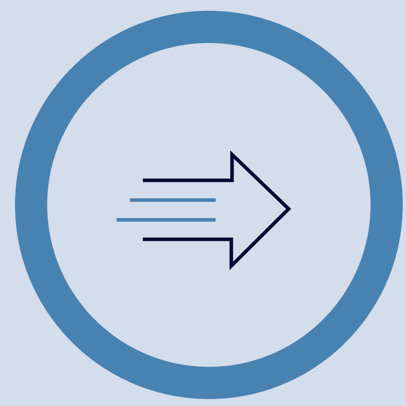
May 2022 | Investment perspectives

A fine balance



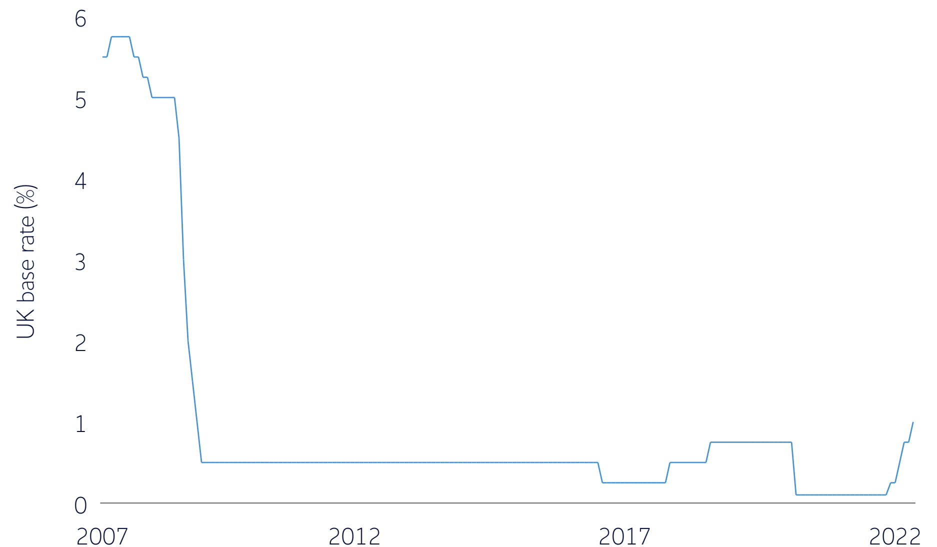
Central banks around the world are trying to tame inflation by increasing interest rates. What are the likely implications for the global economy, financial markets and investment returns?

Why are central banks increasing interest rates?

You've probably noticed that the price of most things has been going up rapidly over the past year. Household energy bills have doubled for many of us and our weekly supermarket bills are rising too. A high rate of inflation is unsettling for many reasons, and central banks are increasing interest rates in an effort to bring it back down. For example, the Bank of England base rate rose to 1% from 0.75% at the beginning of May, which is the highest level since 2009.

Figure 1: Interest rates in the UK are now the highest they have been since before the Global Financial Crisis of 2007/2008.

Many expect interest rates to end up above 2% by the end of 2022.



Source: Bloomberg

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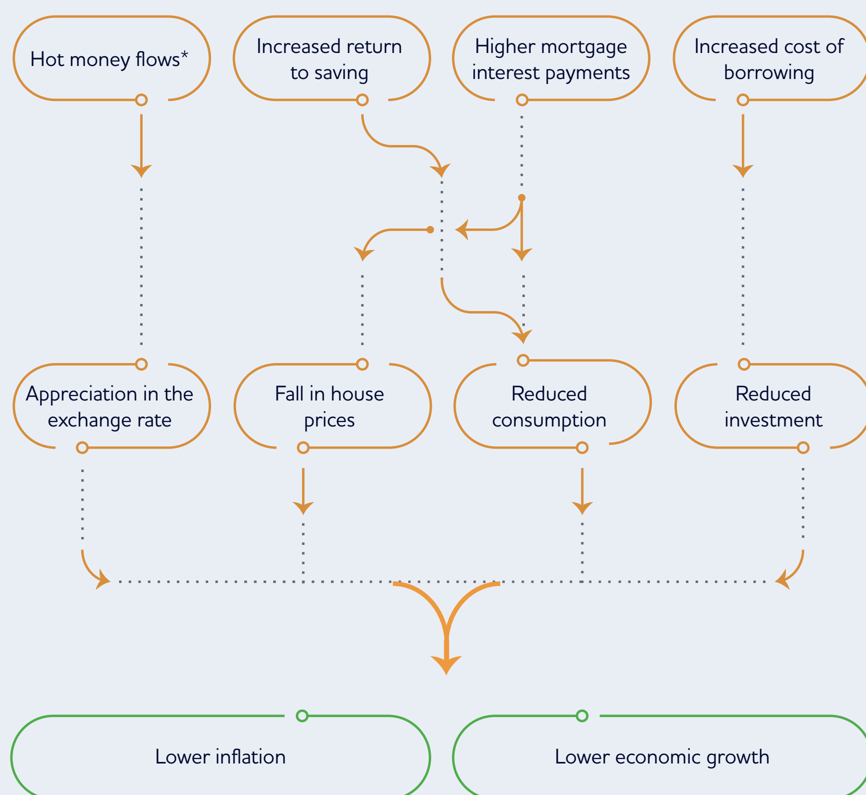
Why is there a risk of recession?

The theory is that by increasing interest rates, central banks can take some of the heat out of the economy, which should in turn cool inflation. Policymakers at the Bank of England, and other central banks, expect inflation to remain high for some time and are planning further rises over the rest of 2022. Specifically, higher interest rates increase the cost of borrowing, reduce disposable incomes and therefore limit the growth in consumer spending. This is how higher interest rates tend to reduce inflationary pressures. The challenge they have is that the economy is already cooling off from the high levels of growth we saw in 2021. This means that there is a risk that central banks could slow the pace of economic growth too much and then cause a recession – which is officially defined as two consecutive quarters where the economy contracts.

Figure 2: Effect of higher interest rate



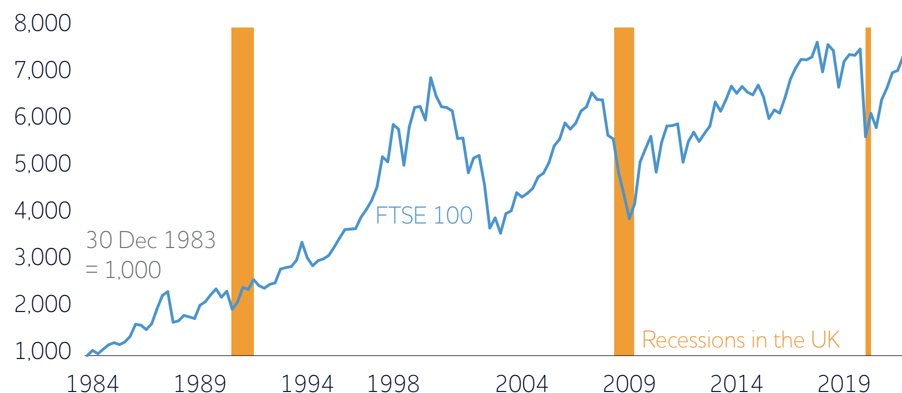
Source: www.economichelp.org

* When interest rates are increased, you get better returns on UK savings accounts and as a result money flows in to the UK, likely from areas where the interest rate is lower. This increases the demand for Sterling leading to an appreciation in the value of the Sterling Pound.

What happens to markets during a recession?

During a recession, the stock market tends to fall. Conditions can be volatile with share prices experiencing relatively large swings in both directions over the course of just a few hours or days. Investors tend to react quickly to any hint of news — either good or bad. Yet investment opportunities always remain, even when the going gets tough. They include the shares of companies that are less exposed to the economy, for example in so-called defensive sectors like healthcare and utilities because, even in a recession, people still need to pay for their utility bills and need access to healthcare and medication.

Figure 3: Equity markets tend to begin falling ahead of a recession and often recover promptly whilst we remain in a recession.



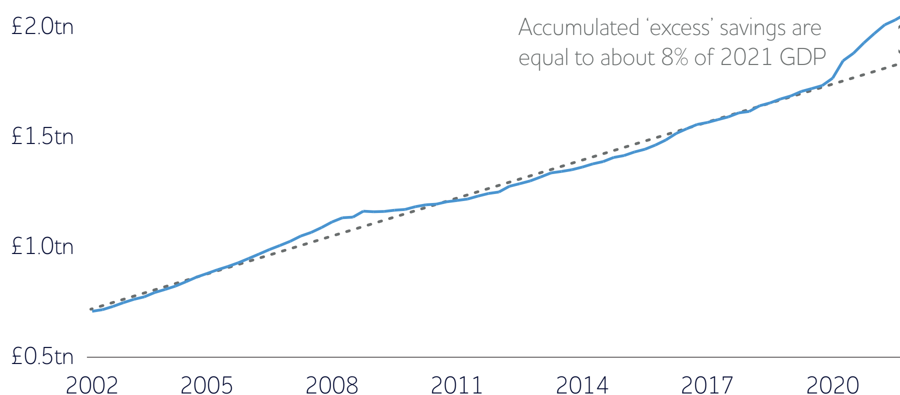
Source: Bloomberg

Why we think 2023 will be a better year for the economy than 2022

The global economy is still readjusting from the disruption caused by the pandemic, which affected manufacturing output, global trade flows and patterns of consumption. One side-effect of the lockdowns is that many of us have excess savings as a result of not be able to spend so much when we couldn't go out. As inflation moderates and real disposable incomes rise, we expect economic activity to pick up next year after a slowdown – or possibly a contraction – in the second half of this year.

Figure 4: The UK consumer holds a golden ticket.

The economy could benefit from households releasing the almost £180 billion worth of 'excess' savings (8% of GDP) built up during the pandemic.



Source: Bloomberg

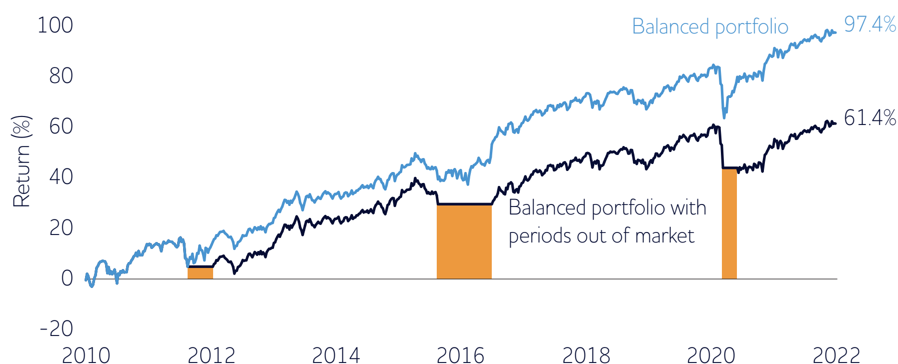
Should I sell my investments until we are out of the woods?

History shows that patience and commitment tends to be a winning strategy, which is why it's important to remain invested in line with your risk profile even when conditions are challenging. A diversified portfolio of different asset classes that are actively managed to reflect the evolving environment can be the most successful approach.

Even professional investors admit that timing the market is incredibly difficult. For example, if you invested £10,000 on 29 June 2001 in the UK stock market[1], 20 years later it would be worth £29,510. If you had missed the 10 best days in the UK over the last 20 years, you would seriously dampen your investment returns and it would only be worth £15,339. Don't forget that some of the market's best days come straight after some of the worst– so trying to time the market can often mean you lock-in the losses and miss on the subsequent recoveries. Another way to look at it would be to see what would happen to a well-diversified portfolio if you tried to time the market (figure 5).

Figure 5: The cost of getting it wrong.

To assess the impact of divesting when big markets shocks occur, we assessed two identical 'Balanced' portfolios*. In one portfolio, the investor pulled out when the market fell 10% and only reinvested once stock markets had risen 10% from that point. In the other portfolio, the investor stayed invested throughout. As shown in the chart, missing out on recoveries can be very costly for long term investors.



Source: FE fundinfo. 1 January 2010 – 31 December 2021.
* Using Graphene C2 Balanced Index Equivalent for Balanced Portfolio. Assumes investments are withdrawn when market falls 10% and reinvested when market subsequently recovers 10%.

[1] Investing in the FTSE All Share Total Return index.

Find out more

We recently recorded a podcast to explain the current state of play for investment markets, which you might find useful to listen to.

As always, the best thing to do when you are feeling nervous about your portfolio is to stay calm and speak to your financial adviser who will be able to assess your portfolio against your long-term objectives.

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