fall in the rouble will have significantly reduced the value of these assets. Foreign investors also own $21bn of corporate debt, some of which is likely to default due to the new capital controls in Russia. Moscow has recently made an interest payment due on March 16th which may indicate a more positive situation in the short term at least.

In general, spreads have widened in the recent crisis which perhaps provides some opportunities, particularly in high yield investments but the trend for yields is upwards for the time being. There are arguments that in the short-term short duration assets are likely to be the best place for investors and can at least deliver some coupon ahead of holding cash. Other areas of opportunity are emerging markets, but this may depend on the pace of tightening in the US and its effect on the dollar, and careful country selection will be needed.

Some assets with higher rates have attracted investors, and emerging market debt has been one of these. Many emerging market central banks have hiked rates making them more attractive, and this should also help control inflation expectations. In Asia, especially in China, inflation has been quite low, whilst on the other hand certain currencies such as those used in Turkey and Latin America have seen significant depreciation which is a cause of inflation. The other big question for the region is monetary policy in the States and whether this was behind the curve. The pace of tightening will be important for the emerging world, not just the absolute level of rate rises, but if the pace of tightening is faster than expected then the emerging markets would be at risk.

Property

This quarter there was a definite difference between physical property returns and property shares. Physical property was for once ahead as equity markets fell on the back of the issues we have discussed in the sector analysis above. Physical property funds were up around 1-1.5% driven by further growth in rental values.

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The property sector had a strong 2021, as did most risk assets, but with the positive returns being very sector dependent. Following the trends already established, the areas that have been most positive so far in 2022 have been warehousing and residential property. Most physical property funds are heavily into the former but have less exposure to the latter where property share funds and REITS tend to have more exposure. In residential property, demand continues to outstrip supply and higher interest rates would make housing even more expensive to buy and build which will further choke new supply, making housing affordable to those with the lowest cost of capital (i.e. institutions). The rental businesses in all market segments should also enjoy robust growth. Distribution warehouses and London's industrial sector are set to see the highest investment returns over the next five years, at 11.6% and 9% respectively (source - Schroders), but shopping centres could also be set to make an unlikely resurgence.

The retail market still hasn't fully come out of the pandemic downturn but trends in this area are around the repurposing of existing units rather than maintaining past use. The office sector has seen confidence grow and is expected to see cyclical recovery, albeit structural trends may temper this somewhat – home working and flexible employment have changed the way in which offices will be used.

The Evergrande issue in China continues to be an issue for foreign investors and has seen downgrades from credit agencies with a knock-on effect on their ability to raise future capital for projects. In Hong Kong the recent Covid-19 outbreak has hit the price of property as demand has fallen and residents have left the territory.

REITs have struggled more this quarter with the same issues as other risk assets in the wake of the Ukraine crisis. Inflation has been reflected in the potential for rental upgrades as they tend to follow rate rises. The same areas of the market have performed well – industrials and warehousing with the addition of some residential developments.

Property has proven to be a decent source of portfolio gains in the last 12 months, and as we have seen this quarter has acted as a lower correlated asset to other risk assets in portfolios with a positive return. The issue as always is the liquidity for retail investors, and we have seen one fund, Janus Henderson, has taken the step of suspending ahead of its sale. We also await the FCA review which is delayed at the moment. Direct property can still offer low correlations to other asset classes so should not be ignored, but clearly practicalities need to be factored into any investment decision.

Investors are likely to remain focused on core, well-located retail space with secure and long-term income streams, underpinned by high-quality tenants. This partly reflects the normal reaction of companies to economic weakness, but also the pandemic's impact on working from home.

Summary

Despite market noise, investment is a risk management exercise and especially in times of uncertainty investors need to analyse markets in terms of the three market risk drivers. The first of these is economic fundamentals, the second valuation, and the third is shorter term in nature looking at market sentiment. Investment regimes can be highly important drivers of the return profile of financial assets. During the 1970s the world lived through an inflationary regime which changed with the appointment of Paul Volcker to chair the US Federal Reserve, whose tough inflation fighting credentials altered long-term inflation expectations, but only after instigating an economic downturn to achieve this through sharply higher interest rates. The question for investors now is whether the long-term investment regime has changed from that prevailing prior to the pandemic. As we suggested in the introduction, the two key themes looking forward are inflation and the Ukraine crisis, both of which are interlinked.

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The global economy was still seeing the aftershocks of the Covid-19 pandemic through supply chain disruptions when the Ukraine crisis hit. The problems facing the global economy are very different from the past 30 years where economic downturns have been caused by demand shocks. Monetary authorities, and more recently governments, have become more adept in dealing with demand shocks by aggressively reducing interest rates and adopting unconventional monetary policies including negative interest rates and quantitative easing. Governments realised the limitations of a reliance on monetary policy alone in a severe demand downturn by putting in place a very significant fiscal response to the pandemic. Central banks are currently grappling with how to deal with elevated levels of inflation and whereas traditional 60/40 (equities and bond) portfolios could cope with demand shocks as the bond element of portfolios rose in value, this type of strategy does not work in a supply shock as bonds and equities become correlated in a higher inflation environment. Equities suffer because of the higher discount rate applied to future corporate earnings, while bonds suffer due to the impact of higher inflation and interest rates on the nominal returns offered so bonds do not dampen down portfolio volatility at a time of rising inflation. Market returns in the post Covid-19 period have been mainly as a result of multiple expansions rather than driven by increases in corporate profitability and the market rating was likely to come under pressure pre-Ukraine. With the prospect of higher levels of inflation this pressure is only likely to increase in future years.

The primary driver of global financial markets in 2022 will be linked to the behaviour of inflation, especially in the United States. The annual rate of US price inflation has now risen to 7% and may reach 8.5% by the end of the first quarter when numbers are finally published. Market expectations remain that inflation will fall to around 2% sometime during 2023. In the UK prices rose over 6% in the 12 months to February and the Bank of England has warned inflation could hit double digits later this year due to rising energy prices. Even in the European Union, a traditionally lower inflation economy, the rate has risen to above 6%. In a response to the disinflationary forces from the GFC central banks had targeted policies to get inflation higher, but clearly did not expect the outcome now being seen. This urgency behind inflation has been caused by various economic shocks connected to the pandemic, mostly supply side issues. However, the unprecedented level of fiscal support to economies meant that compared to other recessions when supply might have been disrupted, demand remained strong, adding to inflationary pressures. Japan is the only major global economy where inflation rates remain below central bank inflation targets.

Investors need to isolate themselves from market noise and focus on what we argue are the three long term drivers of equity markets. The first of these are fundamentals which have now become much less supportive. The second factor is valuation and coming out of the pandemic, unlike the period coming out of the Financial Crisis, equity markets were at high rather than low valuation levels.

The third factor investors need to consider is short term market sentiment and this undoubtedly became overly bearish immediately following the Russian invasion, and with markets initially oversold any hint of a peace settlement was and remains likely to drive a short term rebound in equity markets. Once the euphoria from any peace settlement passes, investors will return to looking at economic fundamentals and valuations which argue for a more cautious and selective approach with lower returns than have occurred over the previous decade as asset prices adjust to the new investment regimes of higher inflation and heightened geo-political tensions over the next few years.

Given the events that have taken place this quarter it is perhaps surprising that equity markets have been as robust as they have – perhaps a mix of hope and faith as much as based on fundamentals? Global economic growth forecasts have been marked down but the effect on the global financial system has been limited with global equity indices now higher than pre-war levels. There is a view that there

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could yet be some nasty surprises still lurking and it is probably a little early to be declaring victory over volatility. As Carmen Reinhart the World Bank's chief economist noted, 'contagion moves in mysterious ways'.

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