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"May you live in interesting times" – An ironic expression often referred to as the "Chinese curse" although the origins are largely unknown and there is no known saying in China.

If you had to rank the list of things for investors to worry about a year ago, the war in Ukraine would undoubtedly have topped the list. In addition to the tragedy of the war itself, there were obvious ramifications for energy, wheat and other commodities where the resulting price rises would add to the rise in inflation which had already troubled central banks in December of 2021.

The Bank of England were the first to send a strong warning to markets that they would be quick to raise interest rates to combat rising inflation; at the time running at less than half the 10.1% recorded in March of this year. However, their rhetoric was quickly overtaken by the US Federal Reserve who, following the initial 0.25% interest rate rise in March 2022, accelerated their hikes to 0.75% every two months.

In order to fight the same global inflation threat, the Bank of England initially followed the Fed with rate hikes of their own but quickly found themselves almost impossibly conflicted. There is a big difference between the way US and UK mortgages work. US mortgage rates are priced off long-term interest rates which tend to rise far less quickly than base rates, whereas UK mortgages are typically priced on floating rates, linked to base rates, or much shorter-term 2-year fixed rates – impacting mortgage payers much sooner.

The European Central Bank and Bank of Japan were similarly unable, or unwilling, to raise interest rates as far and as fast as the Federal Reserve and this showed up in the performance of their respective currencies as the US dollar went from strength to strength throughout 2022. For Sterling, this meant a drop against the US dollar from $1.38 to just $1.06.

However, the end of the calendar year marked a change from worrying about inflation, to worrying about a recession – caused by a combination of the rise in the cost of living and higher rates impacting business debts, new loan financing and mortgage payers facing increased payments.

From that perspective, it may be surprising for many that the UK stock market index has held up so well – Indeed, except for the brief February high, it has not been higher since the summer of 2018. This is far better than the US index lagging around 14% behind the UK over 12 months. The difference has a lot to do with the composition of both indexes, the UK being heavily weighted towards the financial sector versus the US index, containing as it does well-known tech heavyweights of Apple, Amazon and Tesla which fell 27%, 50% and 65% respectively in 2022. US techs have staged a significant rally year-to-date, however, as the prospect of further interest rate hikes have been curtailed in the face of a slowing economy.

This easing of the upward pressure on interest rates is evident in the US 10-year bond yield which has fallen from over 4% in March to 3.4% at the end of April. This may have provided some relief for US government bond holders (whose bond prices move inversely to yields) but set against the rise from 0.5% in the summer of 2020, the speed and relative scale of the rise has not been seen for decades. This has implications for banks globally, but in particular US banks.

Three mid-sized US banks, Silicon Valley Bank, Signature Bank and First Republic have failed since March. Like the collapse of Credit Suisse, all three have been sold to rivals at a fraction of their value at the beginning of the year. The common denominator between them are unrealised losses on US government bonds sitting on their balance sheets – collateral which was previously considered the safest and lowest risk assets available to any bank.

In a sense, this remains essentially true since US government bonds will ultimately be redeemed at par (face value) when they reach their maturity dates in 5 to 10 years, for example. However, in the meantime, the low amount of interest they pay can be crippling for banks now that interest rates are significantly higher. It also presents a liquidity problem since selling bonds at a loss damages balance sheets. There are likely to be further collapses in similarly structured regional banks in the weeks ahead. However, whilst parallels with the Great Financial Crisis of 2008 may strike a chord, they may be premature.

As we have commented many times in the past, stock and bond markets are typically forward looking gauges of how markets believe the world will look around 9 months to a year from now.

US Inflation has fallen for nine straight months having nearly halved from 9.1% in June last year, to 5% in March. This is still higher than the Federal Reserve target of 2% but the base effect of year-on-year comparisons will likely bring the headline figure lower still. The direction of travel is what's important and this is evident in the continued fall in the 10-year US government bond yield.

This is no time for complacency, and there remains the possibility of policy error from all the major central banks, not just the Federal Reserve. But, as we saw from the significant bounce-back in stock markets following the sell-off in the wake of the Credit Suisse collapse, the real risk is selling out at low levels in response to distressing headline news. Even investors who may be lucky enough to time an exit would have to be doubly lucky to time their re-investment.

One commonly cited study by J.P. Morgan Asset Management found that between 1st January 1999 and 31st December 2018, an investor who remained fully invested in the US stock market would have earned an average annual return of 5.6%. However, if that investor missed just the 10 best-performing days out of that entire decade, their average annual return would have dropped to just 2.0%.

Stock markets have been remarkably resilient in the face of a dramatic rise in interest rates and geopolitical uncertainty and investors with longer-term strategies will have benefitted from staying invested. In challenging, and sometimes volatile markets, we remain committed to well-diversified portfolios to both protect wealth as well as benefit from compound income over time.

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