Advisory Portfolio Service

Markets Bulletin 3rd May 2022

Market volatility, inflation and global growth concerns

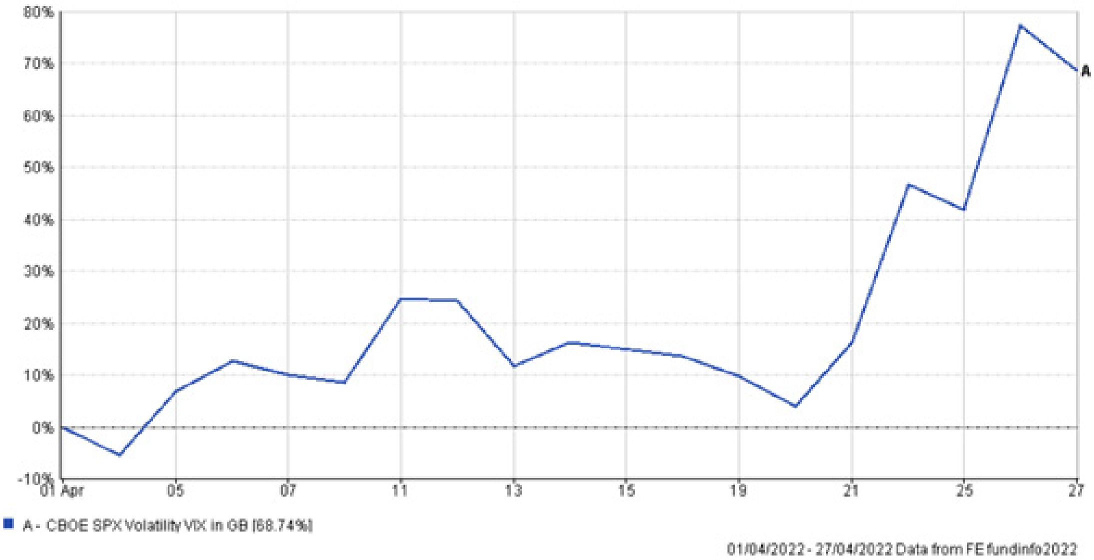
The first quarter of the year has been difficult for both equity and bond markets. Concerns over the economic implications of the Russian invasion of Ukraine and the potential need for a faster pace of interest rate hikes to combat higher inflation, weighed on both equities and bonds.

As was detailed within our bulletin of 18th March 2022, Russia is a major energy and commodity producer and combined Russia and Ukraine produce 30% of the world's wheat. Globally, the escalation of tensions between the two countries has pushed energy and commodity prices to extreme levels, intensified the pressure on supply chains and accelerated the rate of inflation. These factors combined are risking global growth and increasing the possibility of recession.

The first quarter was also hard for Chinese markets. The main concern was related to a new outbreak of Omicron and subsequent lockdowns in Shenzhen, Shanghai and other cities. China has continued with its zero-tolerance approach to the virus, however these lockdowns are further impacting the global supply chain, which as stated is already under significant pressure. Beijing is the current city of concern, with mass testing being instigated and the possibility of several areas of the city being locked down increasing.

Developed markets did recover some of their losses during March, ending the month up about 3%. The second half of April did however see volatility return to markets, as Federal Reserve chair Jay Powell confirmed that a possible interest rate rise of 0.5% in May is on the table. Markets are now weighing up the possibility that further 0.5% rate increases could also be implemented as the year progresses.

Market Volatility April 2022



Burley Fox Limited 20 Cathedral Road, Cardiff CF11 9LJ
Tel: 029 2167 9770 Email: info@burleyfox.com

The Federal Reserve, as with any of the central banks, raise interest rates to slow down the economy by moderating growth, which in turn should manage inflation. By increasing rates at pace, the goal is to quickly reduce the level of spending by both consumers and companies. The risk is however that growth could be slowed to a level that pushes the economy backwards and into recession.

Over the last few weeks markets have also been closely watching the U.S. Treasury yield curve for signs of a recession in the U.S. The yield, or return, from a bond increases with the time to maturity. So, a bond with a longer period until it matures, for instance ten years, should have a higher yield than a bond that matures in two years. That's because there's more time for things to go wrong before you get your money back, so you want a higher return for longer-dated bonds to compensate for the additional risk you are taking.

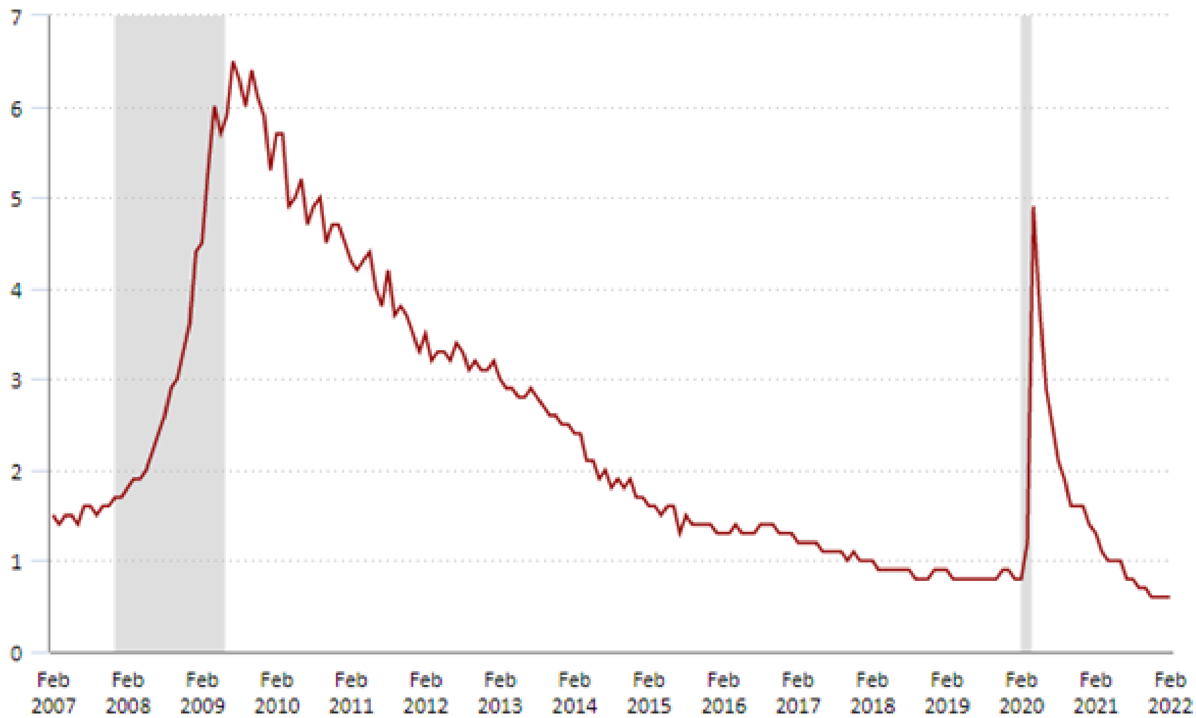
At the end of March, the two-year US Treasury yield rose above that of ten year Treasuries — or 'the curve inverted' — for the first time since 2019. When yield curves invert, they typically spell trouble ahead for longer-term economic prospects: that's because shorter-term two year yields move with interest rate expectations, while the ten year yield moves in line with inflation and growth expectations.

Yield curve inversion seems to be advising that investors think Fed efforts to tame inflation with rate rises will stall economic growth. Inversions have preceded every US recession for the last 50 years. Some think it's a less reliable warning sign nowadays and the downturns predicted by past inversions have often taken quite a while, up to two years, to materialise.

The inverted curve is however not the only signal that markets and the fund houses that we utilise within our portfolios use to analyse the probability of recession in the U.S. The actual definition of a recession is two consecutive quarters of negative economic growth and one of the main concerns around a recession is that it increases the level of unemployment.

As can be seen from the chart below, the level of unemployment in the U.S. is currently very low. What is also not shown on this chart is that the number of job openings in the U.S. has been increasing since 2020. With a low level of unemployment and an increasing number of job openings, the figures suggest that a steep rise in the level of unemployment in the U.S. is by no means imminent and that a recession in the U.S. is not around the corner.

U.S. Number of Unemployed Per Job Opening



Source: U.S. Bureau of Labor Statistics.
Shaded area represents period of recession, as determined by the National Bureau of Economic Research

This is a view that is taken by many fund houses, however Artemis believe that the biggest risk to markets today is that financial conditions fail to respond in the way that central banks expect. A point that they make is that fighting central banks is generally not a good idea. If markets continue to ignore the Federal Reserve, then it will become more forceful. Therefore, there is the risk that the Federal Reserve could increase interest rates quicker than markets expect. This could lead to the final rate of this rate hiking cycle being higher than markets are pricing in, which in turn could trigger a recession.

We are now well into reporting season in the U.S. and first quarter earnings across sectors and companies have come in better than what was expected. Financial reports and updates from some of the mega technology firms have however disappointed, sparking further volatility as shown in the earlier chart. Apple's earnings revenue for the first quarter beat market expectations, however a call post the announcement saw share prices fall as executives highlighted supply chain issues affecting their ability to meet customer demand. Amazon announced its slowest ever quarterly revenue growth, which it attributed to falling online sales and rising costs. Share prices in streaming and media companies have also seen significant falls this year with Netflix falling 67%, Facebook 39% and Google (Alphabet) 18% as at 28th April.

Over the last few weeks market sentiment has been changing on a daily basis, swinging between positive and negative performance. Investors are trying to predict the future trajectory of the Federal Reserve and how their decisions shall affect company performance, the U.S economy and the consumer. As stated, a recession in the U.S. is not expected to be on the horizon, however there are a number of economic and geopolitical factors that could change this outlook. The Federal Reserve themselves could also bring on a recession if they increase interest rates too fast and stall economic growth, as predicted by the inverted curve.

Until we start to see global rates of inflation fall and have a greater understanding on how central bank policies are affecting global growth, we do not expect to see stability in markets. The war in Ukraine also continues to affect many aspects of the global economy bringing additional instability and increased volatility.

As we have continued to advise throughout this year, remaining invested at this time and focusing on your long-term investment objectives is the best course of action.

Should you have any queries or concerns, please do not hesitate to contact your Investment Director.

Kevin Hunt, Dip PFS, Cert PFS (DM)
Investment Manager
Technical Team

Burley Fox Limited 20 Cathedral Road, Cardiff CF11 9LJ
Tel: 029 2167 9770 Email: info@burleyfox.com

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https://www.burleyfox.com/documents/BFL-Privacy-Notice-2018-V1.pdf

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