Private Capital Advisers

# The Ukraine, inflation and interest rates

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Markets have been profoundly unsettled in the early part of the year with a humanitarian tragedy unfolding in the Ukraine, inflation rates around the world hitting levels not seen for decades and Central Banks preparing to finally lift their emergency interest rate settings. As if the Omicron wave of the pandemic was not enough.

At times like this it is fair to ask whether we should be taking defensive action in portfolios. Our process for assessing situations like these is as follows:

1. What is the likely impact of this event on the long-term outlook for interest rates or company profits?
2. Has the market's reaction already taken the long-term impacts into account?
3. Do we have any special short-term insights that are not known to the rest of the market?

More often than not, we find that there is no case for action when events like these take place. In fact, markets mostly over-react to news and so responding is normally a very expensive strategy. Our assessment of these events is shown below:

## Russia invades Ukraine

**Likely long-term impacts on interest rates and profits:** Unless this conflict spirals into a major war with the US and or NATO involvement, this is likely to remain a humanitarian tragedy for the people of Ukraine with little long-term impact on profits or interest rates.

**Market reaction:** So far, the markets have shown very modest movements other than in Russia itself. Without wanting to diminish the tragedy this invasion is for the people of the Ukraine, this market response appears appropriate.

**Do we have any superior short-term insights as to how this will develop?** None.

**Portfolio action required:** None.

## Inflation hits decades high levels in the US and Europe

**Likely long-term impacts on interest rates and profits:** This, so far short, bout of inflation has changed the rate at which Central Banks will remove their emergency settings of zero interest rates and Quantitative Easing. We believe that as long as Central Banks remain committed to keeping inflation at moderate levels then they will do what is necessary to bring inflation back to the 2-3% range that have long been part of our base case forecasts.

**Market reaction:** The likely increases in cash rates have already been factored into market prices, most particularly in the bond market where yields on 10-year government bonds have risen from 0.8% to 2.1%pa. This means that the markets are assuming that cash rates will rise to around 2%pa over time which is line with our expectations.

**Do we have any superior short-term insights as to how this will develop?** There is much genuine uncertainty about how this situation will pan out in the short-term particularly insofar as whether Central Banks will be able to achieve a soft landing or whether they may trigger a recession. The former will be good for markets while the latter is clearly bad but as we have no special insight as to which way the short-term will unfold, we rely on our long-term forecasts which are largely unchanged.

**Portfolio action required:** None.

### Rising interest rates

**Likely long-term impacts on interest rates and profits:** These moves have long been incorporated into our forecasts and so do not change our outlook for long-term returns on equities.

**Market reaction:** The likely increases in cash rates have already been factored into market prices.

**Do we have any superior short-term insights as to how this will develop?** No.

**Portfolio action required:** None.

### We constantly monitor but rarely need to take action

The bottom line is we never ignore these types of events. We are constantly analysing their likely impact on portfolio returns but our process means that we will rarely take action. A great example was in March 2020 when we assessed the likely long-term market impact of the pandemic to be minor and that the market had over-reacted. In those circumstances we would rather be buyers than sellers.

Our long experience is that knee jerk reactions to, even momentous, global events, rarely produces good outcomes for investors. For now, we are continuing to suggest that no action is the correct response to these emerging themes.

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