Monthly Flow OUTLOOK

March 2022
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FlowBank
Seriously Simple Swiss Banking

Too much uncertainty

- Russia's attack on the Ukraine adds more layers of uncertainty
- Higher volatility is likely to persist as investors climb the Wall of Worry
- Clarity should arrive throughout March, helping markets move higher again

The Russian attack on the Ukraine shocked markets, sending equity indices through their January lows, and commodities skyrocketing. The aggression has also significantly changed global politics. As the conflict rages and Ukrainian troops and civilians hold off the Russian military, questions abound.

Putting aside the humanitarian disaster, the situation has left markets with even more uncertainty. A fluid situation that has quickly escalated means uncertainty surrounding Russia and the West's next steps. Consequences of the most severe economic sanctions ever leave questions about the ripple effect on other economies, and Europe in particular. Potential counteractions by Russia maintain uncertainty about oil and gas prices. How high can they go, and for how long? Will these prices push the US into a quick deal with Iran, to unleash more oil output? Finally, ongoing tensions and risks of further escalation raise questions about an impact on Federal Reserve thinking. This suggests investors' Wall of Worry has only gotten higher, with markets now positioned for a very dire outlook.

For now, we believe the Fed will remain on its stated path. Indeed, the situation appears to be a *net zero* at this point. Growth is at risk, but inflation will likely remain higher for longer as well, suggesting the Fed will hike rates by 25 basis points as planned in March. Beyond that, developments could impact the situation both in a hawkish and in a dovish direction, though speculation is ramping up that the March meeting will have more dovish rhetoric than in the recent past, though we would caution about dismissing tightening risks too easily. Supply chains are starting to show some improvement, though this could reverse with the crisis, and, in any case, inflation will take time to abate. Conversely, growth has held up despite some Omicron-induced January weakness, though we are starting to see levels come off from 2021 reopening highs. In Europe though, with EU growth at risk, a more dovish tone is likely of the European Central Bank.

Given the high volatility and the extreme bearish positioning of investors, we maintain our allocation for now, awaiting further information. March is set to be a very busy month in terms of data releases and now, geopolitical developments. We continue to believe that the market is pricing in too many rate hikes by the Fed, suggesting a lot of the move higher in yields might already be done, even though upside risk remains, especially if geopolitical tensions ease. We also expect equities to remain the more attractive allocation for investors for 2022 as a whole, given persistent Fed tightening risk. Still, markets are unlikely to rebound strongly while this much uncertainty persists. Volatility is therefore set to remain high, but clarity from the Fed, the ECB and on the Ukraine War should eventually lead to a move higher.

In the meantime, we maintain some hedges, especially as sovereign debt does not offer the same piece-of-mind investors have been accustomed to. Gold is likely to benefit from geopolitical risk and from higher commodity prices in general, though Fed tightening remains be a hurdle. We also look to safe haven currencies like CHF and JPY. The dollar is likely to remain in demand as risk-off sentiment weighs on EUR and others. However, upside could be limited given the move already seen. Moreover, the dollar tends to retreat after the rate hikes start.

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Equities

The Russian invasion of Ukraine shocked markets and added geopolitical tensions to investors' Wall of Worry. However, we expect the recent lows to hold, and while the current volatility could persist for the coming weeks, we believe the latest correction provides attractive entry points for the medium term. In addition, March should give more clarity on the path of monetary tightening from the Fed and the ECB, which should alleviate some investor concerns.

We maintain our current allocation with an overweight to cyclicals, as reopening is set to continue as Omicron fades. Energy should benefit even if we see a swift resolution to the Ukraine War. Tech companies that continue to show strong and sustained earnings growth should perform well, though more selectivity is likely needed going forward. Reduced dears surrounding Chinese regulation should support emerging markets over the year.

Fixed Income

Even though the consensus is pricing in 7 interest rate hikes from the Fed in 2022, yields peaked mid-February and have retreated since. Geopolitics certainly is one of the reasons, but a retreat from expectations of a 50bp hike in March and more aggressive balance sheet run-off also contributed to lower yields. Given ongoing tensions, we expect yields to remain contained, though another very high inflation print for February, a strong non-farm payrolls report and of course a hawkish tone at the FOMC meeting could push yields higher again. In addition, the ECB could confirm its hawkish "pivot", suggesting a negative surprise cannot be excluded.

We therefore continue to prefer credit over duration risk and still see opportunities in high yield and emerging market hard currency debt, despite recent volatility.

Currencies

The dollar is likely to remain underpinned by stronger growth and interest rate differentials compared to other major central banks, in addition to geopolitical tensions. However, the dollar tends to rise more before the rate hike start, suggesting less upside from here. In addition, the euro should benefit from improving risk appetite when volatility eases. The yen could retreat as risk off sentiment abates and the BoJ remains steadfastly dovish. Overall, we expect broad range-trading across major currencies.

Commodities

Commodities have been the main beneficiary of recent geopolitical events, with oil prices set to remain high even if the Ukraine War ends swiftly. Demand is recovering towards pre-pandemic levels and OPEC+ is neither inclined to add production quickly, nor able to logistically. The unknown remains a potential US-Iran nuclear deal, which would add substantial supply to the market. Gold has benefited from a safe haven bid, but tighter monetary policy remains an obstacle to much higher prices. Base metals should hold up as demand remains buoyant and Chinese policymakers are easing policy to support the economy. Overall, supply chain bottlenecks imply higher-for-longer prices across most commodities.

Crypto

Cryptocurrencies have suffered alongside risk assets since the beginning of the year, but lows are holding, and long-term adoption is not in question, which is set to continue throughout 2022. The higher correlation of crypto with tech and equities should prove supportive in the end, though swings around rate hike fears and risk-off bouts might come as a result. Moreover, the growing adoption of NFTs and other blockchain-based innovations, will likely be an added support.

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