Strategy & Outlook

MARKET UPDATE

JULY 2022

Quarter 2

Year-to-date losses for global equities accelerated in Q2, finishing the quarter down 10.8% in euro terms (the worst quarter since Q1 2020) and -13.3% year-to-date, driven by accelerated tightening from the Federal Reserve and increased hawkishness from the ECB as inflation concerns remain elevated. The losses in European equities (-11.6%) were matched by losses on eurozone government bonds as yields rose dramatically, German yields rising by 75 basis points and periphery bond spreads widening. US equities fell by 17% on the quarter, led by technology (-21.6%), growth (-20.4%) continuing to underperform value (-12.2%).

The negative environment for equities and bonds has been driven by stubbornly high inflation and the reaction function of central banks, in particular that of the Federal Reserve, which has accelerated an already accelerated timeline to reach at least a neutral rate “expeditiously” – over the course of this year market pricing for year end rates has moved from barely 4 hikes of 25 basis points each to more than 350 basis points of rate hikes. The ECB is also reacting to higher-than-expected inflation and is now expected to move away from the negative rates that have prevailed since 2014 by September of this year.

Not only has the Fed started to hike rates in increments of 50 basis points, but a month after telling the market that “75 basis points is not under consideration”, the Fed raised rates by 75 basis points. A higher-than-expected CPI inflation print for May, combined with an increase in longer-term inflation expectations from a University of Michigan sentiment survey (since revised lower again) were the triggers for this move. In additions, the summary of economic projections showed a dramatic increase in expectations for short term interest rates over the next year.

In Europe, ECB President Lagarde announced an end to asset purchases this month, committed to a 25bp rise at July’s meeting, and suggested that a 50bp hike is on the table for September unless we see inflation pressures recede faster than current ECB expectations. The end of asset purchases and talk of rate increases inevitably sent periphery spreads wider, forcing the ECB to hold an emergency meeting and the promise of a new tool that could be activated should borrowing costs for weaker countries rise to fast.

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 rapid tightening of financial conditions and continued hawkishness from central bankers has caused the market to move on from the inflation story to talk of recession, with an increasing narrative that central banks will continue to hike regardless of the economic consequences, as long as inflation remains high. Of late, this has led to significantly lowered inflation expectations, but also lower equity markets as fear of earnings cuts abound.

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Positioning and Outlook

At the most recent FOMC press conference, Jay Powell highlighted the need for the Fed to bring down not just core but headline inflation, tough he also stressed that the Fed would need to be "nimble" in responding to evolving data. Any focus on headline inflation is a concern. Central banks have always focused on core inflation when setting policy, for two main reasons: food and energy prices are volatile (as has been amply demonstrated in recent weeks); and there isn't much they can do about them. Lagarde has stressed this latter point on numerous occasions, and Powell also admitted as much at the Senate semi-annual testimony. However, there is abundant evidence indicating that we are at peak inflation and therefore peak policy tightening. Close to 75% of the current US inflation rate comes from energy, food, lockdown goods and services reopening. In Europe, these factors are closer to 95%. Over the next twelve months these should unwind - commodity price shocks are unlikely to repeat, (and may even go into reverse), demand should rotate away from over-stocked goods and towards services, Chinese production should normalise, and services should return to normal operating conditions. Every supply chain indicator, from freight rates, lead times, trucking rates and corporate commentary suggests normalisation is under way. In that environment, central banks can certainly be "nimble", the obvious risk being that they are set on a path that tightens policy too much, too quickly, forgetting that monetary policy acts with a lag, and based on faulty assumptions about the underlying secular inflationary environment (which remains, in our view, disinflationary).

The key question that will continue to drive markets in the near term is whether inflation can come down fast enough to prevent central banks from pushing financial conditions too far. Growth is clearly slowing given the dramatic tightening of financial conditions we have witnessed year-to-date, but if commodities continue their recent move lower, or even stabilise here, it reduces margin pressure on companies and cost-of-living pressure on consumers, takes pressure off central banks to be hawkish ("nimble"!) and reduces bond market volatility (which reduces rating pressure on equity markets).

There are of course always issues to be addressed as an investor: food price inflation, Chinese property collapse, Chinese covid lockdowns, geopolitics. The bigger problem for markets year-to-date has been confusing normalisation with recession and one-off covid-led inflation with structural inflation. The structural forces which led pre-covid to a prolonged period of low rates, low inflation and strong asset price returns have not disappeared and will re-establish themselves.

Equities and bonds have experienced a very poor first half, and MIM funds have performed poorly. Inflation (and the reaction of central banks) has been the main driver of this downward move in prices, but there is abundant evidence that this has or is peaking. The tone of central banks, the Fed in particular, is therefore more likely to become less hawkish not more hawkish from here. Global equities are very attractive, even assuming modest downgrades to earnings, particularly companies that operate in those areas that are experiencing structural growth. We remain close to the upper end of our range for growth assets, with short-term hedges in place to reduce that exposure in the event equites resume their downward march. Within growth assets, we remain focussed on quality / structural growth themes rather than cyclical / value.

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