May 2022 | Monthly update

Omnis Managed Portfolio Service

The global economy could be flying into a perfect storm: certainly, clouds are gathering on horizons in Europe, China and the US. After a strong bounce back from the pandemic in 2021, the pace of economic growth was always going to slow. However, a combination of inflation, war in Ukraine, ongoing Covid lockdowns in China and more assertive central banks risks are accelerating the global economic slowdown.

Shock waves from Russia's invasion of Ukraine continue to reverberate around the globe with both the World Bank and International Monetary Fund lowering their global growth forecasts. Both institutions have downgraded their forecasts as they expect supply shocks to intensify, while commodity prices remain elevated – particularly for those, such as oil, gas, wheat and sunflower oils, for which Russia and Ukraine are major suppliers.

The UK economy is already slowing, growing by just 0.1% in February after supply chain bottlenecks hit manufacturing and the cost-of-living crisis started to grip. Meanwhile, the US economy unexpectedly shrank in the first quarter, albeit partly due to temporary factors, such as companies rebuilding inventories, which are likely to reverse later in the year.

With inflation at multi-decade highs, concerns are mounting about its potential impact on corporate profitability. For example, in its latest quarterly update, Amazon announced its first loss since 2015 due to a drop in online sales and rising costs. As the boom to its business from the pandemic starts to fade, the online retail giant saw its sales slip 3%.

Amazon's loss highlights how consumers are tightening their belts in the face of spiralling prices and demanding energy bills as the cost-of-living crisis starts to bite. UK households this year are likely to experience their biggest hit to inflation-adjusted incomes in decades.

Much of the economic outlook will depend on whether households are willing to maintain their levels of consumption by drawing on a large stockpile of savings accumulated over the pandemic. In this respect, it is encouraging that, while consumer confidence currently remains very low because of inflation, expectations of job security remain healthy. If consumers are not worried about losing their jobs they may decide to dip into their savings to maintain their standard of living, which could offset the headwinds to growth coming from elsewhere.

Russia turns off the taps

Russia has told Poland and Bulgaria it will halt gas exports following their refusal to pay for supplies in roubles. The move highlights the risk that Russia could turn off the taps to Europe whenever it wants – an outcome which would almost certainly push Europe into recession.

Gas accounts for around a quarter of the European Union's energy usage, and Russia typically supplies around 40% of its natural gas imports. Concerns about the future of the economy are particularly stark in Germany, Europe's largest economy, because of its heavy reliance on Russian energy. While the UK is far less reliant on Russian gas imports than its neighbours, any disruption in Europe will no doubt have a knock-on effect and push global gas prices higher.

Russia's invasion of Ukraine continues to fan inflation, with the prices of cooking oil, wheat, fertiliser and fuel soaring. Russia is a major supplier of oil, gas, and metals, and, together with Ukraine, of wheat and corn. Reduced supplies of these commodities have driven their prices up sharply, stoking fears that inflation could remain higher for longer.

China locks down

Towards the end of the month markets tumbled over fears Covid restrictions in China could hit supply chains and the global economy. Millions of people have been placed under strict lockdown in Shanghai and other Chinese cities in response to the latest outbreak of Covid. It is looking increasingly likely Beijing will follow after officials launched mass testing exercises, shut schools and imposed targeted lockdowns on some residential buildings to try to rein in infections.

Shanghai and the regions near it are among China's biggest manufacturing hubs and lockdowns could have significant implications for the rest of the world. The worry now is that China's strict Covid-19 lockdowns will exacerbate global supply chain problems and extend the period of high inflation over the coming months.

As the lockdowns weigh heavily on domestic economic activity, the Chinese government has pledged to take measures to support the economy and markets. So far, however, there has been no sign of any meaningful action.

Investment outlook

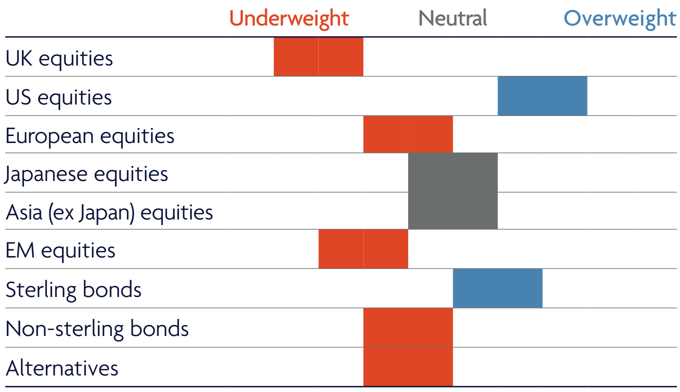
Central banks are still talking a tough game, which presents near-term challenges for the economic outlook. We are sceptical of market expectations for a rapid and material increase in interest rates over the next 12 to 18 months, believing the growth outlook too fragile to support such a meaningful tightening of policy. Nonetheless, central banks will raise interest rates to some degree: a perilous task against a backdrop of slowing growth.

We have therefore reduced our overweight position in US equities and reduced our overweight position in Japanese equities to neutral. These changes take us underweight equities in aggregate from a previously neutral stance.

Due to the ongoing economic uncertainty, we've maintained our overweight position in UK gilts to provide diversification and protection against stock market volatility. We have added to cash, which we're ready to deploy as and when investment conditions improve.

Despite the current outlook, we are optimistic the investment environment will improve, inflation will begin to fade, and global growth will pick up, all towards the end of the year. Importantly, central banks retain the right to halt or even reverse policy tightening if the economic outlook deteriorates. The existence of this pressure release valve should reassure long-term investors, even in the face of near-term challenges.

Asset allocation



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