Multi asset: Recessionary conditions good for bonds, but the equity bear market isn't over

by Trevor Greetham

ROYAL LONDON
ASSET MANAGEMENT

Trevor Greetham
Head of Multi Asset

Trevor Greetham is an investment strategist and fund manager with 24 years of experience. Prior to joining Royal London Asset Management in 2015, Trevor was Asset Allocation Director for Fidelity Worldwide Investment, where he was responsible for implementing tactical investment decisions across a wide range of institutional and retail funds. From 1995 to 2005, Trevor was Director of Asset Allocation for Merrill Lynch, advising fund manager clients on their multi asset investment strategy. Trevor qualified as an actuary with UK life assurer Provident Mutual and has a Master of Arts in Mathematics from Cambridge University.

A relic of the 1970s, Stagflation, returned to haunt financial markets in 2022. Broad diversification was very beneficial, with inflation hedges like commodities surging and commercial property posting solid returns. For balanced funds investing only in stocks and bonds, there was nowhere to hide. Bonds suffered a once in a generation crash as central banks hiked rates to counter double-digit inflation, despite a slowdown in growth.

Higher bond yields, in turn, saw growth stocks de-rate with global equity markets seeing their worst year since 2008 in local currency terms. Much of this pain was offset for UK investors by a slide in sterling which raised the value of overseas assets – and this currency effect helps to explain why many bond-heavy 'low risk' portfolios saw much larger losses in 2022 than those with a higher equity exposure. We believe that inflation is set to drop as economies move into recession and this should benefit government bonds over 2023. Equity investors may need to be patient. The earnings recession is yet to start and, if history is any guide, we could see a second leg downwards in stocks which could be amplified for UK investors if dollar strength reverses.

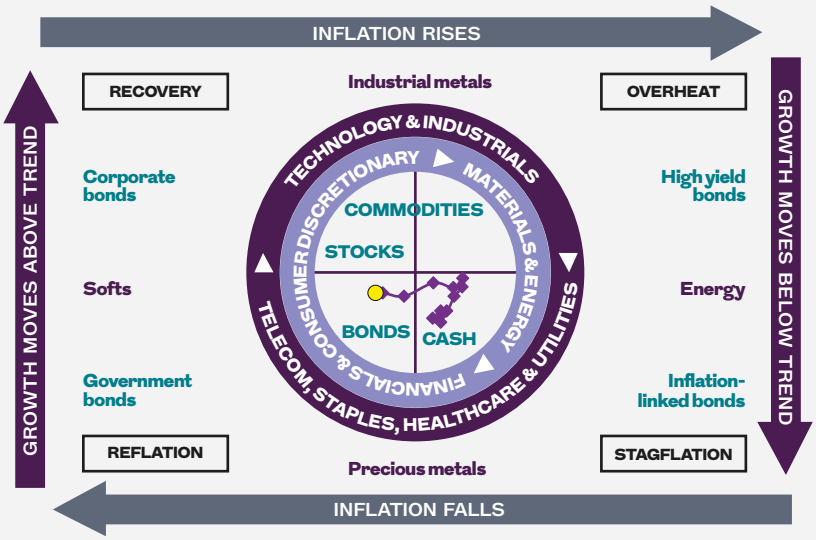
The move from low, stable inflation to high inflation was caused by the pandemic and the policy response to it. When Covid-19 hit in early 2020, governments asked people to stay at home to reduce transmission. Without further intervention, the Great Lockdown would have caused a collapse in consumer incomes and corporate cashflow, so it made total sense that monetary and fiscal policy was eased aggressively. The problem came in the recovery. Wartime levels of fiscal and monetary stimulus were left in the system far too long. Re-opening saw a rapid bounce back in activity into a supply-constrained world economy, with surging inflation the result.

Strong growth and rising inflation over 2021 would, in normal circumstances, have seen central banks raise interest rates but they were reluctant to remove stimulus in case another lockdown was necessary. As recently as December 2021, they were publishing 'forward guidance' suggesting they wouldn't start raising interest rates until mid-2023. The thinking was that tighter policy was risky and the spike in inflation would be 'transitory'. This view was shattered by Russia's February 2022 invasion of Ukraine and the associated increase in energy prices, leaving central banks scrambling to raise interest rates.

Our Investment Clock, linking asset class returns to the stages of the global business cycle, spent most of 2022 in Stagflation, with growth slowing and inflation rising. This combination has historically been bad for both stocks and bonds, and 2022 was no exception (figure 1).

During the disinflationary four decades from 1980 to 2020, recessions were rare and central banks were generally on the side of investors, cutting interest rates in times of trouble. You have to go all the way back to 2000 (in the US) or 1990 (in the UK) to find a recession that was caused deliberately by central banks in an attempt to create spare capacity and bear down on inflation. This is what we see ahead.

Figure 1: The Investment Clock moving into Reflation



Source: RLAM. For illustrative purposes only. Trails shows monthly readings based on global growth and inflation indicators. Yellow dot is the current reading as at November 2022.

There is some good news. There are early signs that inflation may be peaking, with traded goods prices dropping and global supply chains opening up. This would move the Investment Clock from Stagflation to Reflation, the best stage of the cycle for government bonds. Falling real interest rates, lower inflation expectations and eventual central bank rate cuts are all positive for the asset class. We were strongly underweight bonds in early 2022 but we expect to move overweight tactically as inflation drops. We also expect to add to bond exposure in strategic asset allocation reviews. High allocations made little sense to us when yields were close to zero but at current levels prospective returns are much improved.

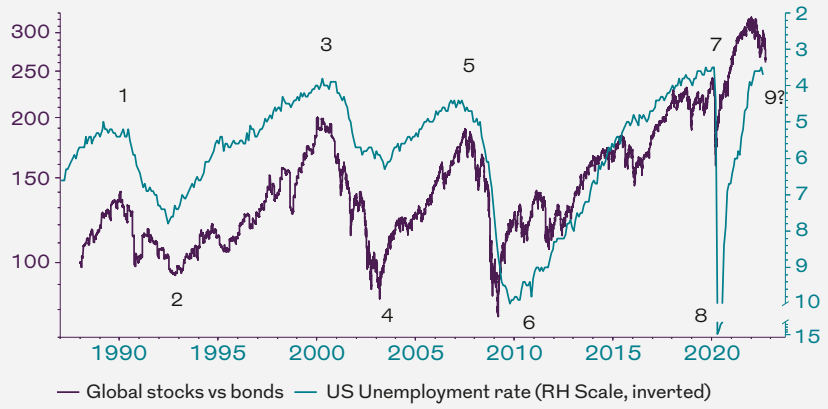
In the UK, the Sunak administration looks set to deliver spending cuts and tax rises just as rate hikes take effect, a deflationary mix that could make gilts particularly attractive. This makes us cautious about economically sensitive UK assets like commercial property, where we have moved underweight. Gilts went into a tailspin when the short-lived Truss/Kwarteng government announced a massive easing in fiscal policy. We are at risk of going to the other extreme with a new round of austerity. Lower gilt yields can signal policy credibility, but can also signal an over-tightening of policy. In our view, spending cuts should be back-end loaded or their scale reduced by credible policies that boost growth – fixing the trading relationship with the EU, for example.

While the prospects for bond markets are brightening, there is still some way to go before we can get bullish about equities or credit markets. The fall in stocks in 2022 can be explained by the sharp rise in bond yields, with interest rate sensitive growth sectors like technology hit hardest. While a turn downwards in bond yields may support a bear market rally, we don't think stocks have priced in a global recession. Analysts have only just begun to downgrade their earnings forecasts. A large drop in corporate earnings is ahead and history suggests it could result in a second leg of the bear market as well as a default cycle in credit markets.

In keeping with the Investment Clock approach, we believe equity bull and bear markets are closely linked to the economic cycle. To illustrate this, we plot the performance of global stocks versus global bonds against the US unemployment rate, shown inverted (figure 2).

- Bull markets usually start in the depths of recession, when unemployment rates are at their peak and about to fall – points 2, 4, 6 and 8 on the chart.
- Bear markets usually start at the end of an economic expansion when unemployment rates are at their lows and about to rise – points 1, 3, 5 and 7.

Figure 2: Global stocks vs Bonds and US unemployment rate (inverted, RHS)



Source: Refinitiv DataStream as at 31 October 2022.

It's hard to argue, looking at this chart, that the current bear market is over. In fact, it's hard to argue the bear market, as it relates to the coming recession, has even begun. We don't expect a new bull market to start until unemployment rates peak and that could be a year or more away. The last two central bank-induced recessions we associated with four- and three-year bear markets, respectively.

With such a high level of uncertainty about the future, general investment principles are more important than ever. This year has been difficult for passive multi asset funds investing in a simple mix of stocks and bonds. While inflation is likely to drop in a recession, structural changes, from underinvestment in energy capacity to de-globalisation and populism, suggest it will keep coming back in the years to come. Broad diversification, including inflation hedges, will remain important, as will tactical asset allocation. Business cycles are likely to be shorter and more violent than they were in the disinflationary past and this will create opportunities for active managers.

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Royal London Asset Management
55 Gracechurch Street
London EC3V 0RL

Business Development Support
bdsupport@rlam.co.uk
+44 (0)20 3272 5950

For institutional client queries
institutional@rlam.co.uk
+44 (0)20 7506 6500

For any queries or questions coming from EEA potential investors, please contact:

Javier Igartua
FundRockDistribution S.A.
9A rue Gabriel Lippman
Luxembourg-L-5365, Munsbach
+352 691 340 728
Javier.Igartua@fundrock.com

www.rlam.com