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At the start of 2022 optimism was building as the lockdowns imposed by Covid were being lifted, and financial markets started to anticipate the release of pent-up demand from the global economy emerging out of the pandemic. Since then a biblical combination of war, famine, pestilence and death have drowned this sentiment, and financial assets have been pummelled. It has been particularly unusual to see the bond and equity markets fall in tandem. For the last forty years whenever the equity market tumbled the bond market provided a safe haven, but starting from record highs, and the arrival of much more inflation than was anticipated, bonds have collapsed. Equities have entered bear market territory, but even the poor performance of the indices has disguised the real damage which has been suffered. Many stocks have fallen more than 60%. Underlying this decline were three unexpected outcomes. First inflation, which was expected to be transitory, has proven to be more persistent, leading to a sharp rise in bond yields and one of the fastest rises in mortgage rates in history. Second China has not ended its harsh policy on omicrom leading to multi-month lockdowns in Shanghai and partial ones in Beijing. For most of this year about a quarter of China's economy has been impacted, compounding the supply chain problems that have built up over the past two years. Third the full-scale invasion of Ukraine by Russia created shortages, almost overnight, of numerous commodities. About the only good thing that can be said about the Ukraine situation is that the worst-case scenarios have been avoided so far, but the huge supply shock of losing the world's biggest producer of energy, industrial metals and agricultural commodities at just the moment that the world was grappling with deglobalisation, and exiting macroeconomic profligacy, combined to create considerable inflationary pressures. This leaves every major economy facing an unpalatable choice of either accepting much higher levels of inflation, or imposing much tighter monetary and fiscal policies than have prevailed in the post 2008 period, which in most cases means recession. The uncertainty of this situation has unsettled markets, and they are unlikely to regain their poise until there is more clarity on what choice policy makers will make.

Inflation is now at the highest level for decades – 8.6% in the US, and European inflation is at a similar level, with some countries experiencing much higher rates. The Baltic nations, for example, are all in the high teens, and Estonia is over 20%. Some of this inflation is not the fault of Central Bankers. There is nothing they can do about rising food and energy prices. However, they were slow to realise how overheated labour markets were, and how the effects of deglobalisation were raising barriers to labour mobility, encouraging companies to relocate production back home, and that the balkanisation of the world was increasing bottlenecks and costs generally. In addition to being slow to raise interest rates the West exacerbated inflation by adopting enormous monetary stimulus during the Covid pandemic. The effect of this can be seen by comparing inflation between the US and China. Both economies have experienced the same inflationary pressures from commodities but China had been reducing monetary stimulus and its inflation is only 2.1%, a quarter of America's. Belatedly the Federal Reserve has been raising interest rates from the record low of 0.25% to 1.75% currently, and indicating that they will rise to above 3% by the end of this year. In Central Bank terms this is the definition of slamming on the brakes, and neither inflation nor this dramatic hiking cycle is something that most people in the market are used to. On top of this from June the Fed is reducing its balance sheet by $47.5 billion a month, increasing to $95 billion by September, removing a powerful and stable buyer of US debt from the market. This has had significant effects on all bond prices. As a dramatic example the 100-year bond issued by Austria in 2020 has fallen more than 50% this year. Of wider significance the 30-year bond issued by the US in May 2020 at par with a 1 ¼% coupon is now trading at 59 cents in the dollar and yielding 3.5%. Short term US Treasuries that yielded less than 0.25% as recently as last December now pay about 3%. These moves represent huge losses for investors in bond markets. The return of inflation also has implications for the fiscal latitude of governments. Governments are still running substantial deficits, but they are becoming more constrained given the size of debt to GDP. US debt to GDP is now at 120% compared to 40% in the early 1980's and 60% in 2008. The needs of an ageing population threaten to push this higher. With the Fed withdrawing from the market and being replaced by more price sensitive investors, if inflation remains stubborn then it will be much harder to embark on a new era of fiscal largesse to provide another round of stimulus.

The rise in bond yields has also eliminated the relative valuation edge that equities have enjoyed versus bonds in the last few years. 3% guaranteed income will coax the return of bond refugees who fled to equities in search of return. This year has shown that quality growth stocks do not always outperform. The performance of growth stocks and many profitless technology stocks over the last two years has been as much a function of the loose monetary policy as earnings growth. As financial conditions tightened the mega cap 8 (Amazon, Alphabet, Apple, Meta, Microsoft, Netflix, Nvidia, Tesla) are down by an average of -39.4% this year. Far worse damage has been suffered in companies that have not yet attained profitability. The last two years saw a huge boom in these companies, many of which were in the technology sector, as they were boosted by the work from home phenomenon during Covid, as well as Central Bank monetary excess. As life normalises and liquidity tightens these companies have crashed. For example, Peloton (a company that enabled subscribers to participate in exercise classes remotely), has fallen 95% from its peak, shedding about $60 billion of value. Cathy Wood's Ark Invest, arguably the best-known investment product in these disruptive technologies, has fallen about 75%. Unfortunately, these technology stocks were where most investors were herded, enticed by the attractive growth stories, but that growth is less attractive in an inflationary environment, and indeed in a number of cases that growth is slowing.

Inflationary pressure in commodities was evident already at the start of the year, but these pressures were multiplied by Russia's invasion of Ukraine. There is a long-term problem in energy markets due to years of underinvestment caused by the demonisation of the industry, resulting in a lack of supply that will plague the world for several years. The depth of the problem can be seen in the labour shortages. Since 2015 25% of skilled petroleum engineers have left the industry. The remaining engineers are getting older. The University of Calgary has suspended admission for its oil and gas engineering program for lack of demand, and worldwide the number of universities offering this course has shrunk from 35 to 20. This loss of skilled labour has created a bottleneck at the worst possible time, just as Russian supply is being removed. The environmental movement has created real impediments to generating new production – you can't get workers, you can't get capital from Wall Street, and it is near impossible to get permits to explore new areas. This situation leaves the incumbents in a strong position, and their stocks have become cheap as investors became allergic to fossil fuels. A knock-on problem is that, because agriculture is energy intensive, fertiliser prices have soared. Gas prices have caused a number of fertiliser factories to close, which will hurt crop yields, and the effect can be seen in eurozone food prices rising 9.1% year on year in May. The impact on food from the Ukraine invasion is just as serious as that on energy. Besides the disrupted harvest, costs for farmers are rising everywhere. Fertiliser costs have spiralled, and fuel prices have vastly increased the cost of running tractors and harvesters. Worse the US, Australia and India have all suffered poor weather conditions that have affected their harvests. The International Fertiliser Development Centre say that current fertiliser costs will cut corn and rice yields by a third in Africa this year. The UN Food and Agriculture Organisation have said that already twenty countries face a critical food emergency. Energy and food are in acute crisis, but other commodities are supported by the long term need to transition to renewable energy sources. Solar, wind and other renewable energies require huge amounts of metals such as copper and lithium which should underpin their prices for decades. While decarbonisation initiatives may be the worst policy mistake in a generation in their execution, having pushed a billion people into near famine and energy poverty, they are fuelling an enormous bull market in many commodities. Paradoxically for the world to achieve the green transition requires significant help from industries deemed to be dirty. Investors are probably wise to try to stay in the countries with the best legal frameworks when investing in commodity stocks, as they will attract a jurisdictional premium. Investors also need to be attentive to the political ramifications caused by higher energy prices. For example, the Democrats are likely to endure considerable damage in the mid-term elections in November given that the price of gas at the pump in the US has risen from $2 to $5 a gallon since they took control in Washington in January 2021.

The investment landscape is more problematic than for many years due to the return of inflation. Cash has become unattractive as its value is steadily eroded. Bonds face a similar derating. Generally, equities' high ratings, after years of monetary stimulus, leave them vulnerable to greater derating. However, the positives shouldn't be ignored. The consumer has high savings, employment remains strong, and banks are healthy. There are areas of the equity market that remain attractive. Commodity stocks are an obvious example. After recent falls a number of quality growth stocks offer good long-term entry points. The Japanese market is full of opportunity, having been ignored by investors for years. Japanese managements are showing a marked improvement in shareholder friendly initiatives. Many companies have strong balance sheets, are raising dividends, buying back shares and boosting returns on capital. Moreover, the yen is exceptionally competitive having fallen 65% against the dollar since 2012. Inflation could also start to nudge Japanese financial institutions out of the fixed interest market where they are heavily overweight, and into equities, as their bonds start to lose money. Japanese individuals hold approximately $7.5 trillion in cash. Inflation may encourage them to seek protection and yield in the equity market. Elsewhere it is noteworthy that Emerging Markets have been outperforming Developed Markets despite the impact from Russia's market collapsing, and China struggling to reopen its economy and get back to normal. Emerging Markets' outperformance is probably due to their economies adopting much more orthodox policies, raising interest rates much earlier than the West, having much less inflation, and having smaller debt burdens. Food and energy prices are clearly a problem, as elsewhere, but labour markets are not tight in Emerging Markets, so these countries have much more policy flexibility. If China does succeed in reopening its economy that will be a major boost for the whole Emerging Markets asset class. In terms of sectors biotech looks interesting. The share prices of biotech companies have fallen hard but the sector is brimming with potential. It is an odd example of an industry where productivity has declined – typically now it costs $2.5 billion to bring a product to market, and only 5% of drugs succeed. However, money has been poured into biotech for ten years, and computer science has been harnessed to use robotics to make millions of tests a week which has built up an enormous database. This allows scientists to spend more time analysing than experimenting, and vastly increases the chances of successful outcomes.

After a rout such as the markets have suffered this year it is hard to be confident about their direction in the short term. Investors are wrestling with two longstanding assumptions that seem to be going into reverse – low inflation/interest rates, and China growing like a weed. For now, the inflation scare is the more challenging. If the inflation genie is out of the bottle then most conventional portfolios are incorrectly positioned. The stock market has been brutal at unweaving the rainbow on profitless growth stocks, but the same treatment will apply to the rest of the market if margins are squeezed by revenues struggling to increase and costs surging. Persistent inflation will also put upward pressure on bond yields, and be particularly destructive to any country or company that is perceived to have structural weakness. A panic in the bond markets of the southern European countries similar to that of ten years ago cannot be ruled out. With inflation such a crucial factor, investors should watch the price of energy and food closely, and particularly the effect that it has on wage inflation. Bonds are unlikely to be compelling investments until interest rates peak. Selectively equities can perform well but great care is needed to ensure that their business and management can cope with the current environment. Many commodities have a structural tailwind behind them. And in currencies the dollar is likely to remain strong given its reserve currency status. When the dollar breaks, that should be the signal for investors to shift from US to non-US assets. Gold's traditional role as a safe haven has also returned. Above all volatility is likely to remain elevated.

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