

*Market Report -
inflation, interest rates & volatility*

28th January 2022

Market Report – Inflation, Interest Rates and Volatility

Considering the recent market activity, I thought that it would make sense to send out a note that attempts to explain why we are experiencing such volatility before our next interim update call in February. Hopefully by then the news flow will be clearer, but in the meantime, we remain vigilant and continue to stand by our sentiments expressed in our Macro Economic Report earlier this month – we remain steadfast that we should keep a longer-term perspective amid shorter term fears.

The Fed and the US economy

The main issue is not necessarily that we are going to see an increase in rates, or indeed the removal of the liquidity, but that the Federal Reserve (Fed) may make a mistake as it raises interest rates to fight inflation and that the rate rises are higher than expectations.

News that the US economy grew faster than expected in the fourth quarter gave shares an initial lift on Thursday, but the gains faded away, underscoring that the Fed's plans for higher rates remain a major risk. So far, earnings reports have looked fine. Three-quarters of companies have beaten earnings estimates in the fourth-quarter reporting season thus far.

Positive economic data initially helped sentiment. Growth in GDP for the fourth quarter was 6.9%, beating expectations for 5.5%. Initial weekly claims for unemployment benefits slipped to 260,000, better than the expected 265,000 and lower than the prior result of 290,000.

Importantly, the GDP number also included a heavy dose of spending by companies to rebuild their inventories. Spending on inventories contributed the highest portion of GDP growth since 2020, as higher corporate inventories of goods could help reduce inflation. That could mean that, while the Fed is ready to increase rates, it may not do so as quickly as some fear.

The main issue as I can see is that there are just too many commentators debating how many and how high the Fed will go and so whilst there is still uncertainty about the direction it adds to the

risk. The Fed may have a playbook for how it plans to tackle inflation and keep the economy humming along, but as any sports fan knows, the best coaches always have to adapt to what's happening in the game. Sometimes, the strategy has to change. Investors understandably don't love that approach, and that's why there's a disconnect between the Fed's intentions and how the market reacts.

Chairman of the Fed, Jerome Powell, said that the economy is strong enough to handle several increases. The markets have known for months that rate increases are on the cards, but investors appear to have been spooked as he appeared to take an increasingly hawkish (1) tone. For most of the pandemic era it was doing whatever it took to support the economy and markets, and now it is reversing that policy.

- (1) An inflation hawk, also known in monetary jargon as a hawk, is a policymaker or advisor who is predominantly concerned with the potential impact of interest rates as they relate to fiscal policy. Hawks are seen as willing to allow interest rates to rise in order to keep inflation under control.

The stock market is still showing signs of wariness. The S&P 500 is trading below its 200-day moving average, a sign that investors are not yet confident enough to buy stocks at prices consistent with their longer-term trends. And even once the index rises above its 200-day moving average, we might have multiple resistance points so it's not going to be an all clear to buy stocks.

The market as a rule doesn't like uncertainty. It is incapable of coming to grips with the fact that there is still a lot that we don't know about where the economy is headed in the short-term. "Making appropriate monetary policy in this environment requires humility, recognizing that the economy evolves in unexpected ways. We will need to be nimble so that we can respond to the full range of plausible outcomes," Powell said in his press conference Wednesday.

Equities v Interest Rates

The main issue is that equities have a sensitivity to interest rates. Growth companies (tech mostly) do very well when interest rates fall. Cyclical companies do well when interest rates rise (as it is usually associated with economic growth).

As we have written before, there is a bubble in growth stocks in the US. As interest rates rise, they will be hit because they are so sensitive to rate movements, in the same way a 30-year bond is more sensitive than a 1-year bond.

Inflation is a problem as well and I think that the equilibrium will be higher than 2%, so more like 3% and that makes a difference to a lot of assets. There will be a continued weakness in growth/Tech/Crypto, SPACs and expensive stocks. Value and Cyclical stocks so therefore do better.

So investors have to begrudgingly get used to the idea that the Fed is going to raise rates as long as inflation remains a problem. Powell isn't going to get bullied into keeping rates on hold. The only thing that would change the central bank's approach is if the job market and the broader economy suddenly cools. That's what happened four years ago, when consumer spending slowed as rates rose. It will take more than a stock plunge to convince the Fed that more rate hikes are unnecessary.

The good news is that stocks could still move higher even if the Fed is more aggressive with raising rates, as long as companies continue to post solid sales and profits.

While the Family Office may not appear officially on an organisation chart detailing the family's business holdings, it will frequently operate as the strategic catalyst for the family's various enterprises.

Conclusion

We remain cautiously optimistic but can expect more volatility, especially in the early months of 2022. Furthermore, when talking to the investment managers in the last couple of weeks they are in unison that the first half is going to be volatile but importantly the second half looks much better, mainly based on the world economy continuing to be strong.

The upbeat comments from Chair Powell on the US economy are also consistent with the view that economic growth should remain well above trend in 2022, even as the Fed begins to tighten monetary policy. This supports equities over fixed income, with a possible cyclical bias within US equities favouring Value (over Growth) and mid-cap stocks.

Our baseline forecast is that the global economy gradually transitions from a highly unusual pandemic recovery to a more normal expansion starting in 2022. During this transition, demand slows while supply rises, growth shifts from very rapid to merely solid, activity rebalances from goods to services, and inflation moderates. Monetary policy shifts from highly accommodative to slightly more normal, although the normalization speed varies greatly by economy.

We are not out of the woods yet but note the volatility has been caused mostly by uncertainty, and that uncertainty is rising interest rates.

We remain steadfast that we should keep a longer-term perspective amid shorter term fears.

Mark Estcourt

CEO



CAVENDISH

— FAMILY OFFICE —



www.cavfo.com

Cavendish Family Office (London) Ltd Registered in England No. 11213617
Registered Office at 1st Floor, 3 Sharrow Lane, Sheffield S11 8AE
VAT Number - 327 7076 88