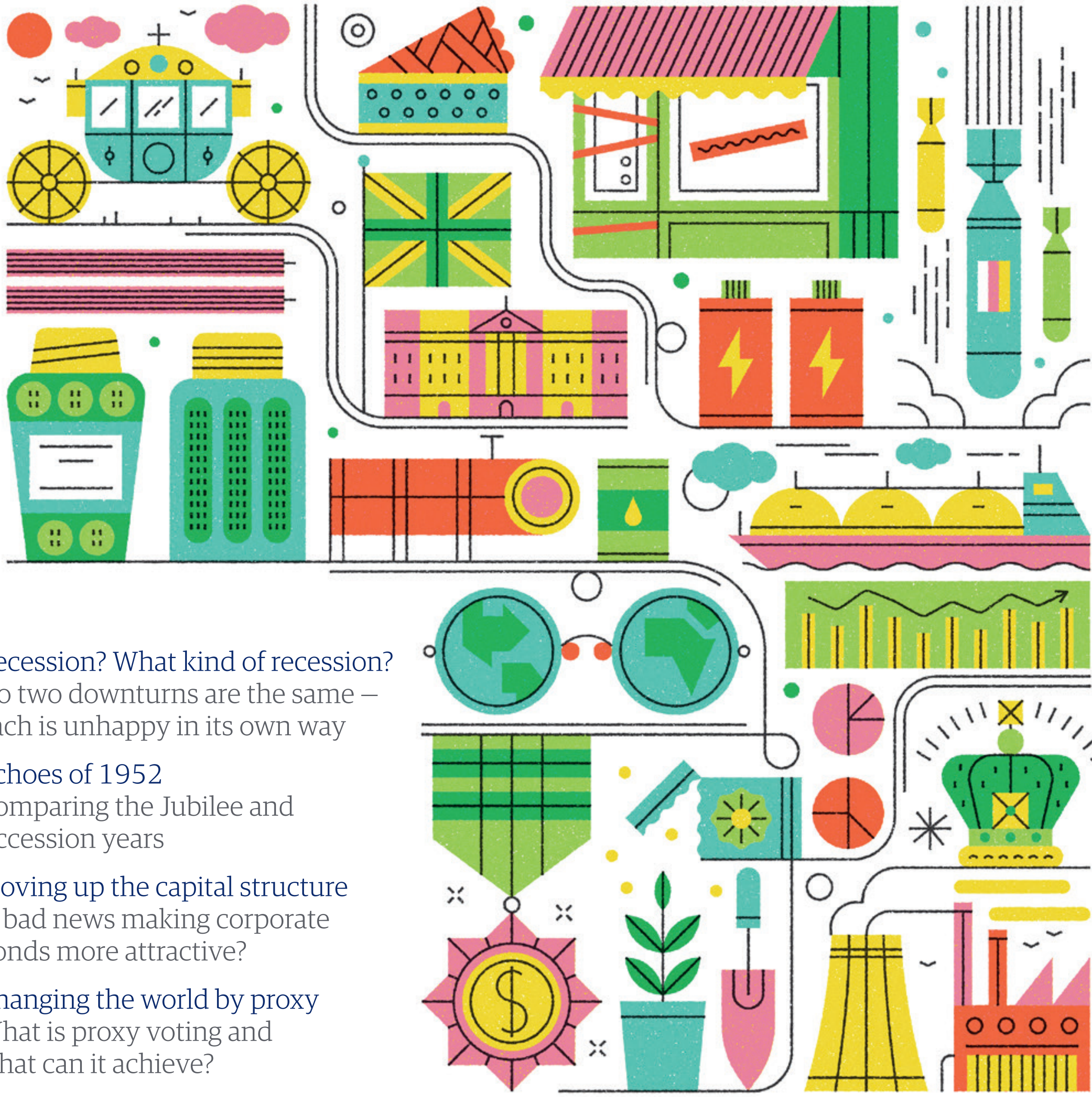
Investment*Insights*

Issue 33 — Third quarter 2022

Recession risk: US versus UK

Policymakers on both sides of the Atlantic have the unenviable task of taming the highest level of inflation in decades without doing undue damage to economic growth.



Rathbones
Look forward

Foreword

In the latest surveys of business confidence, demand has clearly weakened. However, order backlogs have cleared, inventories rebuilt, and shortages were reported as being their least severe since early 2021. The risks to inflation and economic growth have broadened, but we still think a protracted episode of stagflation is unlikely for the global or US economies.

Our lead article takes a look at how policymakers are tackling inflationary pressures on both sides of the Atlantic. To understand the investment implications, it's important to know the differences between the situations in the US and UK — from how their governments handled the economic shock caused by the pandemic to the composition of inflation in both countries.

As speculation continues about when the next recession will happen, we explore the nature of these economic contractions on page 4. While no two downturns are the same, it can be helpful to look at them through the lens of two basic categories — from those driven by a drop in demand or those where falling supply is the main culprit.

Having just celebrated Queen Elizabeth II's Platinum Jubilee, there are some uncanny parallels between the economic environment we're experiencing today and that seen in 1952, the year of her Accession. On page 5 we explore the similarities seen in both periods, including high inflation and labour shortages.

In our next article on page 6 we look at whether bad news is making corporate bonds more attractive. In the wake of a significant rise in bond yields amid rising fears of corporate defaults, we believe some value could be emerging within investment-grade corporate bonds.

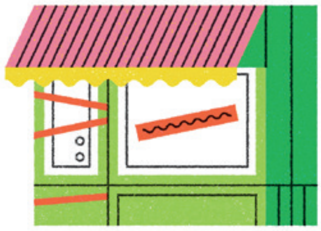
Shareholder voting is a fundamental tool to ensure management and boards act in the best interests of all stakeholders. On page 7 we explore how proxy voting can shape the corporate landscape through meaningful change, but also take a closer look at some of its limitations.

Finally, we think about the investment implications of the transition from fossil fuels to renewable energy. This shift will take around three decades and requires a fundamental reshaping of the way the electricity grid operates, meaning it could open up a range of opportunities (and some challenges) for investors.

We hope you and your family remain healthy and safe during this uncertain period. Please visit rathbones.com to find out more about our latest views on issues affecting the global economy and investments.

Liz Savage and Ed Smith
Co-chief investment officers

Same unenviable task but with clear differences



How do you tame the highest inflation in decades without doing undue damage to economic growth? That's the unenviable task facing policymakers on both sides of the Atlantic. Yet beyond that headline similarity, there are clear differences between the situations in the US and the UK, with potentially significant implications for investment strategy.

The key differentiator here is how governments responded to the initial economic hit of the pandemic back in 2020 and 2021. In the US, fiscal support was extraordinarily generous, more so than anywhere else. Cheques worth a combined $3,200 per person were sent directly to tens of millions, and that was just a fraction of the total response. With spending temporarily suppressed as people stayed at home, this helped US households build up additional savings on a scale not matched elsewhere (nearly 14% of GDP in the US, compared to around 5% in other advanced economies – figure 1).

In contrast to what you would expect in a typical recession, survey measures of financial distress in the US *fell* during the pandemic. And while a lot of those savings accrued to the very rich, who may be less inclined to spend them, not all of them did. Data from major US banks show that households across the income distribution hold substantially more cash now than before the pandemic.

That huge pile of savings now appears to be supporting demand in the US, which has remained strong this year even as cost-of-living pressures have increased. Household spending there is still above its pre-pandemic trend and continues to grow. In contrast, we've seen more evidence of weakness in the UK economy (and in the eurozone, where the situation is more like that of the UK than the US). The risk of a recession appears greater in the UK, where the latest data suggest that the economy was already contracting in the second quarter, than in the US.

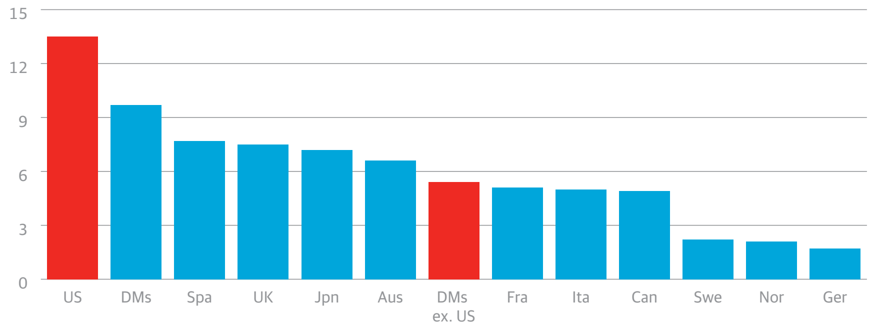
Meanwhile, the differences between the US and UK economies are also evident in the composition of inflation, even though the headline rates are similar. The strength of domestic demand in the US is clearly showing up in the figures there – with faster wage growth and services inflation than elsewhere, for example. In the UK, inflation has had more to do with imported cost pressures. The UK (and Europe) is more exposed than the US to the Russia-related disruption to energy supply, for example.

We need to take care in accounting for these differences in our investment strategies. The large multinationals that comprise the FTSE 100 make most of their money abroad, so depend more on the global than the domestic economy. That index has actually held up better than most of its global peers this year, even as the outlook for the UK has deteriorated. Since the invasion of Ukraine in particular, the FTSE 100 has also benefited from its high exposure to sectors, like consumer staples, pharmaceuticals and healthcare, that are relatively resilient to the economic cycle, and to commodity producers – both factors which may provide ongoing support. Instead, it is indices of medium and small-sized UK firms that are hit hardest by weakness at home. They've fared a lot worse than the FTSE 100 recently, something that may repeat later this year.

Finally, the contrasting growth and inflation outlooks for either side of the Atlantic suggest to us that interest rates won't rise nearly as far in the UK as they will in the US. This situation is one reason why we favour UK government bonds over their US counterparts. There's a greater chance of US-style demand-driven inflation remaining high for an extended period in the absence of higher rates. Whereas the relative weakness of demand in the UK suggests that it would take fewer rate hikes to tip it into recession, probably causing the Bank of England to change course.

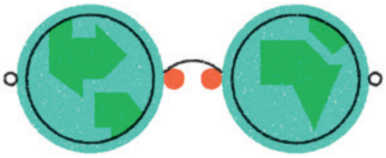
Figure 1: 'Excess' savings

'Excess' savings accumulated in 2020/21 (% of GDP)



Notes: DMs = developed markets. Source: Capital Economics, Refinitiv.

No two downturns are the same



Although the global economy is still growing at a respectable rate, clouds are gathering on the horizon. The risk of a contraction next year is rising, so how should we adjust if the outlook deteriorates further? We think what may help investors weather the next recession could be quite different to what served them best in the last few. It's not just whether the economy is flagging that will matter, but why.

No two downturns are the same — to borrow from *Anna Karenina*, each is unhappy in its own way. It can therefore be helpful to divide them into two basic categories: those driven mainly by falling demand, and those where falling supply dominates. Not every recession is easy to put into one box or the other, but it is still a useful exercise for guiding strategy.

Demand-driven recessions

The first type of recession has been more common in recent years. The global financial crisis fits this description, as does the brief downturn in 2001 after the bursting of the dotcom bubble. Falling demand dominated in the earliest stages of the coronavirus shock too, though it has bounced right back. We're now dealing with the repercussions for supply. Turning the clock back further, the deep recession of 1981-82 falls into this category too; policymakers deliberately crushed demand to tame inflation.

In this demand-led type of recession, both economic output and inflation typically fall. Usually, conventional government bond values rise in these circumstances (inflation-protected bonds less so), helping to cushion the blow of declining stock prices. The pattern within stock markets can vary a lot depending on the precise circumstances. But you might typically expect the worst performers to include the stocks of commodity producers (as commodity prices fall), along with those in other sectors highly dependent on the economic cycle — like banks, industrials, and discretionary consumer products.

At the other end of the spectrum, more defensive sectors like healthcare, utilities and consumer staples — where profits tend to fluctuate less with economic ups and downs — may hold up better.

Supply-driven recessions

The second type of recession includes those of 1973-75, 1980 (distinct from 1981-82) and 1990. All of these followed major disruptions to global energy supply — the OPEC oil embargo, the Iran-Iraq War and the First Gulf War, respectively. In these supply-driven recessions, output falls but inflation remains high or rises because of increased energy costs, which flow into all areas of the economy. Conventional government bonds may therefore not provide the same offset to losses in the stock market because inflation makes their fixed income payments less attractive (but inflation-protected bonds may perform a bit better than conventional ones). The patterns within stock markets may look quite different to those in a demand-driven recession too. For example, the stocks of commodity producers may perform relatively well, while some companies that might otherwise prove defensive (like producers of consumer staples with slim margins) may struggle with rising input prices. Finally, gold may fare much better than in demand-driven recessions, given the inflationary implications.

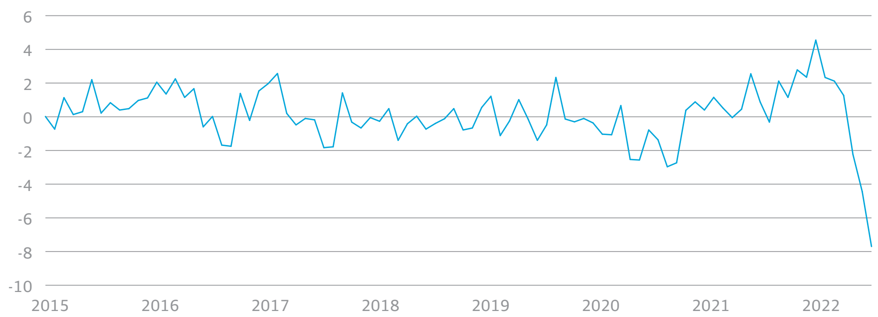
What about the next one?

There's a good chance the next downturn won't be a purely demand-driven one. Although rising interest rates will bear down on demand, we may not have seen the last of the disruption to global supply either. With China sticking to its tough zero-Covid policy, we cannot rule out further disruption to global manufacturing supply chains. Meanwhile, Russia is preventing crops from leaving Ukraine's Black Sea ports. And it has sharply cut gas deliveries to parts of Europe again recently (figure 2). A full shut-off would probably cause another surge in global energy prices, adding to the likelihood of the second type of recession. We're adapting our portfolios accordingly — for example relying less than usual on conventional government bonds for protection, while favouring inflation-linked bonds and gold.

We think what may help investors weather the next recession could be quite different to what served them best in the last few.

Figure 2: EU fuel imports from Russia

Fuels, lubricants and materials imports from Russia (month-on-month, %)



Source: Eurostat.

Comparing the Jubilee and Accession years

Economic history may not repeat itself, but it certainly echoes sometimes. In our last edition of Investment*Insights* we noted some of the recent echoes of the 1970s, while also pointing out the important differences that have convinced us that we're not about to repeat that decade's prolonged and painful experience with stagnant growth and high inflation. There are also other echoes we're hearing, and fortunately they sound less ominous.

Having just celebrated Queen Elizabeth II's Platinum Jubilee, let's wind the economic clock back to 1952, the year she ascended to the throne… *far from home, a war is decimating an eastern country, causing a synchronised spike in the cost of commodities. Here in the UK, inflation is running alarmingly high…*

So far, this uncanny parallel between the Queen's Jubilee and her Accession – of the invasion of Ukraine and the Korean War – is not what you would call a pleasant echo. But it's made more palatable by the fact that inflation rapidly returned to normal in 1953. Does this offer hope for 2023?

High inflation and labour shortages

When Elizabeth II was crowned, interest rates were low by historic standards at 2% (though they are a little over half that today). Inflation was climbing toward a peak of 9.2%, eerily close to the 9.1% inflation in the latest release of CPI data. Like today, there was also low unemployment and a labour shortage. In that post-war year, national debt was high too, eventually peaking at 250% of GDP, compared with about 100% now after a massive surge in spending on the battle against Covid-19.

A crucial difference between 1952 and the high inflation of the disco era – one that makes 1952 more akin to 2022 – is that wages and prices weren't spiralling as they did in the 1970s, and inflation did not become entrenched.

In the period of high inflation in the early 1950s, UK interest rates peaked at 4%. Current consensus forecasts are for the Bank of England's base rate to peak at 3.25% next year (although we are sceptical it will rise that far). By June 1954, inflation had retreated back down to 0.7%.

Government policies after the end of the Second World War encouraged mass migration from Commonwealth nations, which helped alleviate the labour shortage and had a dampening effect on wage pressures. Such policy is unlikely to be repeated today. Yet while labour shortages in some pockets of the economy are leading to sharp increases in wages, average UK wage growth remains well below inflation. In the late 1960s and early 1970s, wage inflation ran ahead of price inflation. We don't expect it to start doing so now, not least because labour market institutions are different – there are few inflation-indexed wage contracts, labour movements are weaker and so is bargaining power (union settlements are still, by and large, well short of inflation).

A series of unique shocks

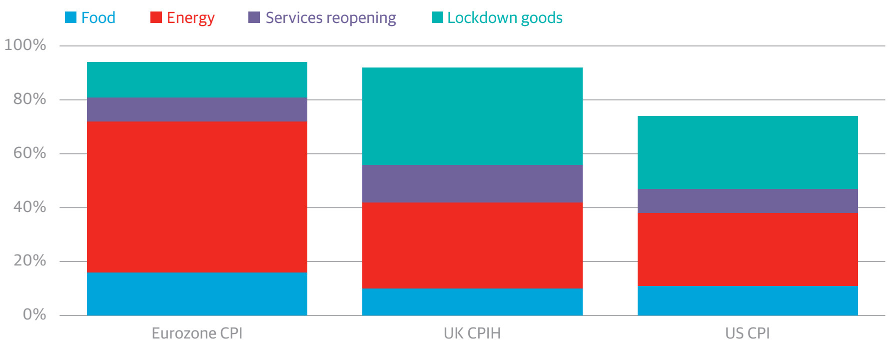
Just like in the early 1950s, today's inflation is primarily explained by a series of unique shocks to the supply of goods and services over the last two years, rather than fundamental shifts in the inflation forming process. In the UK, 75% of today's inflation is due to food, energy and the categories of goods that had outsized demand during lockdown and supply chains that failed to keep up – in the eurozone it is over 80% and in the US it's about two-thirds (figure 3). In other words, we think we would need more shocks to cause a more profound, longer-lasting shift in the rate of inflation.

The economic outlook may not be as bright today as it would've been as Queen Elizabeth II headed into the second year of her reign, but we have solid grounds for hope that inflation – that arch nemesis – will also be in retreat as we head into Her Majesty's eighth decade.

Just like in the early 1950s, today's inflation is primarily explained by a series of unique shocks to the supply of goods and services over the last two years, rather than fundamental shifts in the inflation forming process.

Figure 3: Contributions to inflation

Today's inflation is mainly due to food, energy and other goods that have seen outsized demand



Source: Redburn.

Is bad news making corporate bonds attractive?

Bonds have undoubtedly had a tough start to the year. Many headlines have highlighted that Treasuries and gilts (US and UK government bonds respectively) have had one of their worst starts to the year on record. Focusing on the sterling market, investment grade (IG) corporate bonds have benefited from their shorter duration, which means they're less sensitive to rising yields. So, all else being equal, their prices should fall less than government bonds as yields on the latter rise. But they've also been hit by a big widening in credit spreads – the extra yield (or spread) they offer relative to government bonds to compensate investors for taking on default risks.

There may be more pain ahead...

The reasons for the sharp rise in government bond yields (and hence fall in bond prices) this year are well documented. Inflation is running at levels not seen in decades and is proving more persistent than many expected. With inflation data repeatedly coming in higher than forecast, investors have been forced to keep shifting their expectations about how quickly rates will be increased and also about how high they might go. This has driven government bond yields up right across the maturity curve and prices down.

Despite the significant fall in gilt prices year-to-date, we aren't convinced that prices have yet reached rock-bottom (or that yields have peaked). Current yield levels suggest investors expect nominal GDP growth to slow until it settles around low levels similar to those seen in the 2010s. But if inflation sticks higher than we saw in that period or if it moderates more slowly than most investors currently anticipate, government bond yields could come under more pressure.

...but it might not be as bad as it seems

Nevertheless, we believe value is emerging within IG corporate bonds in the wake of the significant rise in government bond yields and widening credit spreads. Current credit spreads are pricing in a five-year default rate that's significantly above any actual five-year default rate for IG bonds over the past 50 years (figure 4). Yet when we look at the fundamentals of most of the businesses issuing IG debt, overall they're in good shape: they aren't over-burdened with debt and their earnings are strong enough to comfortably meet the interest payments arising from that debt.

For investors with a medium-term investment horizon, we believe it looks like an attractive time to add some exposure to the asset class to take advantage of its higher yields (while also securing income streams whose levels are fixed, unlike equity dividends, where payout levels are discretionary as we were reminded during 2020).

In the short term, credit spreads could continue to widen. However, IG corporate bonds are 'lower beta' (less volatile and so lower potential return) investments than equities. This suggests they could be expected to outperform equities if an economic slowdown develops into a full-blown recession (which isn't our base-case scenario).

The credit spread is analogous to the equity risk premia (ERP) of equities (the extra compensation investors require over the government bond yields to take on the uncertainty of tomorrow's earnings), so we can compare the sensitivity of them to changes in the business cycle. The ERP of European equities is 2.5x more sensitive to the business cycle than IG credit spreads. The US ERP is 2x more sensitive.

Companies' capital ranks higher up the capital structure than its equity: debt holders get priority claims on a business's assets if it fails. With the moves seen year-to-date, we think investors are now getting attractive compensation for the risks involved in lending to IG corporates. At the same time, adding some of the asset class to overall investment portfolios could bring valuable volatility-dampening benefits.

For investors with a medium-term investment horizon, we believe it looks like an attractive time to add some exposure to the asset class to take advantage of its higher yields.

Figure 4: Corporate bonds are pricing in sharply rising defaults

Bloomberg Sterling Aggregate Corporate Yield to Worst* (%)

*lowest possible yield an investor would receive barring default.
Source: Bloomberg.

What is proxy voting and what can it achieve?

When you buy shares in a company, in effect you own a stake in it and that comes with the right to vote on many aspects of how it's run. You're entitled to vote on who sits on the board, how executives are compensated and a number of other matters that are directly relevant to your ownership of the stock, such as the payment of dividends. Increasingly, shareholders are also being given the opportunity to vote on important environmental, social and governance (ESG) issues, such as a company's strategy for reducing its carbon emissions in the face of climate change.

Voting is widely acknowledged to be one of the most fundamental tools available to shareholders to ensure management and boards act in the best interests of all stakeholders. Voting can bring about material change, but it also has its limitations.

Bringing about meaningful change

Academic studies show that companies do, in many cases, make meaningful changes to their practices in direct response to shareholder voting activity. For example, in a study of Say on Pay votes in the UK, which give shareholders the opportunity to cast an advisory vote on a company's executive pay proposals, Ferri & Maber found that where shareholder dissent exceeded 20%, boards implemented 75-80% of shareholder requests to remove specific provisions.[1]

Indeed, this echoes much of our experience of voting shares on behalf of our clients at Rathbones. There have been numerous instances where our votes, or the private communication of our voting intentions to investee companies prior to our votes being cast, has led to tangible changes benefiting the company, its shareholders and the wider community.

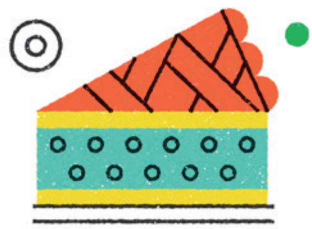
Take for example our recent Votes Against Slavery campaign. Rathbones convened an investor coalition representing over £9 trillion in assets under management, identifying 44 companies in the FTSE 350 that had failed to meet the reporting requirements of the 2015 Modern Slavery Act. The investor group used the prospect of a potential abstain vote on the acceptance of the Financial Statements and Statutory Reports at each company's 2022 AGM as leverage to drive changes in reporting practices. So far, 61% of the companies targeted as part of the engagement have become fully compliant with the reporting requirements, and we expect this figure to have risen by the time the engagement is concluded later this year.

What are the limitations?

Still, voting as a means of communicating concerns to an investee company or having a say over the way it operates is not without its limitations. Company law varies from country to country, and as a result, there are varying degrees to which companies are legally bound to act on the outcome of a particular vote.

In the US, resolutions that have been put forward by shareholders, as opposed to the company itself, are merely 'precatory'. This means that even if the resolutions are supported by a majority and pass, companies are under no legal obligation to act on them. In a study of US shareholder resolutions tabled between 2007 and 2019, Matsusaka, Ozbas & Yi found that companies only implemented 31% of majority supported requests by shareholders.[2]

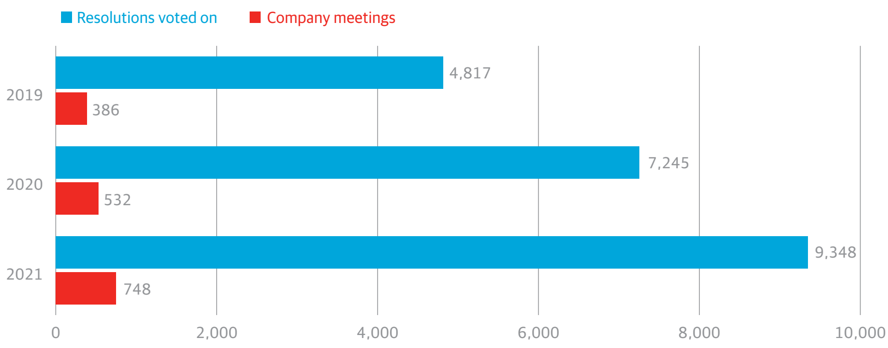
In many cases we shouldn't expect voting to bring about sweeping changes in business practices overnight. But it is undeniably a powerful feedback mechanism and an effective vehicle for incremental change – bit by bit, shareholders can help shape the corporate landscape for the better.



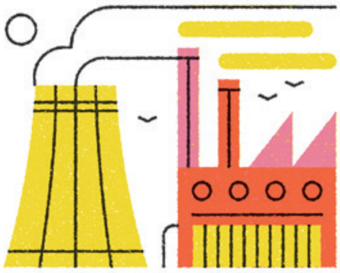
[1] Ferri & Maber, 'Say on Pay Votes and CEO Compensation: Evidence from the UK,' p5
[2] Matsusaka, Ozbas & Yi, 'Can Shareholder Proposals Hurt Shareholders? Evidence from SEC No-Action Letter Decisions', p22

Figure 5: Our engagement record

The number of resolutions we voted on in 2021 and preceding years



Source: Rathbones.



Risks and opportunities in the energy sector along the way

Increasingly, countries and businesses are committing to 'net zero targets' for reducing their carbon footprints, pledges that now cover about two-thirds of the world's CO_2 emissions. To reach the targets set out in the 2015 Paris Agreement on tackling climate change, two-thirds of the world's energy supply needs to have switched to renewables by 2030. That's four times what is produced today (figure 6).[1] Can the target be reached? And what are the risks and opportunities for investors as the world weans itself from fossil fuels?

The transition to renewables

The transition to renewables presents clear challenges for fossil fuel producers, exacerbated by the considerable risk of falling behind in reaching Paris goals, which could lead to sudden policy shifts that could be even more damaging.

But what about the opportunities, given the huge investment that will be required? We believe that the best opportunities may be found not in the rapidly growing renewable energy generation business, but in the infrastructure and support services needed to enable growth in this naturally variable source of energy, and ultimately to get it to consumers.

To be sure, a favourable combination of supportive policy for tackling climate change, continually improving economics and technological advances, plus huge and rapidly increasing demand from electrification will result in substantial growth in renewable energy generation. As the transition will take place over the next 30 years and beyond, this presents a multi-decade investment opportunity. But there are significant questions as to how attractive the returns will be. There are justifiable concerns that returns from renewable energy are getting squeezed by too much money chasing too few projects.

For large projects, the spread between the cost of capital and estimated returns is already thin compared to typical spreads for capital investment. Fairly minor deviations from these core assumptions – whether relating to development cost, lease cost, load factors or power prices – could quite easily make the difference between creation and destruction of value.

Fortunately for investors, renewable generation is only one part of a complex interconnected system. The potential returns may be more attractive from the substantial investment that will be needed in the infrastructure to enable this huge global transition. This shift from bulk fossil fuels to bulk renewables requires a fundamental reshaping of the way the electricity grid operates. Crucially, this entails a move to more variable sources of energy – which depend on wind and sun conditions for example – and the battery technology needed to even out the supply.

We see two areas that are key to overcoming bottlenecks and enabling this transformation, and that we believe provide the potential for attractive and sustainable investment returns:

1. Getting energy where it's needed: transmission networks and supply chain equipment
2. Getting it there more flexibly: decentralisation and digitisation of distribution

Getting energy where it's needed

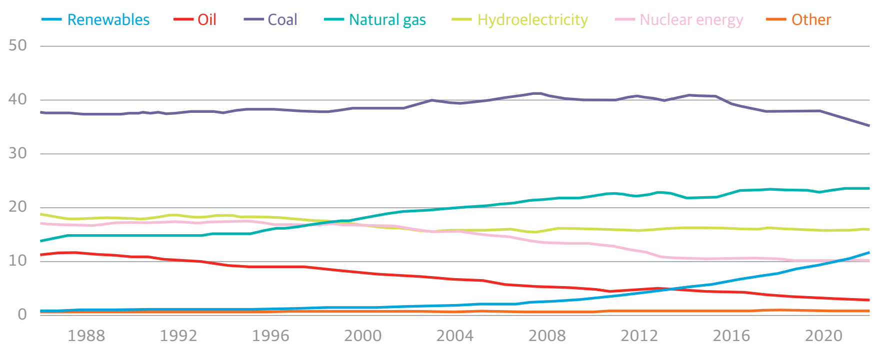
According to energy consultancy DNV[2], investment in electricity grids is falling significantly short of the requirements to integrate high levels of renewables. DNV expects $20 trillion to be invested in grids globally over the next 30 years, and for grid expenditure to grow more strongly than power supply. This is expected to be driven by greater electricity demand, the connections needed to get the electricity to consumers, and the reinforcement of transmission and distribution systems. Similarly, BloombergNEF estimates that at least $14 trillion must be invested in the grid worldwide by 2050 to support an evolved power system[3], warning that without adequate investment the grid could become a bottleneck.

According to DNV, low-voltage grids are expected to be receiving the largest proportion of spending by 2050. These are the distribution networks that take electricity from the high-voltage transmission system (think pylons) and step it down to 240v for households and businesses (figure 7). Underground and undersea expenditures are also expected to grow significantly.

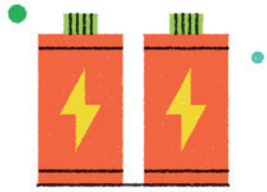
Equipping the supply chain for offshore wind, with the exception of the supply of the wind turbines themselves (from the turbine manufacturers such as

Figure 6: Is the shift to renewables too slow?

Share of global electricity generation by fuel (%)



Source: BP Statistical Review of World Energy 2021.



Vestas and Siemens Gamesa) presents opportunities for service companies. These include the foundations, the cables that connect the turbines to each other and to the power grid (known respectively as inter-array cables and export cables), and the transportation and installation of the turbines. We are also beginning to see offshore wind awards being offered as integrated packages. An example of this is Subsea 7 being awarded the Seagreen Offshore Wind project in Scotland, which combined foundations and inter-array cable installations. This trend also plays to the complex project management strengths of services companies.

Getting it there more flexibly

The other area that will require significant investment to support high penetration of variable renewable energy is increased grid flexibility and decentralisation. In order to meet demand and ensure the safe operation of the grid, the variable nature of renewable output must be compensated by sources of flexibility such as battery storage and demand response. According to the International Renewable Energy Agency (IRENA), the key sources of flexibility are the large-scale deployment of electric vehicles (EVs), hydrogen production, battery storage and demand-response systems.[4]

Grids must become smarter to integrate various sources of supply and demand in order to accommodate this flexibility, benefiting companies that can play a role in facilitating this transformation. Distribution grids will also become more important due to increases in smaller power plants closer to demand, requiring decentralised energy systems (DESs).

Unlike traditional centralised power generation and distribution, DESs generate energy close to where it is consumed and typically use renewable energy sources – mainly wind, solar, and biomass at present. Alongside advantages such as proximity, energy security, reduction of distribution losses and cost savings, DESs can help address urgent environmental concerns.

To meet their ambitious renewables targets, a growing number of countries are adopting DESs. Investment in DESs is forecast to grow 75% by 2030, with up to $864 billion to be invested over the next decade.[5] DESs are projected to then account for 10% of global installed power generation.

Due to the modular nature of solar panels, technological advancements have benefited both large- and small-scale installations, rapidly driving down the cost of solar power. Battery storage technologies have seen similarly rapid cost declines. In the transport sector, EVs raise the importance of smart charging and active management of local electricity networks.

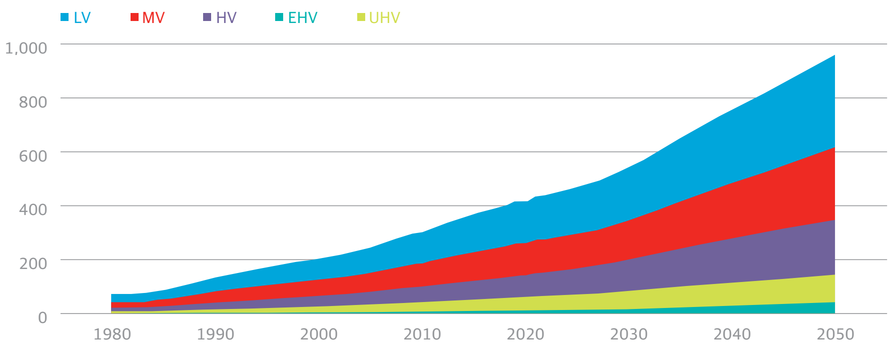
Finally, development of IT has profound implications for how different elements of the power sector interact. Advanced Metering Infrastructure (AMI) at the household, business and community level enables more efficient and reliable operation of the energy system, while also allowing consumers and utilities to closely monitor their usage.

The energy transition, including the storage and transfer of power throughout the networks, will be a significant task for energy companies and utilities. This will include core providers to the system such as National Grid, as well as various listed utility companies – also, dare we suggest, oil and gas sector companies such as Shell, BP, Eni and Repsol. The knowledge, capital and skillset to deploy capital as required may sit at present in these companies, and their plans to reinvent themselves are underway at varying levels, company dependent.

We have a dedicated group of investment professionals keeping a close eye on this world-changing transition, and how, as long-term investors making this journey together, we can avoid the potential roadblocks and potholes and make the most of the opportunities along the way.

[1] The International Energy Agency, 'Net Zero by 2050: A Roadmap for the Global Energy Sector', 2021
[2] DNV, 'Global Energy Transition Outlook 2020'
[3] BloombergNEF, 'Power Grid Long-Term Outlook 2021'
[4] IRENA, 'Global Renewables Outlook', 2020
[5] Frost & Sullivan, 'Growth Opportunities in Distributed Energy, Forecast to 2030', June 2020

Figure 7: Spending on low-voltage grids is expected to be the highest by 2050
World grid expenditure by voltage class ($ billion / year)



Source: DNV Global Energy Transition Outlook 2020. Note: LV = low voltage; MV = medium voltage; HV = high voltage; EHV = extra-high voltage; UHV = ultra-high voltage.

Financial markets

Stock markets fell sharply over the second quarter of 2022 amid fears that persistently high inflation and rising interest rates would lead to economic stagflation (where inflation remains high despite a slump in growth).

Share prices in the US, Europe and Asia-Pacific all plummeted. The benchmark S&P 500 share index fell 20% in the year to date. The Nasdaq suffered deeper losses over the quarter as the technology companies that dominate the index bore the brunt of rising interest rates. It was down 29% year to date.

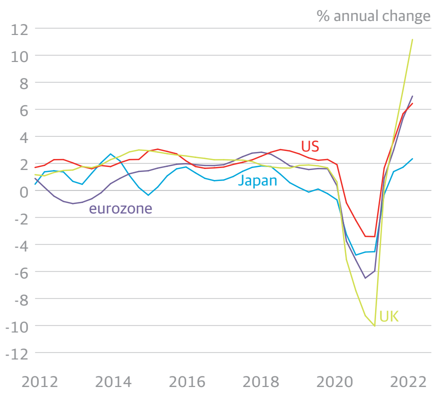
Rates continue to rise
US Federal Reserve chair Jerome Powell said he will back interest rate increases until inflation starts falling back toward a healthy level. The persistence of US inflation has investors pricing in multiple half-point interest rate raises by the Fed, which some fear may tip the economy into recession.

Emerging markets also suffered heavily, given their greater sensitivity to economic cycles and in particular to the slowdown in China, which is a growth driver for Asia in general.

Inflation remains elevated for now
Geopolitical uncertainty and the ongoing pandemic mean the price of crude oil remains high. Gold prices moved back up toward recent multi-decade highs after US inflation unexpectedly accelerated in the latest reading.

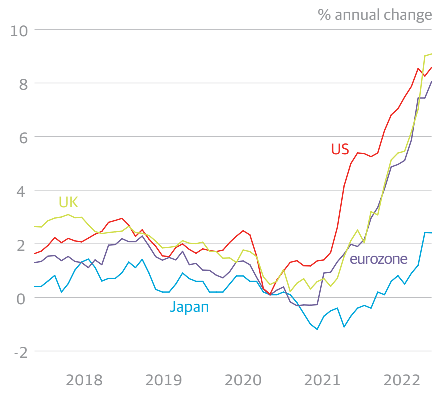
However, we see several reasons to think that inflation should fall from its multi-decade highs. High energy prices should start to fall out of the equation, unless they surge again. Meanwhile, the worst of the supply chain problems that helped drive inflation up last year now seem to be behind us. This is probably helped by the ongoing normalisation of consumer spending from goods to services that are now opening back up.

GDP growth



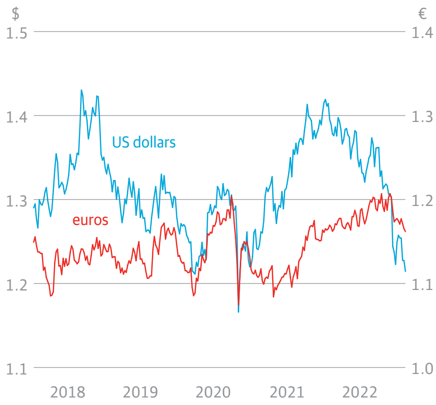
Source: Factset and Rathbones.

Inflation



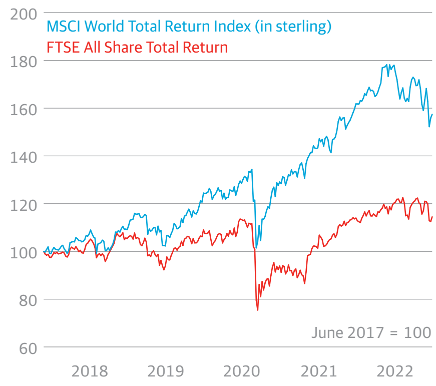
Source: Factset and Rathbones.

Sterling



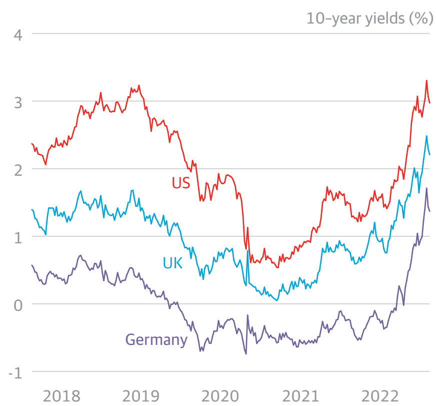
Source: Factset and Rathbones.

Equities



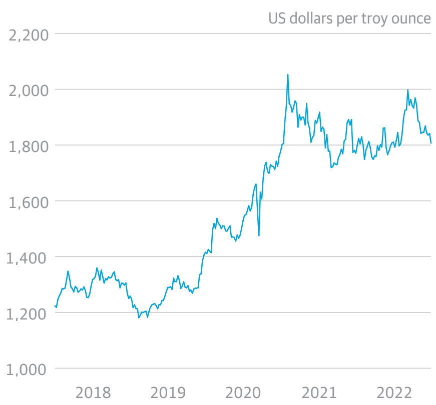
Source: Factset and Rathbones.

Government bonds



Source: Factset and Rathbones.

Gold



Source: Factset and Rathbones.

Past performance is not a reliable indicator of future performance.

Important information

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