Strategy & Outlook

MARKET UPDATE

MAY 2022

April

Equities and bonds fell precipitously in April, a 3.4% decline for global equities in euro terms very much flattered by a 4.7% drop in the euro. US equities fell by 9.1% in local terms, technology falling even further (-11.8%), and a continuation of the outperformance value (-5.2%) over growth (-11.3%). Bonds also fell, European bonds falling by 5.4% and US Treasuries falling by almost 3%.

The reversal from the rally in late March was driven by continued hawkish comments from Federal Reserve (and ECB) officials, with confirmation coming from the minutes of the March Federal Reserve Meeting that the Committee anticipates the monthly cap on the decline holdings of Treasuries will be $60bn and the cap on MBS runoff will be $35 billion, with a "three months or modestly longer" phase-in period. The minutes also noted that "most participants judged that it would be appropriate to redeem coupon securities up to the cap amount each month and to redeem Treasury bills in months when Treasury coupon principal payments were below the cap." This is important, as it should allow surplus liquidity, currently sitting on the Fed's overnight reverse repo, to gradually decline from the current $1.7tln, which may effectively sterilise some of the QT whilst still reducing the Fed's enormous balance sheet.

Inflation concerns continue to drive markets, financial markets now pricing a further 250 basis points of rate hikes in the US over the next year, including a few 50 basis point hikes. The US yield curve briefly inverted during the month, 10-year US Treasury yields falling below 2-year yields, resulting in much commentary about recession. That this comes so early in the hiking cycle (the Fed was still easing policy last month!) speaks more to the pace than the extent of rate hikes being priced – a terminal rate of ~3% would still see real rates close to zero even assuming inflation falls markedly. Nevertheless, markets remain concerned that the Fed is more concerned about inflation than growth ("inflation" being referred to 83 times in the March minutes with no mention of "recession").

The war in Ukraine continues, with expectations of more sanctions against Russia. To wean Europe off Russian energy dependency, total capex of more than 125bln euro will be required – this is on top of the spending required for decarbonisation and defence. Capex and government spending should remain a support for the European economy for the next number of years.

Covid continues to disrupt the Chinese economy, rolling lockdowns causing the services PMI to fall dramatically. Officials signalled they would step up monetary stimulus, in addition to setting up a financial stability fund to stem financial risks ranging from weak rural banks to distressed developers. The Chinese Renminbi has also started to weaken which at the margin increases disinflationary forces.

Over the month, we saw more evidence that inflation may be peaking with the Mannheim used car prices showing a decline and core US CPI was lower than expectations. We believe we are at or close to the peak of central bank hawkishness as more evidence develops that inflation is peaking which should be supportive of upside in both equities and bonds.

Nevertheless, global equites towards the end of the month have retested their early March lows as volatility continues to rise. That the move comes during what has been quite a reassuring earnings season to date, given the level of caution over inflation, supply chains and tough comps coming into the reporting period suggests that the market moves are being driven by macro concerns. The relative outperformance of European equities suggests that US inflation, a strong dollar and a hawkish fed are the key drivers rather than the conflict in Ukraine. As we have noted above, there are a number of signs suggesting that inflation is not far from peaking if it has not already. ***Continued on next page***

MERRION INVESTMENT MANAGERS | CANTOR Fitzgerald **Want to talk to us about investments? Contact us.**

T: +353 1 670 2500 | **e:** info@merrion-investments.ie | **www.cantorfitzgerald.ie** | Cantor Fitzgerald House 23 St Stephen's Green, Dublin 2.

The reporting season highlighted again the secular growth themes that continue to underpin earnings growth. Enterprise spending and digital transformation projects are not slowing down. Capgemini did not see any change in consumer behaviour, all accelerating digital transformation, telling us that "sustained demand will be there, demand for digital transformation is de-correlated from GDP". Microsoft paint a similar picture, telling us that businesses are not looking to cut their IT budgets or digital transformation projects. Cloud businesses continue to grow at a mid-40s clip. Results from Qualcomm and Texas Instruments point to continued strength in demand for semiconductors from the automotive and industrial sectors. Meanwhile results for Visa, raising guidance despite exiting Russia, point to a healthy consumer and a strong recovery in travel with management expecting a return to 100% of 2019 levels by October (had previously said 90%).

Positioning

Over the month we switched some semiconductor holdings into housing-related cyclicals and renewables and reduced our bond exposure, but positioning remains largely unchanged, funds being positioned towards the upper end of the range for growth assets.

Outlook

It has been the worst start to US equities for 20 years, the worst start for technology in 20 years, and the worst start to global bonds markets (by a long way) in 20 years.

After that bad start, we've seen the largest 3-week outflow from global equities since March 2020, there has been significant selling of US equity futures of late, and sentiment on various measures that we track is as negative as March 09 levels.

This is driven by Fed rate hike expectations, which have ratcheted higher by a considerable margin, even as evidence mounts that inflation will subside.

Consumers (and the bond market) also believe inflation will subside, long term inflation expectations being significantly below short-term expectations.

Although we are very disappointed with how poorly MIM Funds have performed in this environment, we remain close to the upper end of our range for growth assets. Within growth assets we remain overweight structural growth winners which will benefit from the ongoing drive towards digital transformation, decarbonisation, and deglobalisation.

T: +353 1 670 2500 | **e:** info@merrion-investments.ie | **www.cantorfitzgerald.ie** | Cantor Fitzgerald House 23 St Stephen's Green, Dublin 2.