SARANAC
PARTNERS

Investment Committee Update

March 2022

AT A GLANCE

- Due to the increased uncertainty in markets and significant swings in sentiment due to the war in Ukraine, we will not be making any significant changes to our portfolios right now as the risk of being whipsawed is high.
- Growth is likely to slow, mainly due to elevated commodity prices caused by the conflict and related sanctions. If war is protracted then recession risk, particularly in Europe, becomes elevated.
- Stagflation in regions that are particularly reliant on energy imports is becoming our central case, although the US is much more insulated from this than Europe.
- European stocks have fallen the most due to their dependence on Russian energy supply and the sensitivity of earnings to the conflict, although few areas of the market are yet discounting recession.
- Short-term inflation expectations have risen to reflect the spike in commodity prices, longer term expectations have also risen but far less so.
- Sustained sanctions will drive commodity prices higher, not only slowing growth but also raising the risk of further geopolitical upheaval in areas where grain imports are essential.
- Our equity allocation in portfolios is in line with the long term average we would expect, although we are reassessing the level of cyclical exposure we hold.

The conflict in Ukraine could have profound consequences for markets and the global economy. However, we have no information edge as to how this crisis will be resolved. The situation is highly fluid and market reactions have been volatile as news unfolds. In such an environment of heightened uncertainty and significant swings in sentiment, we are not minded to make dramatic changes to our asset allocations.

Helpfully, global economic momentum has been strong coming into this year, with the impact of Omicron on activity less severe than feared. Economic surprises have turned positive in the last three to four months and growth is running above trend currently.

However, if resolution to the war is protracted then growth will slow, primarily due to elevated commodity prices and the ensuing hit to demand caused by high energy and food prices. Investor concerns are mounting about the possibility of recession in some geographic regions, particularly those that are heavily reliant on energy imports.

Such an outcome also raises the possibility of a stagflationary environment in which inflation remains stubbornly high but growth decelerates. Our own investment committee's votes with regard to potential scenario outcomes would confirm this, as the probability of a stagflationary outcome, as well as the risk of the recession scenario, are rising (from low levels).

This is not, as yet, our base case for the economic outlook more broadly but we recognise that, for Europe in particular, a stagflation environment is possible. Central banks are facing a potential policy dilemma if inflation remains high and growth slows. Markets briefly lowered expectations for interest rate hikes this year as the growth outlook weakened, but the US Fed remains hawkish and is forecast to lift rates 8 times this year. We think that assumption will prove overly aggressive but it remains the case that the monetary policy backdrop looks very different in 2022 than to the past 2 years.

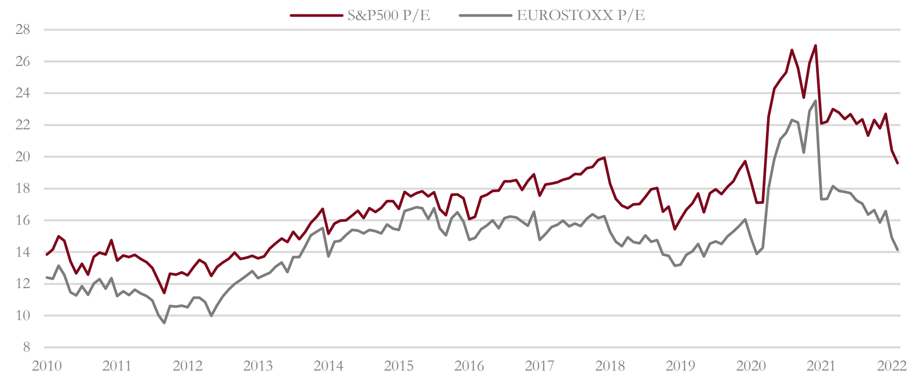
Equities

Sentiment is now extremely negative and has reached levels similar to the depths of the pandemic in March 2020. Risk assets have corrected sharply and unsurprisingly, European stocks have fallen the most due to the greater dependence on Russian energy supply and the sensitivity of the economy and earnings to the conflict.

Year-to-date European equities are down 10%, while many parts of this equity market are oversold on a short-term view. US equities have held up better in recent weeks although they too are down over 5% having also suffered a correction through January as interest rate expectations aggressively ratcheted higher.

This correction has, to date, been entirely valuation driven as earnings forecasts have remained stable for the year ahead (figure 1). Sentiment has deteriorated sharply and risk premiums are now much higher than where we started the year, value is starting to emerge in some regions although the US market continues to trade in expensive territory. Our appraisal of the valuation picture would suggest few areas of the market are discounting a recession, although some financial and cyclical stocks, especially in Europe, are pricing in a significant slowdown. Given our assessment of slowing growth, but growth nonetheless this year, the current equity set up seems fair.

Figure 1: Developed market equity valuation
P/E ratios have fallen sharply across all markets since 2020. The drop in valuations in 2021 was due to extraordinary earnings growth, but the most recent move lower has been due to the fall in market prices and the sharp deterioration in sentiment.



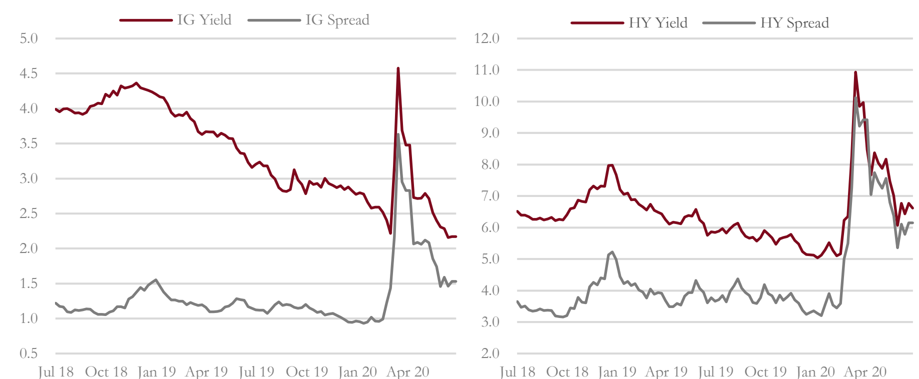
Source: Saranac Partners.

While earnings forecasts have been stable, we are starting to see the remarkable run of positive earnings revisions come to an end. First-quarter earnings forecasts have levelled off and revisions are now more negative than positive for the first time since mid-2020.

Fixed income

Credit spreads have widened, in line with the general risk-off sentiment, but spreads have, in the most part, moved back to long term average levels and are not signalling a more serious economic downturn (figure 2).

Figure 2: Investment grade and high yield spreads
Corporate bond yields have risen significantly but much of this has been driven by the rise in government bond yields. Spreads have clearly widened, reflecting greater risks in the economy, but their levels are only back to long-term averages and do not suggest a more serious outcome.

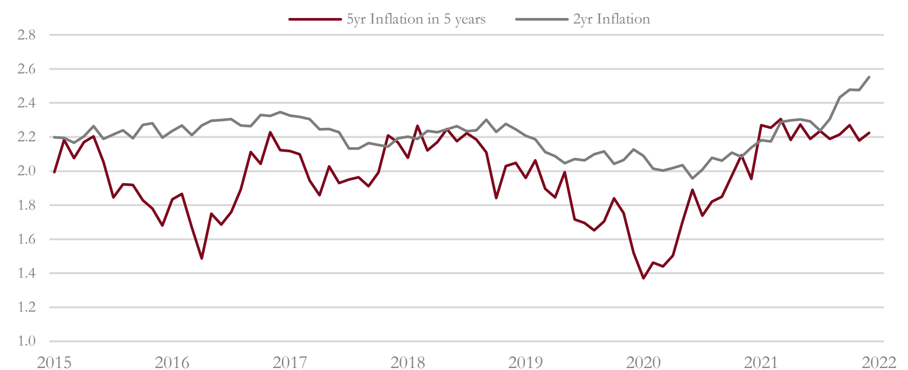


Source: Saranac Partners.

Government bond yields rallied immediately after the Ukraine war began as safe haven assets were in demand but this move has since reversed given the inflation outlook and forward curves predict as many as seven rate hikes by the US Federal Reserve (the Fed) this year, on top of the first move made this month. In Europe, the European Central Bank (ECB) has backed away from predicting any rate hikes this year and is likely to remain well behind the Fed in lifting interest rates.

Short-term inflation expectations have risen sharply to reflect the spike in commodity prices we are now experiencing. Hopes of a robust drop in overall inflation over the coming months have faded due to this widespread pressure on commodity prices. Longer term inflation expectations remain reasonably well contained, but they too have moved higher as labour markets remain tight and policy is still relatively easy.

Figure 3: Long-term vs short-term inflation expectations in the US
The spike in commodity prices has seen short-term inflation expectations move higher to levels not seen in 20 years. However, it is expected that the Fed will tighten enough to bring inflation down as the longer-term expectations have remained relatively stable. Five-year average inflation in five years' time is little changed over the past year.



Source: Saranac Partners.

While oil and natural gas have attracted the most attention, there have been sharp moves higher across all parts of the commodity complex, including industrial metals like nickel and soft commodities such as wheat.

Commodities

Russia produces about 10 million barrels of oil a day, representing around 12% of global oil supply and the rest of the world is incapable of replacing that production. Countries such as China and India are likely to continue to provide a market for Russian oil, but pressure is mounting for the west to sanction Russian energy production and the US and UK have already announced embargoes on Russian oil.

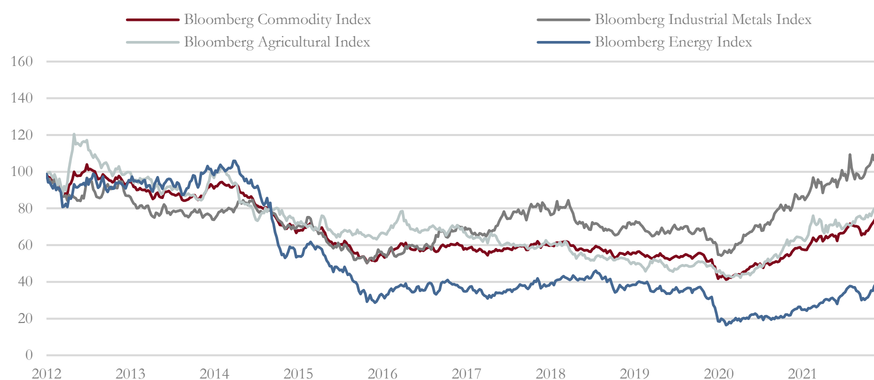
Efforts to advance the Iranian nuclear deal to bring back Iranian oil, pressure on OPEC to lift production and even talks between the US and Venezuela to revive production there, would still be insufficient to adequately replace lost Russian production in the event of major sanctions.

We believe that oil above $100 per barrel will lead to demand destruction and lower economic growth. Brent oil is now above $110 and if this level is sustained, or if the price continues to rise, then we can expect meaningful downward revisions to global growth estimates for the second half of this year.

With Russia and the Ukraine combined representing 30% of global grain exports, a sustained conflict is likely to see painful price rises in these commodities and raise the risk of further geopolitical upheaval in areas where grain imports are essential. The last time we experienced such a sharp rise in food prices was 2011, a period which coincided with political events such as the Arab Spring.

Whereas the move in energy and soft commodity prices is being driven by supply shocks to the system, gold has benefitted from its safe haven status, although it has been volatile, rising briefly above $2,000 before settling back in the $1950 range.

Figure 4: Commodity prices
The war in Ukraine has caused a sharp move higher in commodity prices across the board, which threatens the economic growth outlook and delays any fall back in inflation this year. Food inflation in particular could add further stress to the global geopolitical situation.



Source: Saranac Partners.

PORTFOLIOS

The extreme volatility in markets, as well as deeply negative sentiment, is not a conducive environment for making significant changes to portfolio asset allocation as the risk of being whipsawed is high.

Our equity allocation in portfolios is in line with the average we would expect over time. However, we are reassessing the level of cyclical exposure we hold.

Our base case assumption coming in to 2022 was that we would see robust growth enhanced by diminishing covid concerns. But while the pandemic looks to be fading away, the outlook for global growth now looks threatened by the commodity supply shocks caused by the Ukraine conflict.

The increased risk that 2022 growth slows more dramatically poses significant questions about the earnings potential of companies more exposed to short-term cyclical trends. While they look cheap on current earnings forecasts, the possibility that these earnings are revised sharply lower is a real risk.

Over the short term, however, we see the potential for a market bounce as sentiment is so poor now so we are not actively changing the equity weight in portfolios right now.

Only recently we saw US 10-year Treasury bond yields move above the 2% mark for the first time since 2019 and we took the opportunity to start building a position in portfolios to diversify risk. Our view was to increase that position if yields moved higher, reflecting the hawkish stance of central banks, as we believe fair value to now be around 2.5%.

The flight to safety following Russia's invasion of Ukraine saw yields drop back but they have since moved sharply higher as the Fed has shifted its policy stance to a much more hawkish stance, reflecting the deterioration in the inflation picture. We think the market is adequately pricing in future rate hikes now and we think we will get opportunities to add to this investment in the near future.

We continue to hold credit risk in portfolio, but with short duration. Credit spreads have widened somewhat, but we do not see elevated default risk generally. The situation within Chinese real estate has deteriorated and warrants close attention but recent policy announcements from the Chinese government suggest there is policy relief in the offing as they look to support their economy, property and equity markets.

We continue to hold a 3% position in gold for its diversifying properties and this has been helpful for portfolios in recent days. The BakerSteel commodity fund has also benefited from the surge in commodity prices. However, we are mindful that a resolution to the conflict and/or a renewed rise in real yields would be problematic for the gold price and we are far from wedded to this position.

Currencies have seen the traditional safe havens of the US dollar, Swiss franc and Japanese yen all strengthen in recent weeks. Our position in yen has been helpful at the margin, as has our exposure to Chinese government bonds where the renminbi has also enjoyed relative strength.

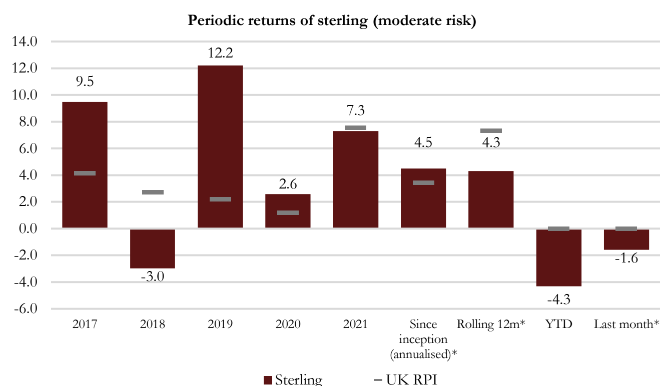
Volatility has risen sharply and as a result we have added new structured products to portfolios. They allow us to generate high single-digit returns with strong levels of protection, which is an attractive proposition given low yields and heightened uncertainty in conventional markets.

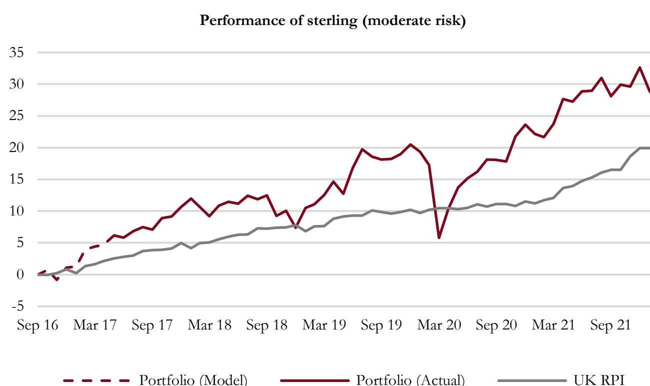
We have introduced two new structures. One is based on a range of developed market equity indices and another is based on the European banks index, which is an area that has seen particularly aggressive selling and where we think the entry point is now attractive.

Multi-asset strategies

Performance as of 1 March 2022

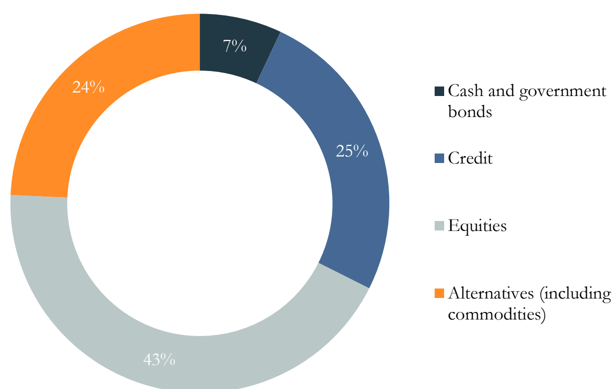
Returns (%)

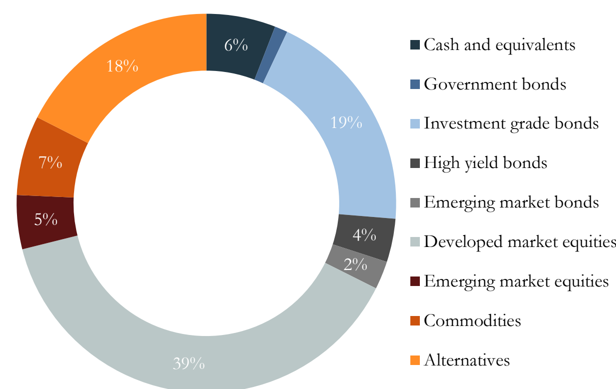




*End January 2021 for Sterling. End January 2021 for RPI (February data not available yet).

Asset allocation (average across all portfolios, %)

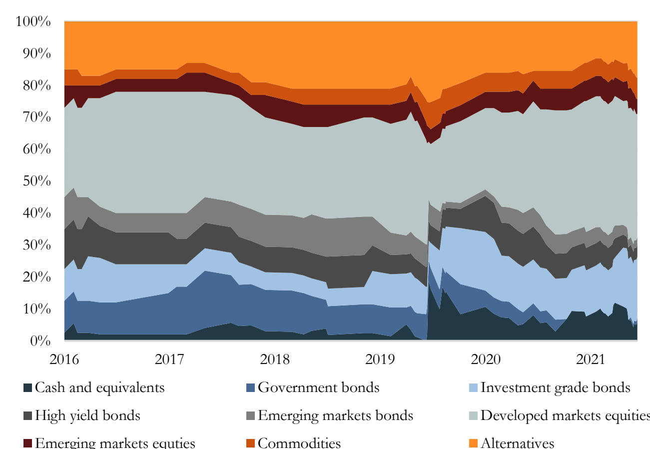




Changes over the past month (%)

	Sterling	Change
Cash and government bonds	**7.0**	**-3.7**
Cash and equivalents	5.9	-4.8
Government bonds	1.1	1.1
Credit	**25.4**	**-0.2**
Investment grade bonds	19.3	0.8
High yield bonds	3.7	-0.4
Emerging market bonds	2.4	-0.6
Equities	**43.3**	**-1.5**
Developed market equities	38.7	-0.1
Emerging market equities	4.6	-1.4
Alternatives	**24.3**	**5.4**
Commodities	6.8	1.0
Alternatives	17.5	4.4

Changes over time (%)

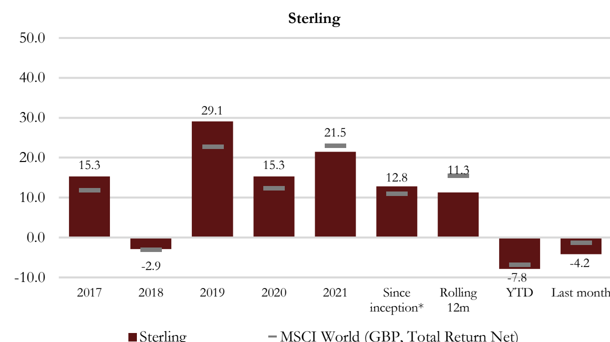


Performance figures from inception (28 September 2016) to end May 2017 are based on model portfolios, simulated from a full record of trading decisions and execution levels are readily available for review. Performance figures from June 2017 onwards are based on an aggregation of actual client portfolios whose mandate most closely follow the Moderate Risk model. Dividends have been included on an accruals basis in both cases. All performance is shown exclusive of fees as charging structures may vary. Your capital is at risk and past performance is not a reliable indicator of future performance.

Equity strategies

Performance as of 1 March 2022

Returns (%)



Euros and US dollar

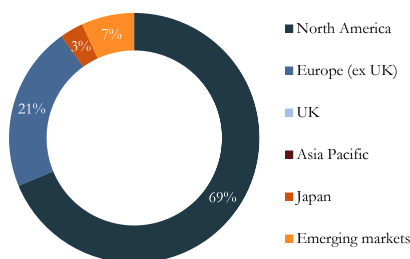
	2017	2018	2019	2020	2021	Since inception*	Rolling 12m	YTD	Last month
Euros	10.9	-4.0	36.7	9.1	29.6	13.4	16.0	-7.2	-4.0
MSCI World (EUR, Total Return Net)	7.5	-4.1	30.0	6.3	31.1	11.4	19.7	-6.5	-2.7
US dollar	26.2	-8.6	34.2	19.0	20.4	14.7	7.3	-8.4	-3.9
MSCI World (USD, Total Return Net)	22.4	-8.7	27.7	15.9	21.8	12.8	10.7	-7.7	-2.5

*Since inception figures are annualised.

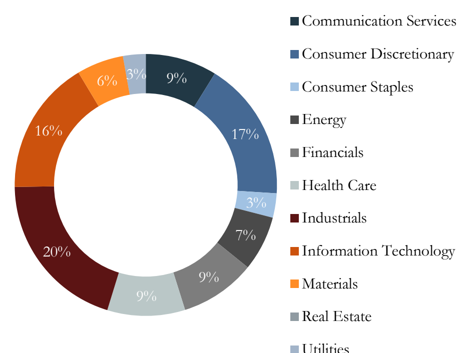
Top 10 holdings (%)

Holding	Weight (%)
MICROSOFT CORP	3.8
UNITEDHEALTH GROUP INC	3.8
ALPHABET INC-CL A	3.7
QUALCOMM INC	3.5
DISCOVER FINANCIAL SERVICES	3.5
LVMH MOET HENNESSY LOUIS VUI	3.5
VISA INC-CLASS A SHARES	3.5
PIONEER NATURAL RESOURCES CO	3.4
TOTALENERGIES SE	3.3
BAYERISCHE MOTOREN WERKE AG	3.2

Regional exposure



Sector exposure

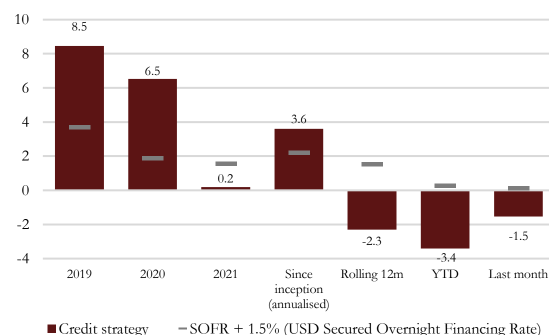


Performance figures from inception (1 January 2017) are based on a model portfolio, simulated from a full record of trading decisions and execution levels are readily available for review. Dividends have been included on an accruals basis. All performance is shown exclusive of fees as charging structures may vary. Your capital is at risk and past performance is not a reliable indicator of future performance. Actual fe.es paid by the client portfolios excluded. Fees may vary.

Credit strategy

Performance as of 1 March 2022

Returns (%)



	Credit strategy			Benchmark		
	USD	GBP (hedged)	EUR (hedged)	USD	GBP (hedged)	EUR (hedged)
Last month	-1.5	-1.5	-1.6	0.1	0.1	0.1
Rolling 12m	-2.3	-2.5	-3.2	1.5	1.4	0.7
2021	0.2	0.0	-0.7	1.5	1.3	0.7
2020	6.5	6.0	5.2	1.9	1.4	0.6
Since inception	11.8	9.2	6.2	7.3	4.7	2.0
Since inception (annualised)	3.6	2.8	1.9	2.2	1.5	0.6

Asset allocation and performance measures

Issuer type	Weight (%)	Yield to maturity (bps)	Modified duration	Composite rating
Core IG allocation	**71.8**	**148**	**4.2**	**BBB**
Developed markets	57.1	138	4.4	BBB
Emerging markets	10.4	202	4.5	BBB+
Asset backed securities	4.2	151	1.1	A
High yield satellite	**28.2**	**353**	**3.3**	**BB**
Developed markets high yield	13.5	316	3.6	BB-
Emerging markets high yield	4.0	473	3.2	BB-
Corporate hybrids	3.4	301	2.9	BBB-
Financial subordinated	7.3	379	3.0	BB+
Total portfolio	**100.0**	**206**	**4.0**	**BBB-**

Performance figures from inception 31/12/18 are based on an actual client portfolio whose mandate most closely follows the Diversified Credit Strategy. All performance is shown inclusive of fees. Since inception, the portfolio has experienced zero defaults. Your capital is at risk and past performance is not a reliable indicator of future performance.

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