SARANAC
PARTNERS

Investment Committee Update

May 2022

AT A GLANCE

- Three materials shocks have changed our investment views over the past few months – Russia's invasion of Ukraine, the re-emergence of Covid in China and the US Federal Reserve's shifting position on monetary policy.
- These shocks have weakened demand and exacerbated inflationary pressures, creating a more stagflationary environment that is challenging for both equity and bond markets.
- Each of the adverse shocks can develop in ways that are favourable as well as adverse but our initial assessment for the investment outlook over the rest of 2022 is tentative.
- Although the increased possibility of recession has become a more central feature of market debate recently, it is important to consider a wide range of outcomes and potential risks when managing portfolios.
- Our positioning includes increased allocations to cash, alternatives and fixed income and a restructuring of the equity holdings to provide greater exposure to some more defensive sectors such as consumer staples.
- Given the potential for a further weakening in growth over coming months the most likely direction of travel for portfolios is to reduce exposure to risk by shifting the fixed income allocation and lowering the allocation to equities.

What are the sources of concern? The macro background

At the start of the year, the Saranac view was that the global economy would be robust in the first half of the year as markets reopened post-Covid, before slowing in the second half and into 2023. Recession risk for 2022 was regarded as low, with the risks rising in 2023 – but these were only on the edge of the radar screen and given low probability.

Since that time, there have been three material shocks, some interconnected but all adverse. First, Russia's invasion of Ukraine has caused a spike in commodity prices and higher inflation rates. This in turn has eroded real incomes and profitability globally, as well as eroding business and consumer confidence, particularly in Europe.

Second, the re-emergence of Covid in China has led to lockdowns in key cities. This has been a direct hit to growth in China and the wider region and has exacerbated the supply-chain challenges that had emerged after the initial lockdowns in 2020. The full impact of these lockdowns on the global supply chain have yet to be seen.

Third, the US Federal Reserve has re-evaluated monetary policy and there is now the likelihood of a much more aggressive tightening cycle than appeared likely at the start of the year.

What are the implications of these shocks?

These shocks have weakened demand, and at the same time exacerbated inflationary pressures. So the environment has become more stagflationary.

Stagflationary environments are challenging to equities and bonds. Inflation and the associated policy response pushes bond yields higher, and equities are depressed through the channel that combines weaker earnings growth with a valuation de-rating reflecting inflation volatility. Global equities are off by around 12% this year, similar to the losses in credit and longer-maturity government bonds.

Figure 1: Equity valuations

Global equity valuations have dropped sharply this year, reflecting the joint concerns of inflation and growth.

Source: Saranac Partners.

Whatever the macro views at the start of the year, these three shocks have the potential to deliver a materially worse environment from now into 2023 compared to these initial expectations.

The impact of higher energy prices is considerably greater for consumers in Europe and the UK than most other regions, and it is here that the erosion of real incomes will be felt most keenly.

What next? Assessing the shocks

It's early days, and each of the adverse shocks can develop in ways that are favourable as well as adverse. Our assessment, necessarily tentative, is that in the first instance the China shock is material and adverse, but also potentially short-lived. It is feasible that it is at least partially reversed in the second half of the year though, of course, lockdowns can also persist for many months. There is little sign of any shift in policy by the Chinese government toward zero-Covid, but the National Congress held later in the year may well mark a shift in this regard. More conventional monetary and fiscal policy measures are moving increasingly to a stimulative stance to try to support growth.

The energy shock is also very material and has spilled over into a broader range of commodity prices, particularly food prices. However, commodity prices were relatively depressed to begin with and their recent rise takes them back to the level that prevailed for a good few years before the 2014 collapse, and well below the level reached in 2007–08. Similarly, there have been periods of significant food price inflation in the UK that did not trigger material cyclical downturns (although food and energy can rise still further). Clearly, the impact of higher energy prices is considerably greater for consumers in Europe and the UK than most other regions, and it is here that the erosion of real incomes will be felt most keenly.

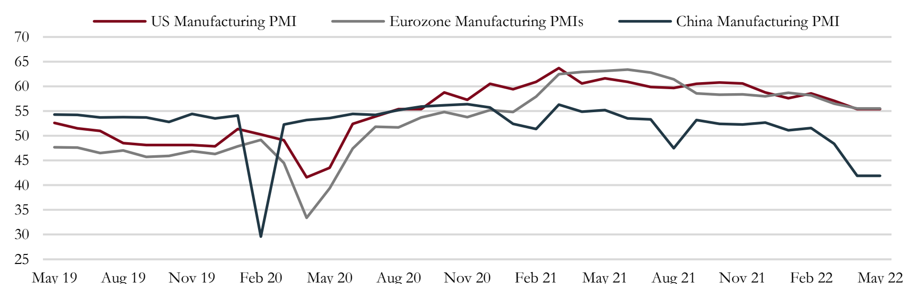
Meanwhile, the US monetary policy shock has the potential to be the most adverse. The market is pricing in US short-term rates of 3.5% by end-2023. This level of rates does not appear particularly draconian, particularly in real terms. However, there are concerns that even this 'modest' level of short rates could trigger a severe slowdown if the economy is particularly interest-sensitive; or that a still higher level of rates will be required to reduce inflation if the economy remains robust, leaving only a narrow 'channel' of potentially positive outcomes. This strikes us a recurrence of the old 'Goldilocks' challenge; if interest rates rise too far, too fast then this could trigger recession (too hot), whilst a robust economy that doesn't slow in response to higher interest rates could see inflation remain too high and further hikes required (too cold). Neither scenario augurs well for equities, although the former may see a rebound in long duration bonds.

Where are we now?

Economics. Economic data are now available up to April. There has been a very modest softening in economic activity globally compared to the start of the year, when growth was very robust. On a regional basis China and Japan have appeared weakest, with the Western economies more upbeat, including the euro area, which is most exposed to the Ukranian shock. Some confidence measures have weakened more significantly, but depressed consumers have carried on spending and business confidence surveys are more resilient. Moreover, recent data on economic surprises show little evidence of any material slowdown. In addition, first quarter corporate earnings growth was fairly upbeat, albeit tempered by more cautious guidance in some cases. It is early days, and there is plenty of time for effect of the adverse shocks to accumulate, but as of now economic activity has held up pretty well.

Figure 2: Manufacturing PMIs

Manufacturing surveys in the US and Europe have yet to show any material deterioration in expected activity, but China has slowed notably as Covid restrictions have hit.

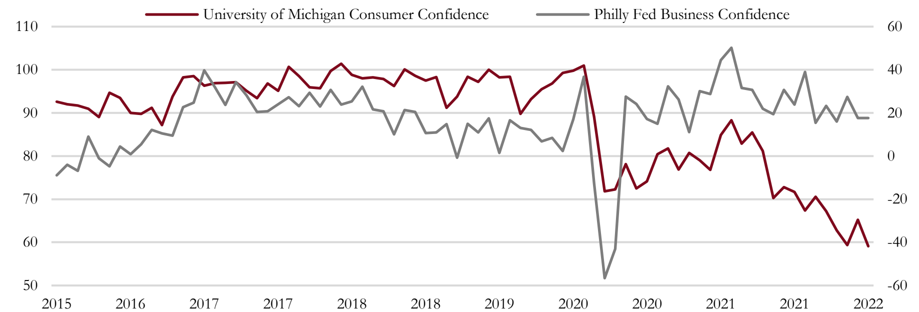


Source: Saranac Partners.

There is a growing sense of capitulation amongst the retail investor as many stocks that rode the retail wave during Covid are now well below their initial prices from early 2020.

Figure 3: Consumer confidence

Inflation and the war in Ukraine have hit consumer confidence levels hard, yet business confidence surveys remain more upbeat.

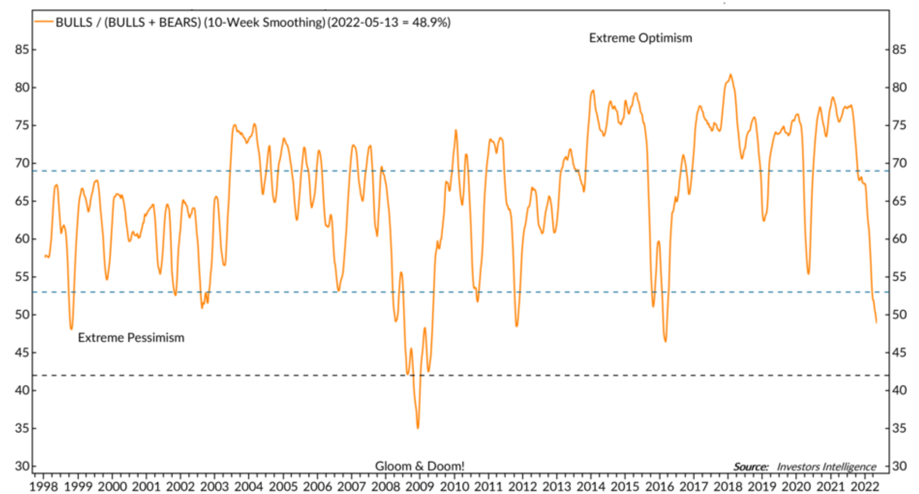


Source: Saranac Partners.

Market sentiment. There appears to have been some genuine selling over recent weeks, and many indicators of sentiment are very depressed – some bull-bear readings are around the lowest levels since March 2009. Notably, there is a growing sense of capitulation amongst the retail investor as many stocks that rode the retail wave during Covid are now well below their initial prices from early 2020. There is a good case for a technical bounce at some stage.

Figure 4: Market sentiment

Investor sentiment is more negative than during the peak of the pandemic and this level of pessimism has only been exceeded during the Financial Crisis.



Source: Ned Davis Research; Saranac Partners.

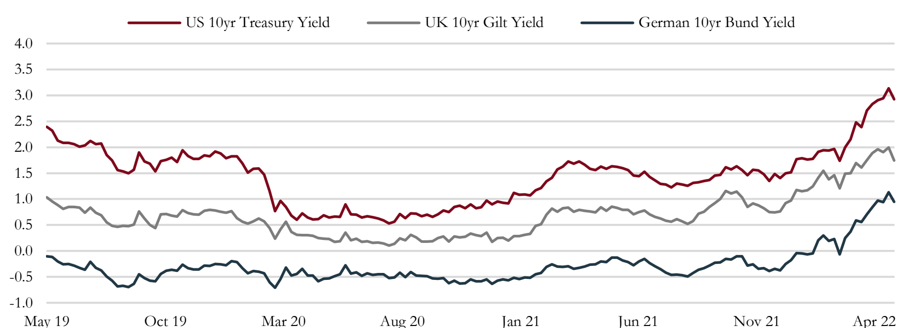
Equity valuations. Depressed sentiment is not, however, feeding into depressed valuations. The global price-to-earnings multiple has dropped back to around 16x, which is broadly in line with its average since 2014. The multiple would drop lower in a more stressed environment – for example, in the recession scare at end-2018 the multiple dropped to 14x, and yet there was no recession. We don't regard equity valuations as remotely bubble-like, but neither have they dropped to anything approaching the level likely if recession pressures were likely to become more apparent.

We do not believe that a recession is imminent, although recession risk in Europe in particular is more significant for the second half.

Fixed income valuations. There has been material repricing of fixed income assets, with an upward shift in many countries' yield curves following the aggressive pivot in US Federal Reserve policy. 10yr US Treasury yields have now topped 3%, a level briefly touched in late 2018 but otherwise the highest yield in over a decade. Credit spreads have also widened, although in the most part this is to long-term average levels and are not signalling stress in the economy. This repricing now allows scope for a potential extension of duration risk in portfolios, not an avoidance of this risk as in recent years.

Figure 5: Fixed income valuations

Bond markets have moved quickly to price in more persistent inflation and the associated tightening of monetary policy now expected.



Source: Saranac Partners.

Saranac strategy

While recession risk has become a more central feature of market debate, it is important that a wider range of outcomes is considered. What happens if there is not a recession? Saranac scenarios are designed to illustrate a wider range of potential risks. The latest evaluation is that the scenario analysis illustrates a greater degree of strategic caution than at any time since 2016, when the process was first implemented. Even if recession is avoided, there are other scenarios that are not particularly favourable for asset markets. In addition, we attribute lower probability to very good outcomes. So we have become more cautious – but how much caution is warranted?

The appropriate degree of caution is still seen as somewhat limited rather than apocalyptic, and on balance suggests a more defensive portfolio structure with some risk still taken, not one where risk avoidance is the primary objective. In terms of our risk scores, we are around 4–4.5 out of 10, down from 5.5–6 last year, but we are not close to the more pessimistic 1–3 range. So a shift to a more conservative stance is underway, but it is contained.

Recessions are notoriously hard to time correctly. Views that the current environment is potentially recessionary may be proved correct, but perhaps only in (say) late 2023 rather than imminently. Opportunities to take sensible risks could be missed by being wrong on the timing. We do not believe that a recession is imminent, although recession risk in Europe in particular is more significant for the second half.

A particular uncertainty relates to the inflation background. We regard it as feasible that inflation could peak later this year as the bulk of the commodity price impact will have been felt, but it is unclear the extent to which inflation will fall back materially, rather than a higher inflation rate becoming embedded in the major economies for a longer period.

We believe the current environment contains multiple uncertainties and potential outturns. Our main objective is not to back a single outturn where we may be wrong, and at the mercy of event risk, but to have a portfolio that provides protection across a range of environments – while acknowledging our overall portfolio structure should be 'conservative'.

At some stage there may be a more aggressive move into fixed income to benefit from higher yields, but we would need to have a higher conviction that plausible interest rate increases are very well discounted.

Key elements of our investment strategy

The more conservative elements of our strategy include the following:

– A higher cash weight than usual: 5% rather than the close-to-zero that we usually target.

– A higher weight in alternatives than usual. This allocation has risen to 20–25% in most of our multi-asset portfolios. There are three components: commodities exposure, the hedge fund portfolio and structured products, which account for most of the increase in recent months. The commodities and hedge fund exposures have delivered more than 5% since the start of 2022, which is a much stronger increase than returns in bond and equity portfolios.

– A slight increase in the allocation to fixed income, funded from cash, and a small increase in duration exposure, through the purchase of US Treasuries, a market we have avoided in recent years.

– Some increase in duration from a low base. These moves have been tentative, but the recent purchase of the 10-year Treasury is a 'foot in the water' in terms of taking advantage of yield increases. Duration is still, however, very much towards the lower end of the range that we could take in this area.

– A slight reduction in the equity weight.

– A restructuring of the equity portfolio, to provide greater exposure to some more defensive sectors (such as consumer staples). The portfolio's exposure to 'growth' has been dialled back. However, the portfolio would still be likely to underperform in a fully recessionary environment. Additional restructuring is likely to lead to an increase in the overweight to energy companies, leaving the direct and indirect exposure to commodities in a balanced portfolio around 10%. Note that commodities exposure tends to perform relatively well in environments with stagflationary characteristics, which is why this exposure has been raised from the end of last year.

Direction of travel

It is likely that additional measures to reduce cyclical risk will be implemented in fixed income through a gradual reduction in credit risk and increase in duration risk, and in equities through a further (small) reduction in the equity weight. However, we are in no rush to de-risk our fixed income exposure because of the potential yield loss as well as uncertainty as to how fixed income markets might respond to the imminent introduction of Quantitative Tightening by the Fed.

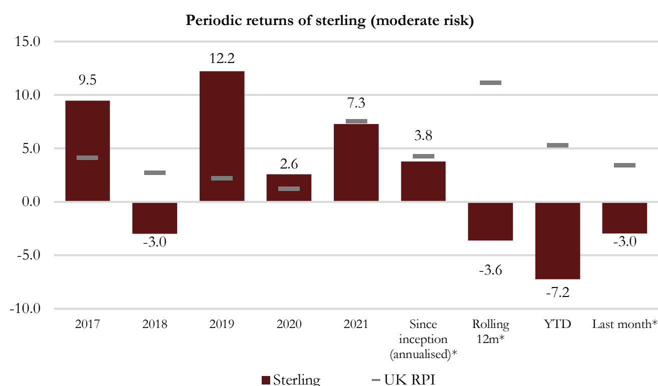
At some stage there may be a more aggressive move into fixed income to benefit from higher yields, but we would need to have a higher conviction that plausible interest rate increases are very well discounted.

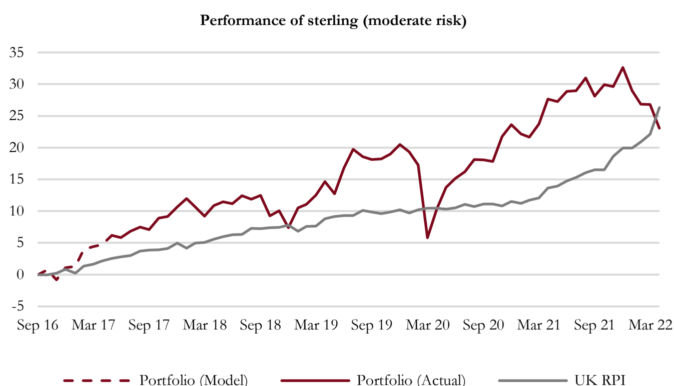
We will continue to explore the potential for hedging strategies, but the high level of volatility makes put spreads and outright puts not particularly attractive. We are unlikely to increase structured product exposure materially unless the equity weight is cut further, and future structures are unlikely to target aggressive returns.

Multi-asset strategies

Performance as of 1 May 2022

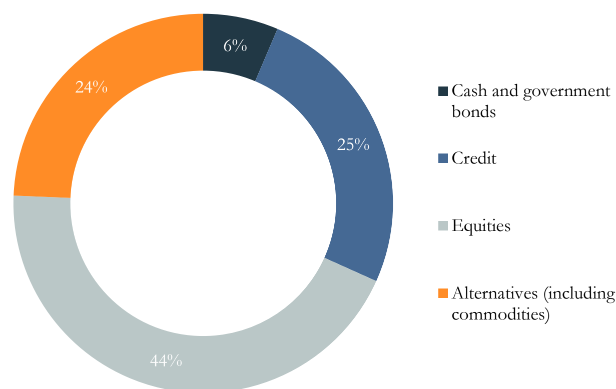
Returns (%)

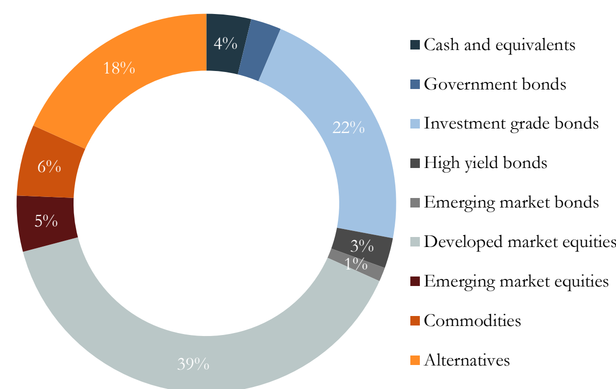




*End March 2022 for Sterling. End March 2022 for RPI (April data not available yet).

Asset allocation (average across all portfolios, %)

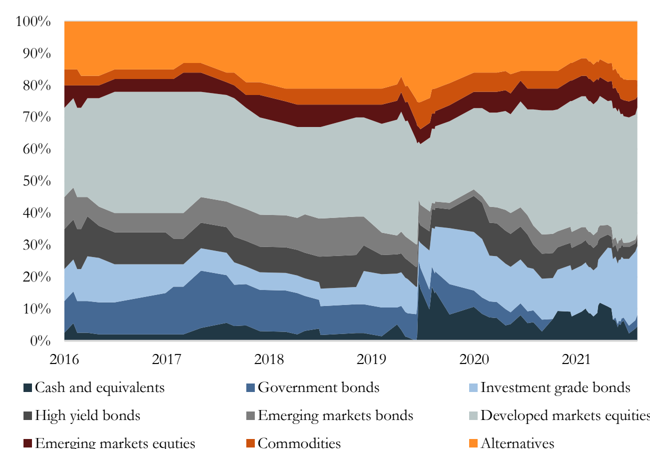




Changes over the past month (%)

	Sterling	Change
Cash and government bonds	**6.4**	**-1.2**
Cash and equivalents	3.8	-2.7
Government bonds	2.6	1.6
Credit	**25.3**	**1.9**
Investment grade bonds	21.6	3.2
High yield bonds	2.6	-1.1
Emerging market bonds	1.2	-0.2
Equities	**43.9**	**-0.3**
Developed market equities	39.2	0.0
Emerging market equities	4.8	-0.2
Alternatives	**24.4**	**-0.5**
Commodities	6.1	-0.6
Alternatives	18.3	0.1

Changes over time (%)

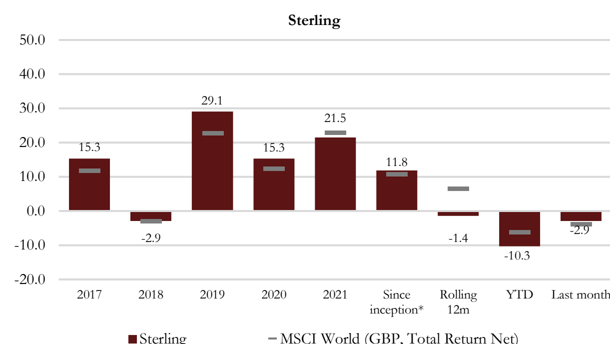


Performance figures from inception (28 September 2016) to end May 2017 are based on model portfolios, simulated from a full record of trading decisions and execution levels are readily available for review. Performance figures from June 2017 onwards are based on an aggregation of actual client portfolios 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 May 2022

Returns (%)



Euros and US dollar

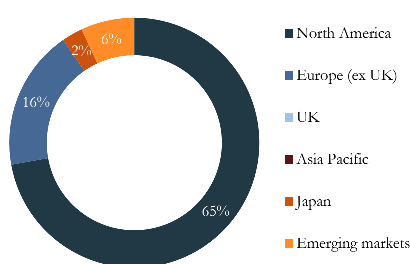
	2017	2018	2019	2020	2021	Since inception*	Rolling 12m	YTD	Last month
Euros	10.9	-4.0	36.7	9.1	29.6	12.2	2.1	-10.4	-2.4
MSCI World (EUR, Total Return Net)	7.5	-4.1	30.0	6.3	31.1	11.1	10.1	-6.3	-3.3
US dollar	26.2	-8.6	34.2	19.0	20.4	12.2	-10.5	-16.9	-7.5
MSCI World (USD, Total Return Net)	22.4	-8.7	27.7	15.9	21.8	11.1	-3.5	-13.0	-8.3

*Since inception figures are annualised.

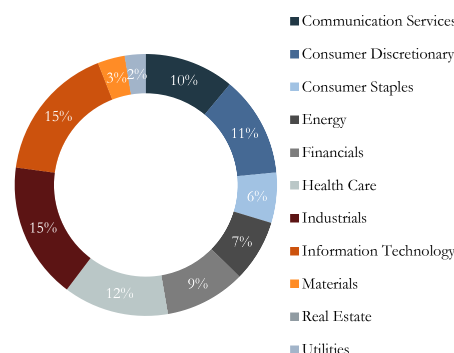
Top 10 holdings (%)

Holding	Weight (%)
VISA INC-CLASS A SHARES	3.8
MICROSOFT CORP	3.7
TOTALENERGIES SE	3.6
UNITEDHEALTH GROUP INC	3.5
PIONEER NATURAL RESOURCES CO	3.3
ALPHABET INC-CL A	3.2
DISCOVER FINANCIAL SERVICES	3.1
M & T BANK CORP	3.1
TELEPERFORMANCE	3.1
CROWN HOLDINGS INC	3.0

Regional exposure



Sector exposure

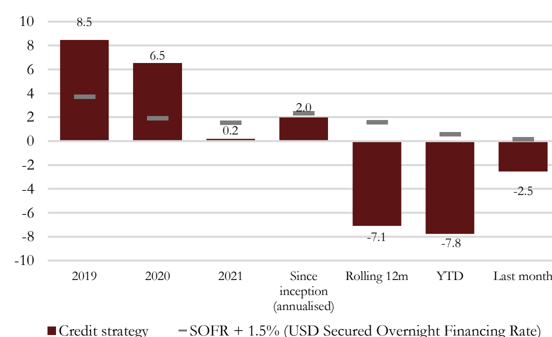


Performance figures from inception (1 January 2017) are based on a model portfolio, simulated from a full record of trading decisions and execution levels are readily available for review. Dividends have been included on an accruals basis. All performance is shown exclusive of fees as charging structures 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 May 2022

Returns (%)



	Credit strategy			Benchmark		
	USD	GBP (hedged)	EUR (hedged)	USD	GBP (hedged)	EUR (hedged)
Last month	-2.5	-2.5	-2.6	0.1	0.2	0.1
Rolling 12m	-7.1	-7.2	-7.9	1.6	1.5	0.6
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	6.8	4.2	1.1	7.8	5.2	2.1
Since inception (annualised)	2.0	1.2	0.3	2.3	1.5	0.6

Asset allocation and performance measures

Issuer type	Weight (%)	Yield to maturity (bps)	Modified duration	Composite rating
Core IG allocation	**74.4**	**418**	**4.0**	**BBB+**
Developed markets	62.5	412	4.2	BBB+
Emerging markets	7.8	446	4.1	BBB
Asset backed securities	4.1	469	1.3	A
High yield satellite	**25.6**	**650**	**3.4**	**BB**
Developed markets high yield	12.2	583	3.8	BB-
Emerging markets high yield	3.3	817	3.4	BB-
Corporate hybrids	3.6	600	2.6	BBB-
Financial subordinated	6.5	718	2.9	BB+
Total portfolio	**100.0**	**478**	**3.9**	**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.

16 St James's Street
London SW1A 1ER
+44 (0)20 7509 5700

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