CIO BLOG

Fahad Kamal | Chief Investment Officer
Investment Strategy | June 2022

SAFE AS HOUSES

THE FUTURE IS YOU
KLEINWORT HAMBROS

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ALL DRESSED UP AND NOWHERE TO GO

More than two years ago, heads of state around the world began issuing shelter-in-place orders amidst the unfolding of the then ominous Covid-19 pandemic. While the virus began to upend life as we know it, it did not upend the basic rules of economics. As closing borders meddled with supply chains, lockdowns shifted consumption patterns, and stimulus money flowed in consumers' pockets, demand for goods surged and supply was squeezed. Prices rose. Coming out of hibernation in late-2021, the global economy experienced something it had not seen in more than two decades: significant, broad-based inflationary pressures.

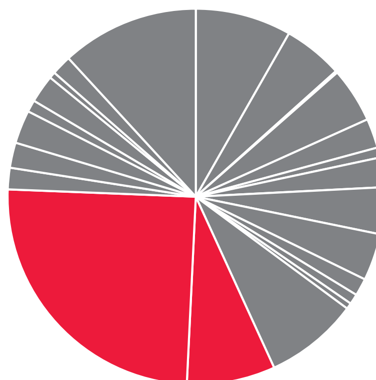
In 2022, Russia's invasion of the Ukraine and lingering effects of Covid in China further exacerbated existing trends. As of March, motor fuel and gas in the US were on average 48% and 22% more expensive compared to the year before. The price of meat rose 14%. Flights became 24% more expensive. Even used cars, plagued by supply chain issues since 2020, still clocked in at a 35% year-on-year markup. All of this contributed to a year-on-year inflation reading of 8.5% in March, the highest the US has seen in four decades. The good news is that prices, especially for durable goods, have begun to ease - in April, CPI growth dropped slightly to 8.3%. The bad news is that those factors quoted above, which had been driving most of this post-pandemic inflation, altogether only account for 16% of the basket making up the Consumer Price Index in the US.

STICKY BUSINESS

In developed economies, the biggest expenditure for consumers tends to be housing - the average Briton or American spends about 33% of their monthly pay cheque on rent. Cost of shelter did not rise as fast as other components of the CPI – 5% in the US in the twelve months to April – but given its prominent weighting likely provided the most painful squeeze to consumers' finances in the aftermath of the pandemic. Worse yet, compared to other components of the index, rent prices tend to be "sticky". Whereas the cost of, say, used cars tends to fluctuate with supply and demand, and patient buyers could hold out for a better deal, tenants signing a new, pricier lease will be locked in with the higher cost for years. Further, rent prices tend to not be correlated with real estate prices on the downside - even if prices fell, tenants are unlikely to benefit from a downward revision of their equivalent rent.

The move from transitory to more systemic inflation spurred central banks to action and uncertainty has crept into economic expectations of consumers, corporates, and ultimately financial markets, depressing asset prices and pushing the S&P 500 to the brink of a bear market. Sentiment has come down markedly, in some sectors verging on over-sold territory. Bond markets seem to suggest that central banks will be able to control inflation in the medium term, with 10-year breakeven yields pricing in an average inflation rate of 3.2% over the next decade. Many markets participants believe policymakers to be behind the curve however, now making up for it by even more aggressive action– the Fed is expected to roll out another seven rate hikes before the end of the year, bringing their target rate up to 275-300bps.

33% of the CPI basket is covered by rent or rent equivalents



Source: Kleinwort Hambros, US Bureau of Labor Statistics

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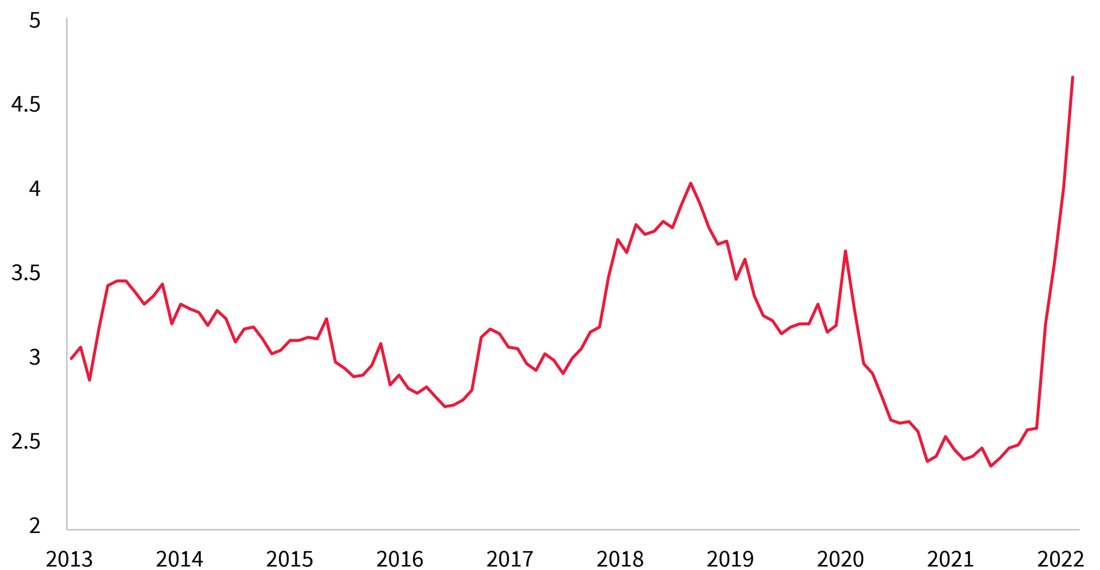
STAY CALM AND CARRY ON

Much of Western monetary policy – and indeed the fate of global financial markets - rests on the near-term inflation numbers. Fortunately, some evidence suggests that price pressures have already begun to subside. Firstly, many of the smaller CPI items that drove inflation throughout and immediately following the pandemic, such as homewares or used cars, have already started to retract. Even those items impacted by the war in the Ukraine, such as oil, energy, and other commodities, are unlikely to experience further significant price pressures from today's high bases.

Secondly, house prices, which tend to lead rent prices by about a year, are one of the few factors central banks can target more effectively to combat inflation. Even in anticipation of monetary tightening, 10-year fixed mortgage rates in the US began to rise, topping out at 4.6% in April from 2.5% at the start of the year, and causing house price growth to retract from a record 18.6% year-on-year in 2021. This development is not restricted to the US - in the UK, house price growth has dropped to single digits for the first time this year, easing from a high of 13.3% year-on-year in 2021.

This may well herald the beginning of the end to the latest real estate boom. A significant easing of rent prices remains unlikely in the short term, but central banks will pay close attention to the development of the cost of shelter over the summer, when the largest proportion of leases come up for renewal. Any signal of a slowdown could provide the Fed with breathing room to soften the most aggressive monetary tightening path and increase the chance of a "soft landing" – reigning in inflation without triggering a major recession.

US 10Y Fixed Mortgage rates have surged to multi-decade highs in anticipation of monetary tightening



Source: Kleinwort Hambros, Bloomberg, Bankrate.com

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SOLID FOUNDATIONS

While not impossible, the balance of probabilities is currently not pointing towards a recession over the next 12 to 24 months. Monetary policy remains loose by historical standards, and there is no evidence of significant degrading of financial conditions: access to loans, whether private or corporate, is still easy. Starting and listing businesses is still possible, if not thriving, and corporate earnings continue to climb to new record highs. Household savings are unusually high following the past few years of fiscal stimulus, and financial regulation has greatly improved the robustness of both banks' balance sheets as well as of their credit approval processes over the past decade, backstopping another potential Great Financial Crisis. Indeed, a record-low housing stock will likely provide a bottom to prices even in the case of a Fed-sponsored contraction of the housing market.

In uncertain times like these it pays to not panic, stay disciplined, and trust the process. A robust economic outlook paired with fair(er) valuations support the case for risk-taking. On the other hand, momentum of equity prices remains negative for the time being: a signal to seek a conservative stance in the near-term. We prefer a neutral allocation to risk assets supplemented by a range of diversifiers, including cash, government bonds, gold, hedge funds and a Tail Risk Protection Note. This provides a resilient positioning in the wake of rising volatility and sufficient flexibility to adjust our views should conditions change: to further cut risk in case of deteriorating economic environment or add to it should momentum turn or if rate hike cycles prove to be drastically overestimated.

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