Are We There Yet?

As central banks rush to raise rates to cope with high levels of inflation, the game has changed.

To anyone who ever travels with children, the incessant question "are we there yet?" will be a familiar refrain that punctuates any long-distance car journey. It's certainly a favorite of my seven-year-old daughter.

Now, I find myself sounding like her. That's as I look at the dramatic declines across fixed-income and equity markets and think about whether markets are now cheap enough for us to increase our tolerance for investment risk.

So, are we there yet? The answer right now is "not quite yet."

The Game Has Changed

As I've discussed in past commentaries, the challenge is that rising interest rates represent a major regime change after years of quantitative easing.

This policy, which saw central banks such as the US Federal Reserve buy trillions of dollars' worth of bonds, resulted in interest rates being pinned at zero with the intention of encouraging borrowing and supporting markets. It meant that investors searching for yield and returns were forced up the risk curve—that is, into riskier assets.

I see this as being like a game of whack-a-mole, the arcade game in which players must be on the lookout for moles popping out of holes to quickly whack on the head with a mallet. When you hit one, it disappears, and another appears elsewhere.

In the market, the parallel is that any hint of yield that has appeared in recent years has been quickly met by a wall of money from investors looking to escape negative real rates. When one investment becomes overdone, everyone starts looking for the next one. Against this backdrop, volatility was suppressed, and any traditional concept of valuation went out the window.

As central banks now rush to raise rates to cope with high levels of inflation, the game has changed. We're moving from whack-a-mole to a game of chess. Investors face a more strategic, adversarial challenge, in which the opponents are the central banks.

Price Check

For now, central bankers aren't looking to support markets, but to quell inflation on Main Street. This means we need to find a new equilibrium for valuations against a backdrop in which the disinflationary maps of the past might not work in the future.

The good news is that valuations have improved on many metrics. Our fixed-income investors in particular now see value in the level of bond yields after a torrid period for bond markets in which yields have surged (prices fall as yields rise).

For our multi-asset team, this is more of a relative assessment. Certainly, bonds are less vulnerable to the risk of recession than equities, where we believe that uncertainty around earnings is still not adequately reflected in valuations.

Insight from sub-adviser Schroders Investment Management

Johanna Kyrklund
Group Chief Investment Officer and Co-Head of Investment

Key Points

- Investors now face a more strategic, adversarial challenge, in which the opponents are the central banks.
- Our quantitative models that assess where we are in the economic cycle are pointing to a shift into the slowdown phase.
- Investors should consider remaining focused on their strategic plan, nurture the resilience of their team, and avoid over-steering.

Our quantitative models that assess where we are in the economic cycle (to which there are four stages: recovery, expansion, slowdown, and recession) are pointing to a shift into the slowdown phase, when earnings expectations are disappointed. This is typically the most challenging phase of the cycle for equities, and so we remain underweight.

Recognizing that growth risks are increasing, the multi-asset team has also closed its overweight position in commodities due to concerns about demand destruction in the energy sector.

Within our equities exposure, the multi-asset team has moved to overweight in China compared to developed markets. With our concerns about rate increases dominating our views in other markets, the likelihood of looser monetary policy in China presents us with a relative opportunity. We also continue to have a bias toward value as a style.

Lessons From Previous Bear Markets

Rory Bateman (who leads Schroder's Investment Division with me and is our Global Head of Equities) and I were discussing what we've learned from our experience of previous bear markets.

First, as valuations adjust to a new equilibrium, we could see strong bear-market rallies, in this case particularly if inflation shows signs of peaking. Investors need to ensure their decision-making process is dynamic enough to cope with this or consider diversifying risk to avoid being whipsawed.

Second, potential valuation opportunities tend to emerge in recessions. So as the growth picture darkens in the next few months, consider not getting too bearish!

And finally, in volatile markets you are more likely to make expensive mistakes. Investors should consider remaining focused on their strategic plan, nurture the resilience of their team, and avoid over-steering.

Hopefully, by the time I come to write my next market outlook, we will have stopped asking "are we there yet" and can start asking "where next?"

Talk to your financial professional to learn more about positioning your portfolio amid market uncertainty.

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