



BREWIN DOLPHIN

# Equities in correction mode – what's next?

26 January 2022

Global equity market volatility has picked up of late, with the all-important US market experiencing a notable decline. Paul Danis, our Head of Asset Allocation, provides context and discusses the outlook.

## What has been happening in equity markets?

Global equity market volatility has increased in recent weeks, with the US market particularly affected. The S&P 500 is down 9.2% from the all-time high it reached earlier this month. Continental European stocks have performed better but are still down 7%. UK equities have been helped by the rotation out of growth stocks and into value sectors like financials and energy, but the FTSE 100 is only flat on the year.

## What has driven the decline in stocks?

Several factors have pulled stocks lower of late. The first is the stage of the economic cycle. Although the phase the global economy is currently in has historically been reasonable for stocks, returns on average have been lower and corrections more frequent. The second factor is monetary policy. Most central banks have rapidly pivoted to stressing inflation risks. As such, they are steering markets to expect a faster tightening in monetary conditions. Finally, perceived geopolitical risks have risen, with tensions between Russia and the West running high over Ukraine.

“

Perceived geopolitical risks have risen, with tensions between Russia and the West running high over Ukraine.

”

## How is the Ukraine crisis affecting markets?

Russia is the world's third-biggest producer of both wheat and oil. Prices of both commodities have soared of late, and the fear is that sanctions could tighten the supply/demand

backdrop further, pushing prices higher. Ukraine is also a big wheat and corn producer. If supply were disrupted on the back of an invasion, that could also contribute to higher prices. Higher commodity prices are a tax on consumers. Sustained higher commodity prices, particularly oil, would act as a drag on economic growth and boost inflation. Central banks tend to look through oil supply shocks. But given how unsuitably accommodative monetary policy currently is, they may be less willing to be patient this cycle. As such, it goes without saying that a further escalation of tensions between Russia and the West would be a headwind for equities.

## Who is most impacted by the Ukraine crisis?

Besides the Ukrainians and Russians, Europe is a notable loser in the event the crisis escalates. Russia is a key trading partner for Europe. Indeed, Europe sources 35% of its natural gas from Russia. It's not in Russia's long-term economic interests to go too far in terms of it using natural gas as a political tool. But it's already done so in recent months to some extent, and the risk is it may go further if the crisis escalates. That would be problematic given that European natural gas prices are already high, and inventories are low.

## Are there any other geopolitical risks?

Tensions between Russia and the West are the immediate concern. But the much bigger longer-term geopolitical risk is the US/China relationship. US President Joe Biden has already ruled out a role for the US military in Ukraine. Chinese President Xi Jinping will have taken note of this given that he believes it is his destiny to achieve unification between mainland China and Taiwan. It's possible that the Ukraine crisis has the potential to raise market visibility around the Taiwan invasion risk.

“

If the US and global economy continue to expand as we expect, corporate profits should keep moving higher.

”

### Is that it then for the equity bull market?

It's impossible to know how the Ukraine crisis will play out. But our sense is that it will not be a gamechanger for the medium-term global economic outlook. Despite the posturing, a Russian invasion of Ukraine would not be easy and would come with a severe economic response. Looking back at past instances of military action shows that the market takes a strangely dispassionate view, confining anxiety to the direct economic impact.

Since 1990, the S&P 500 has peaked on average two months after the US unemployment rate begins to rise. We believe it will be some time yet before the US unemployment rate hits its lows for the cycle and begins to rise anew. If the US and global economy continue to expand as we expect, corporate profits should keep moving higher. Meanwhile, even with central banks hiking rates this year and inflation only moderating, interest rates will likely remain well below the rate of inflation for some time. This means that investors with cash on the sidelines will continue to lose money in inflation-adjusted terms. It wouldn't be surprising to see investors use corrections to put some of this cash to work. Finally, equity markets no longer appear bubbly. This is good news with respect to the sustainability of the rally. Our base case view is that equity returns will be lower this year than in the last two, but our expectation is that we have probably not yet seen the highs for the cycle.

### What are the risks to this view?

There are three main risks to the base case view that the market has not yet put in the highs for the cycle. The first is the economic outlook doesn't turn out to be as strong as we expect. The second is the market becomes preoccupied with inflation. The cycles of the late 1960s to the early 1980s, when inflation was a big problem, saw global equities peak well ahead of the point in time when the economy began to deteriorate. It's still not our base case that we're in a comparable environment for inflation. But it is conceivable that in the current backdrop, markets could eventually become dissatisfied about inflation not coming down fast enough. That could then prompt investors to ramp up their expectations about monetary tightening, causing bond yields to rise further than we currently expect, which puts an early end to the equity rally. The third risk is that something else quite unforeseen happens.

Nonetheless, summing up the probabilities that these risks materialise, they still seem low enough to justify sticking with our bullish base case view on the global equity market.

### What is the bottom line?

We suspect 2022 will be much bumpier for equity investors than has been the case so far this bull market. That said, the odds still seem reasonably good that the market will hit new highs before the next bear market (a decline of greater than 20%) occurs. We view the recent fall in prices as a healthy wash out of complacent sentiment, providing an opportunity to buy some of our preferred equities at more reasonable valuations.



#### Paul Danis, Head of Asset Allocation

Paul began his career in 1998 trading interest rate futures and options in the pits of the Montreal Exchange. In 2001 he moved into research, and has worked as a strategist on the sellside (Lehman Brothers/Nomura), the buy-side (Credit Suisse) as well as in independent research (BCA Research). Paul graduated from McGill University and is a CFA charterholder.

Visit us online at [www.brewin.co.uk/intermediaries](http://www.brewin.co.uk/intermediaries)

[www.linkedin.com/showcase/brewin-dolphin-intermediary](https://www.linkedin.com/showcase/brewin-dolphin-intermediary)

The value of investments, and any income from them, can fall and you may get back less than you invested. Neither simulated nor actual past performance are reliable indicators of future performance. Performance is quoted before charges which will reduce illustrated performance. Investment values may increase or decrease as a result of currency fluctuations. Information is provided only as an example and is not a recommendation to pursue a particular strategy. Information contained in this document is believed to be reliable and accurate, but without further investigation cannot be warranted as to accuracy or completeness.