Ninety One

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Multi-Asset Strategy Quarterly

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Foreword

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Welcome to our latest Multi-Asset Strategy Quarterly. In this edition, Sahil Mahtani explains why the mantra of investing in so-called 'hard assets' during inflationary environments has a number of pitfalls. Philip Saunders then discusses the dramatic policy shift towards defence and energy spending in Europe, and Russell Silberston reviews the policy announcements by the major central banks over the past quarter. Finally, we close with a succinct summary of our higher conviction asset class views, beginning with equities, moving on to fixed income, currency and closing out with commodities.

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Inflation: Why the 'hard asset' mantra needs a rethink

Sahil Mahtani
Strategist

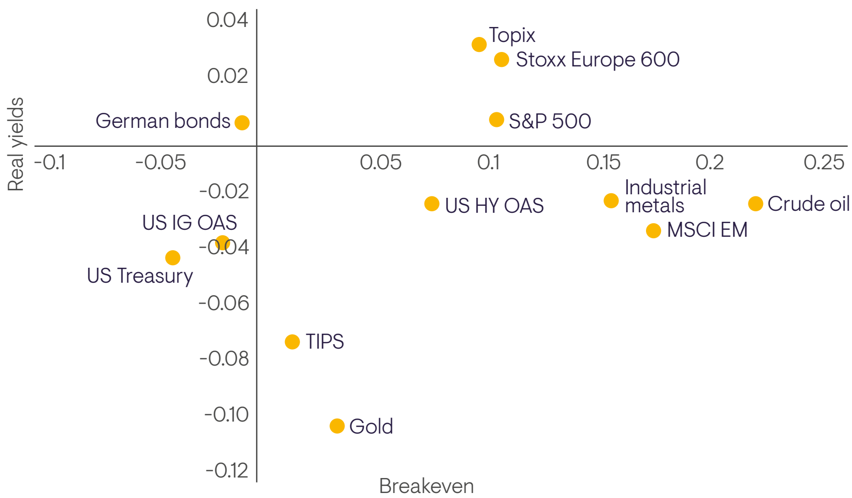
In the US, inflation averaged 1.7% per year during the 2010s, compared to 2.5% during the prior decade. Low inflation and accommodative monetary policy underpinned an unusually long bull market for stocks, falling yields for bonds and a strong negative correlation between the two asset classes. In that environment, stock and bond portfolios generated strong positive real returns.

Yet inflation over the coming decade is expected to be closer to the experience of the 2000s than the 2010s, and perhaps higher. While downside risks remain, the more dominant drivers are aggressive monetary and fiscal easing and high energy prices, which were rising even before the Ukraine conflict. This is compounded by longer-term factors like increased investment spending from green investment, stronger working age population growth in the US, not to mention the triumph of political populism in a number of countries, which has encouraged higher public spending, higher defence spending, and more capital-intensive supply chains. In other words, the post-pandemic world could herald a different inflation regime.

The 'hard asset' mantra

Navigating such an environment is not easy. Certain assets have historically done better or worse under different macro regimes, as shown in the chart below which shows the sensitivity of asset performance to changes in market measures of inflation and growth. For example, breakevens data – a measure of investors' inflation expectations – over the last two decades suggests that in an environment where prices are set to rise, investors should be overweight oil, emerging markets, industrial metals, and equities while being underweight treasuries. Hence the mantra of buying real, tangible assets, also known as 'hard assets', rather than financial assets.

Sensitivities to real yields and inflation expectations by asset class



Source: Ninety One as at March 2022 (data since 30 January 1999). US IG OAS = US investment grade corporate option-adjusted spread; US HY OAS = US high yield option-adjusted spread; TIPS = Treasury inflation-protected securities.

But it is not as simple as that.

The conceptual distinction between real or hard assets and financial assets is messy. Some financial assets undoubtedly have claims on real assets. Equities, for instance, may own tangible, physical assets. Similarly, a physical gold ETF, or a royalty company, is a claim on underlying physical assets or cash flows resulting from the sale of those physical assets. Meanwhile, financial assets like inflation-protected securities can protect wealth in real terms despite no physical asset backing. The distinction between hard and financial assets is probably a legacy of an economic world tethered to a gold standard. In today's heavily financialised world, real assets and financial assets are fundamentally intertwined and it makes little sense to define assets by whether they have physical backing or not.

Stick to the basics

Investors should be sceptical of historical analogies. We have a very limited dataset of asset class returns at our disposal — typically a single-digit number of decades worth of data. In particular, inflation-linked bonds that are used to indicate real rates have only existed since 1981 (UK), 1997 (the US) and 2006 (Germany) — none of those encompassing major inflationary episodes. Meanwhile, expectations have been anchored since the 1990s.

Crucially, it matters what is inflating. In the 1970s inflation episode, high money supply growth interacted with scarce oil resources, exacerbated by wage growth from union intransigence in some countries, lifting inflation expectations in the public. Today, the drivers of inflation appear to be tilted more towards supply chain disruptions, natural gas more so than oil, and wage growth from shrinking labour force participation. It may also be the case that we are not in a world of ever rising inflation but one of higher inflation volatility. In other words, inflation exhibits large or persistent upside or downside inflation surprises.

A dubious distinction

Some parts of the conventional answer for portfolios make complete sense. Sovereign bonds in the US and Europe are highly priced, generate fixed nominal returns, and may not hold their value in an inflationary environment given current prices. However, sovereign bonds in Asia could be attractive given lower inflation and higher starting yields there. Currencies, either commodity price beneficiaries or creditor nation currencies, also represent a neglected opportunity set in such circumstances, offering both diversification and returns.

But other parts of the 'real asset' vs 'financial asset' distinction remain dubious. For instance, real estate investment trusts do poorly in an environment of rising inflation breakevens. Given exceptionally high starting valuations globally, not to mention fluctuations in the geographical location of commercial activity driven by the pandemic, it is not clear these should be a cornerstone of inflation protected portfolios.

Bottom-up selection is crucial

In equities, the key is arguably unchanged: hold companies that have the ability to increase prices easily, even with flat volumes and when capacity is not fully utilised, without fear of market loss, and those that have an ability to accommodate large increases in business with only small additional capital. Some software companies, which investors tend to see as not benefiting from a higher inflation, higher rate world, actually fit these characteristics more than some of the 'value' companies that investors conventionally see as benefitting from inflation protection.

If we are entering a world of above-target inflation for a number of years, investors should ditch the easy answers. Static and inflexible 60:40 (equity:bond) portfolios are likely to struggle, especially those that rely on US and European bonds. Some real assets, like real estate and particular commodities, may not work. Investors should reflect about what specifically is driving the inflationary process and invest in equities that have pricing power, but are not at frothy valuations.

Finally, in a world of higher inflation volatility and high starting asset valuations, central banks are going to remain a key driver of liquidity and therefore asset returns in the years ahead. Their new doctrine means they will put the foot on the accelerator for longer when they are missing their targets, but also put their foot on the brake quicker when they meet them. This implies that static asset allocation may become increasingly suboptimal and dynamic asset allocation will be more necessary.

Russia’s war on Ukraine is shifting the investment landscape

Philip Saunders
Co-Head of
Multi-Asset Growth

While the full impact of the Ukraine crisis on the global economy and markets is unknown, much like the Covid crisis, several major medium and longer-term themes are now readily discernible. In a European context, energy and defence policy is in the process of changing profoundly. Reliance on Russia as an energy supplier will be reduced sharply and materially, whatever the shape of the eventual resolution of the conflict. In retrospect, the extent of reliance on a personalised dictatorship for essential raw materials will seem extraordinarily misguided. To his credit, Merkel’s replacement as Chancellor of Germany, Olaf Scholtz, recognised the need to dramatically shift policy and double down on renewables and the alleged Bucha atrocities will have now silenced any continued resistance to a radical shift.

The extent of Europe’s wider challenge can be seen from the numbers. Since the beginning of the war, EU nations have paid Putin’s Russia over 35 billion-euros in energy payments; by contrast, Ukraine has received one-billion-euros in arms and weapons. The other volte face was in defence spending. European delegates were recorded laughing at the July 2018 NATO summit while then President Trump lectured them on the need to fulfil their defence commitments and described them as ‘captives of Russia’ given their current and projected reliance on Russian oil and gas. Germany is now committed to double defence spending and non-aligned Sweden has announced that its defence budget will rise to 3% of GDP. The peace dividend is well and truly a thing of the past. Increased expenditure will be financed with debt on a pan EU basis, following the precedent of the Covid recovery funds, which will take the EU further down the path of monetary union.

China is in an uncomfortable position given Xi's announcement of the country's 'no limits' partnership with Russia on 4 February – just 20 days before the Russian invasion of Ukraine. The full consequences for China of its close association with Russia are yet to be determined, but those of America's willingness to 'weaponise' its currency via the blocking or confiscation of reserves and exclusion from SWIFT, the dollar payment system, are clear. Over the short-term, we do expect the dollar to remain supported due to policy dynamics, but over the longer term, geostrategic imperatives will force China to permit a more rapid internationalisation of its currency and develop an alternative payments mechanism. Other nations are likely to abet such developments to reduce their reliance on the US currency and payments systems. Saudi Arabia, for one, has recently been negotiating with China to accept oil payments in renminbi, avoiding the need to transact in US dollars.

At a stroke, the momentum behind de-dollarisation, has received a material boost. This is not to imply that the dollar's dominant position will be supplanted in the near future, as it is too deeply embedded in the world's trading system for that, but this probably marks the peak of the dollar era, and America's 'exorbitant privilege', to use former French President Giscard d'Estaing's apt expression, of having first call on the world's savings will progressively be eroded.

Panic sets in

Russell Silberston
Strategist

In our last policy review we described how central bank tightening plans, with the notable exception of China, accelerated from a sedate pace to a disorderly rush for the exit. Over the first quarter of 2022, this rush has turned to panic, as Russia's invasion of Ukraine boosts energy prices further and risks long-term disruption to inflationary expectations.

Fed readies 50 bps hikes

The US Federal Reserve (Fed) implemented a 25-basis point increase in its benchmark federal-funds rate at their March meeting, the first raise since 2018. The Fed's plan, according to Chair Powell, "is to move expeditiously to return the stance of monetary policy to a more neutral level and then to move to more restrictive levels if that is what is required to restore price stability." In practice, this means increasing the benchmark rate to 2.5% this year and then assessing if further action is needed. A shift to restrictive policy is certainly not ruled out. Given how high inflation is, we are highly likely to see a series of 50 basis points hikes. The Fed will also commence running down its balance sheet by a shade under US$100 billion per month, most likely from this quarter.

Whilst freely admitting that "financial conditions generally should move to a more normal level" by using "our tools to moderate demand growth," the Fed's aim is to achieve an economic soft landing, avoiding recession. Indeed, Chair Powell referred to a recent lecture by one of his ex-colleagues, Alan Blinder, who observed that this has only been achieved in 3 out of the 11 tightening cycles in the past 40 years. However, in a rare show of humility, Powell went on to note that "I hasten to add that no one expects that bringing about a soft landing will be straightforward in the current context." With its credibility on the line, nobody should doubt the Fed's intention to restore price stability.

China on the opposite path

The People's Bank of China (PBOC) faces the polar opposite of the Fed's problems, with growth slowing and inflation subdued, reflecting earlier tightening and a strict approach to controlling COVID. Against a 2022 growth target of 5.5%, the State Council is on the verge of rolling out targeted easing as soon as possible. In practice, the PBOC is continuing to focus on favoured sectors, such as high-end manufacturing and rural development, whilst holding back on traditional easier policy, such as rate reductions and further liquidity injections, via cuts in required banking reserves. However, the central bank appears to have weakened the renminbi after its earlier strong run by cutting the official fixing price and it has allowed mortgage rate reductions in an effort to stabilise the housing market. In an interesting development, the PBOC is also consulting on a "financial stability protection fund" which sounds very much like a bad bank to help detect and dispose of distressed debt, a very positive move if confirmed in the coming months. However, with COVID rampant and other major economies likely to see growth slow as monetary policy is tightened, more aggressive policy action is likely if the authorities wish to achieve their growth target for this year.

The ECB's tricky balancing act

In the eurozone, with inflation currently running at 7.5% and likely to average above 5% for the year, the European Central Bank (ECB) is under immense pressure to normalise monetary policy quickly, especially as it is still adding liquidity through quantitative easing. However, the ECB is a forecast-driven institution, and its latest inflation projections see CPI at 2.1% in 2023 and 1.9% in 2024. As such, the central bank talks about 'normalising' monetary policy rather than 'tightening' monetary policy given inflation is expected to be where they want it to be in the medium term. In practice, this means that "if the incoming data support the expectation that the medium-term inflation outlook will not weaken even after the end of our net asset purchases, the Governing Council will conclude net purchases under the Asset Purchase Program in the 3rd quarter." On interest rates the ECB wants maximum flexibility, and it will adjust rates based on its next forecast round in June. Markets, however, are way ahead of the ECB, and are discounting rises of over 100 basis points within the next year. But with growth slowing, confidence collapsing, all while inflation is likely to be four times target at some point this year, the Governing Council faces a very difficult balancing act.

Japan holds its line

The Bank of Japan (BoJ) has also been battling markets, aggressively protecting the upper band of its yield curve control interest rate corridor by buying unlimited amounts of government bonds. These notes have sold off in line with global markets but, much like the Federal Reserve, the BoJ understands the importance of its credibility. Therefore, it has little choice other than holding the line it has drawn itself if it truly wishes to achieve its inflation target of 2% on a sustained basis. Such divergence in the policy stance between the BoJ and Federal Reserve has seen the yen weaken notably, a move which will be welcomed as providing a further inflationary impulse. Perhaps if Japan does actually manage to overcome decades of disinflation, we really are in a new paradigm.

Bank of England sounds more balanced

The Bank of England (BoE), for several months the most hawkish major central bank, raised the base rate by 50 basis points over the quarter to 0.75%, thereby matching the post-GFC high in official interest rates. The bank also started running down its balance sheet by allowing existing UK government debt to mature. However, looking forward, and having made a reasonable start on tightening policy, the latest guidance has sounded a little more balanced, as the trade-off between higher inflation and slower growth is looking far more difficult. For example, in the statement accompanying the last hike, it noted that "developments since the February Report are likely to accentuate both the peak in inflation and the adverse impact on activity by intensifying the squeeze on household incomes" and so whilst "the Committee judges that some further modest tightening in monetary policy may be appropriate in the coming months, there are risks on both sides of that judgement depending on how medium-term prospects for inflation evolve." With markets pricing in a further 150 basis points of rate rises over the next 12 months, the message from the Bank is far more balanced and we should not be surprised to see it push back against this pricing at its next meeting.

Summary of high conviction asset class views

Defensive Bonds

The outlook is now more mixed for defensive bonds with real interest rates very rich and implied inflation now above realised historical levels. This is now true across developed markets, with inflation premium recovering in Europe to catch up with the recovery we had already seen in the US. The US curve is increasingly looking distorted given excessively rich real yield valuation and mispricing of the imminent Fed policy tightening. Other areas such as New Zealand and Korea which have already repriced significantly above medium-term fair value remain attractive.

Positive – China, New Zealand, Korea
Negative – Implied inflation to fall, real rates to rise, US nominal bonds

Growth Bonds

The EM macro score remains negative, whilst our quality scores continue to move more negative reflecting higher inflation which has eroded institutional strength scores, as well as a deterioration in fiscal scores. Valuations remain attractive across the board, in particular real interest rates on a relative basis. We are neutral the asset class but favour those areas that have nominal and real rate advantages to DM, as well as attractive carry dynamics as these should continue to benefit from yield advantages to DM.

Positive – Mexico, Peru, Colombia, Brazil, Chile
Negative - Peripheral spreads

Commodities

Whilst the initial reaction to Russia's invasion was rapid as companies worried about supply, very few actual sanctions have been imposed on commodities. Therefore, the problem is less one of volume but more one of distribution. Bulk commodities and those linked to them are the ones where price rises have stuck as it is much harder and more expensive to redirect them, particularly with the Black Sea almost closed to ships. With such an uncertain outlook to the war, it is difficult to make forecasts, but it must be emphasised that many markets were already tight before the invasion. Now, the demand for materials to supply the energy transition looks set to increase as Europe attempts to wean itself off Russian energy.

Positive — Fertiliser, Energy, Aluminium, Copper, Zinc
Neutral — Iron ore, Nickel, Steel

FX

The Federal Reserve continues to guide for a quicker policy normalisation than expected by the market. This comes at a time when the slowdown in the Chinese credit cycle is feeding through into economic data and we have seen growth momentum decline rapidly. Hence there appears to be upside risk to the US dollar over the next year as macro and policy divergence emerge between the US and major regions. We believe it is likely we will see weakness in China spill over to global growth, notably EM.

Positive – US dollar, Sterling, Czech koruna
Negative - Swiss franc, Chinese yuan, Taiwanese dollar, New Zealand dollar

Regional Equity

Asia has structural tailwinds and is beginning to see earning dynamics trough after a challenging year as regulatory incursion lessens and macro policy becomes more supportive. While the US benefits from further evidence of resilient capital allocation, elevated valuations and the threat of tighter policy offset this and drive a negative outlook on the region. Cyclical growth catchup in Europe ex UK is offset by structural headwinds and expensive valuations.

Positive – Asia ex Japan
Negative – Europe ex UK, US

Sector Equity

Prefer asset light compounders with structural growth underpinning although increasingly wary of high valuations in some areas. Substantial opportunities which benefit from accelerating structural change in cyclical technology and consumer sectors. Pharmaceutical and Consumer Staples sectors offer an attractive combination of high quality and reasonable valuations.

Positive – Materials, Cyclical Tech, Staples, Pharma, Healthcare Tech, Financials
Negative – Telcos & Utilities, Real Estate, Consumer Goods

Credit

Spread widening has driven material changes in valuation scoring particularly for high yield assets. European and EM have generally underperformed the US. Underlying credit metrics remain healthy however with robust 4Q21 earnings within investment grade. Outflows continue across all credit asset classes although were more modest in investment grade. Defensive carry in high yield is preferred on a relative basis particularly in areas where spreads have moved beyond fundamentals.

Positive – Asian high yield
Negative - US/EU high yield

Equity views

Having downgraded the **US equity market** to neutral in the final quarter of 2021, we have now further downgraded it to negative as the valuation risk in that market has continued to grow as we move into a tighter policy environment. Exceptional monetary accommodation has had an outsized impact on asset prices over the last few years, inflating them considerably, particularly in the large cap segment of the US market. As we move into a period where interest rates are being raised and liquidity withdrawn at the same, we believe that the downside risk from valuations is now greater than the positive impact of ongoing earnings growth. This is especially true as the growth outlook for the global economy has deteriorated in recent months as a result of worsening inflationary pressures eating into disposable incomes and a manufacturing sector confronting renewed supply disruption alongside weaker end demand.

We have upgraded **Asia ex Japan**; the pivot in Chinese policy towards easing creates a supportive macro backdrop for Asian equities, in our view. Chinese policymakers have clearly communicated this pivot over recent months, such that the market can begin to look through its previous concerns surrounding the policy and regulatory outlooks. Given the US market's size in the global index, and the clear policy divergence with Asia, these rating changes have implications for broader equity views. We have therefore upgraded emerging market equities versus developed markets.

We retain our maximum negative view on **Europe ex UK**, which has underperformed substantially amid the Ukraine crisis. The near-term risks to growth are most intense in Europe and uncertainty over the duration of the conflict, scope for intensification of direct disruption and second order impacts suggest that significant risk premium will continue to be required. Rising credit costs pose a new challenge for European corporates and with ECB asset purchases nearing an end, there are further upside risks to corporate credit and peripheral sovereign spreads. There are, however, selective opportunities to add to high quality European companies at discounted valuations but overall, it remains too early to upgrade the whole market.

We retain our neutral views on both the **UK** and **Japan**, which are the relatively more attractive pockets within developed markets. The UK market is well aligned with current conditions given its exposure to resources, pharmaceuticals and staples, but other drivers including currency and the UK and broader European growth cycle are potential headwinds. Japan stands out from a valuation perspective and benefits from a more accommodative policy outlook and a currency which has weakened and could continue to do so as policy and yields diverge from the US in particular.

At the sector level, we have upgraded **financials** and added **US banks** to our conviction views. Higher interest rates will positively impact profitability for financials as long as growth rates remain reasonable. Our positive stance on the US banks is predicated on the view that the loan growth outlook has strengthened beyond current consensus pricing. Demand remains healthy across the board with unsecured consumer lending rebounding from the pandemic sharply, structural demand for housing which can support mortgage demand even at higher interest rates and clear potential for upside surprises in corporate lending, in our view. There are well understood challenges on the cost side, with larger banks increasing spending on their employee base and tech solutions, however we believe that strong net revenue growth can more than offset this.

Consumer staples has been downgraded to positive from maximum positive. With raw materials accounting for a large proportion of the sector's cost base, companies are directly impacted by the commodity price inflation that has accelerated dramatically and looks set to remain a headwind for the foreseeable future. We have focused on finding companies with the strongest brands and market positions, providing scope to pass costs on to consumers and maintain margins. Pricing power has tended to be greatest for premium brands, but cyclicality can also be higher at these price points as consumers have the option to trade down to standard or discount products when real incomes are impacted by slowing growth and/or higher inflation. We believe the consolidated market structure and strategic approach of leading consumer staples businesses is attractive, with many demonstrating strong levels of reinvestment in their brands, helping them maintain market share.

Fixed Income views

As detailed in the policy review, following the Russian invasion of Ukraine, very little has changed in terms of the Fed's communication. Whilst inflation is still surprising to the upside and is much more persistent than initially expected, notably as a result of the upside pressure placed on energy prices from the war in Ukraine, meaning inflation is set to continue increasing over next few months.

Government bonds: The more inflationary backdrop has resulted in lower real interest rates despite a significant hawkish shift in communication from major DM central banks. In particular, the Fed has continued to signal the need for a step-change in policy to get rates back to neutral alongside the process of normalising its balance sheet through quantitative tightening. As a result, our conviction in the need for a significant increase in US rates over the coming months has increased and we believe the current backdrop poses significant upside risks to real interest rates.

Emerging market local currency: While growth levels were healthy going into Russia/Ukraine crisis, the combination of tighter financial conditions and higher inflation are likely to weigh on growth in parts of EM. The continued disappointment in Chinese macro data and risks of further lockdowns there also raises growth risks, while the balance of payments divergence between commodity importers and exporters has increased, especially as oil prices start to bite on the external balances of countries such as India and Turkey.

Emerging market hard currency: Although the asset class benefits from its exposure to rising commodity prices, we believe there are significant risks from the tighter global liquidity backdrop as a result of central bank efforts to tackle inflation despite a less supportive growth backdrop. The resulting tightening of financial conditions and the impact on spreads is also likely to weigh on growth, with the biggest risks in those economies where market access has been cut off.

Developed market credit: DM credit spreads widened across the board. We maintain our negative view overall on credit asset classes given the negative macro and policy backdrop and expensive valuations. As an asset class, credit tends to be highly sensitive to cyclical downturns and policy tightening. Consequently, a large valuation buffer needs to be present to cushion performance as we move into the rest of the year if we are to change this stance. Although backward looking credit metrics appear healthy today with record low default rates in both high yield and loans.

Currency views

The **euro** has been upgraded to neutral after the shift in ECB policy. We had previously been expecting large divergence between the ECB and Fed, with the former not expected to change policy within its forecast horizon. However, with the recent guidance on changes to the inflation outlook, it is expected that the ECB will now move towards tightening sooner, diminishing the degree of divergence with the Fed. We have added the **US dollar (USD)** versus the **Swiss franc** as a conviction view. The Swiss central bank failed to ease as aggressively as other developed central banks during the pandemic and therefore saw its balance sheet grow less substantially. This means that it has not seen the same inflationary pressures and is not under as much pressure to tighten policy. The team therefore expects a policy divergence with the US over the coming months as the Fed moves towards quickly removing accommodation and as a result expect the USD to outperform its Swiss counterpart.

The **USD** remains maximum positive to reflect the prospect of aggressive policy withdrawal and divergent economic fundamentals. The US economy remains strong and supported by high excess savings, which contrasts with weak growth in China. We therefore have a long USD position against both the **Chinese yuan** and **Taiwanese dollar**, and continue to see upside risk to the USD over the next 12 months if the market prices a further acceleration in policy withdrawal from the Fed.

We retain our high conviction negative on **US real interest** rates, which are a good proxy for the real policy stance. Real rates are currently close to their lows, and therefore as the Fed moves incrementally towards tighter policy at the same time as inflation peaks, our view is that they are likely to rise, which should remove support for **gold** and as a result we maintain our maximum negative conviction on gold. In the short term, we acknowledge that gold benefits from strong momentum and increased uncertainty because of the Ukraine situation, and as a result may remain well supported. However, longer term, we continue to believe that as the market's focus shifts towards policy tightening from central banks there is an increasing likelihood of gold coming under pressure.

Commodity views

Energy supplies facing huge disruption

Russia's invasion of Ukraine has laid bare Europe's lack of a co-ordinated and rational energy policy. With gas and power prices hitting record levels, Europe faces a major challenge to accelerate a transition away from dependency on Russian fossil fuels. At the same time, high power prices and disrupted supply chains are hitting European manufacturers as well as consumers, raising inflation and threatening growth. Whilst oil prices have settled back to around US$100 per barrel at the time of writing, it has taken large releases from US special reserves and lockdowns in China reducing demand to restore some calm. Clearly, a seasonal lull in April may help in the short term but with the summer driving season due to begin in the US, where the economy is booming, and air travel rebuilding in the West, the risk to oil prices remains firmly to the upside, in our view.

Metals tightness not fully reflected in prices

Most base metals have risen since the invasion began, but the gains for copper are less than 5% and aluminium has fallen more than 3%. With Russia being a major supplier of aluminium and a not insignificant copper exporter, this seems at odds with moves elsewhere. It appears that – whilst supply fears boosted prices initially – poor activity data in China as lockdowns increased and worries about recession in the West have weighed on prices. It also seems likely that many traders have had to reduce positions as margin calls increased and as many were long, this has suppressed the reaction in these metals.

Fundamentals suggest that unless there is a prolonged downturn, whether due to COVID, in China or a rapid worsening of demand in the West, then stock levels look very low and shortages could appear, supporting prices. With China boosting infrastructure spend in Q1, if this metal demand hits the market in Q2, then copper inventories could fall to critical levels and the aluminium market in the West could also destock (LME stocks are already down close to 40% this year). Recession and demand destruction fears are often cited as reasons to be negative, but one would have to see prices rise materially for the latter fear to be realised.

Agriculture markets facing major dislocations

Grains and other agriculture commodities came into 2022 with strong fundamentals. After a near-decade surplus in major markets such as corn and soybeans, balances started improving in late 2020 and throughout 2021 when South American production declined, and Chinese demand took a step up. However, the deficit markets expected for large parts of the complex became significantly tighter the moment Russia crossed the border into Ukrainian territory. While wheat caught the headlines in the days and weeks following the invasion (Russia and Ukraine combined exports 29% of the world's wheat), we expect larger impacts for markets such as corn and sunflower (Ukraine had an 18% share of corn exports last year as well as being China's largest supplier for the grain, and in sunflower markets Ukraine and Russia together grew nearly 60% of global output).

This may sound like good news for farmers in the rest of the world but there has been similar inflation in key inputs such as fertiliser, meaning that crop economics have not improved for all producers. Potash mining has seen a step up in profit margins, as has phosphate fertiliser production for companies who are integrated with their own ammonia production. Nitrogen fertiliser production is more nuanced, with producers in Western Europe suffering from unaffordable natural gas prices and having to temporarily shut down plants, compared to Middle East, US and Canada-based manufacturers who are enjoying a lower cost base and strong export demand for their urea, nitrates and ammonia products.

The commodities market is facing an extraordinary combination of circumstances which will take a number of years to untangle. Russia's invasion of Ukraine has added significant stress to an industry already squeezed by the post-COVID surge in demand, the transition away from fossil fuels and the previous five years of underinvestment in the resources industry. Given that there is no quick fix to any of these issues, prices should – we believe – remain supported.

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