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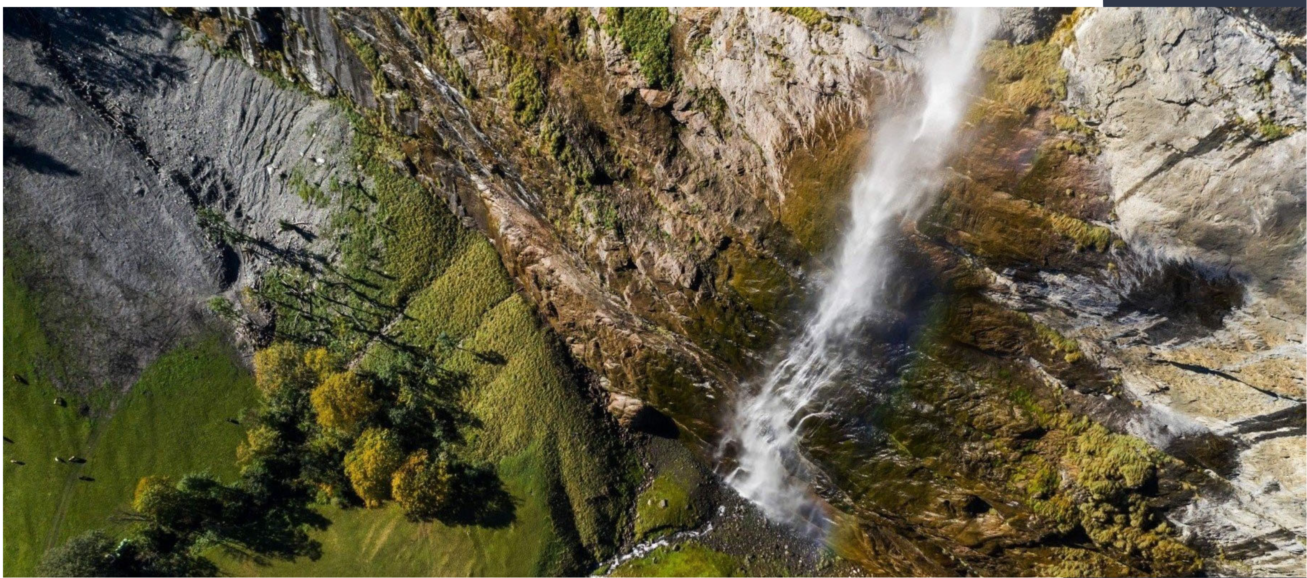
Market commentary



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Overview

It is hard to overstate how difficult the first half of 2022 has been for balanced portfolio investors. Even for those, such as ourselves, who were relatively cautious entering the year, the capital losses inflicted upon holders of both equities and bonds have been impossible to avoid. Although it has been possible to mitigate the scale of overall portfolio losses through increased exposure to other asset classes.

The most extreme statistic that we have seen, courtesy of the market historians at Deutsche Bank, suggests that holders of US ten-year Treasury bonds were subject to the worst performance in the first half of a year since 1788. Global equities suffered their first consecutive quarterly reversals since the Great Financial Crisis, with the S&P 500 Index in the United States having its worst start to the year in six decades. It may finally be the case that even the most grizzled of market veterans can no longer claim to have had it worse when they were in their youth.

What was behind the market falls?

Although the most shocking development so far in 2022 has been Russia's invasion of Ukraine, that was not necessarily the prime catalyst for the markets' malaise. Even before the war started to unfold in February, there were signs of discomfort which President Putin's actions only served to increase. During the latter part of 2021 it had become clear to central bankers around the world that consumer price inflation was proving to be more persistent than they had anticipated and that interest rates were going to have to rise to suppress prices and prevent expectations of future levels of inflation from rising too high. Indeed, the Bank of England was among the earliest central banks to have already initiated its policy-tightening cycle in December.

We would characterise the first period of losses for bond and equity markets as being the result of a "rates shock". Investors rapidly reassessed the level to which central banks would find it necessary to raise short-term interest rates and this set off a cascade of repricing. Bond yields across the range of maturities rose sharply leading to capital losses that could not begin to be offset by the paltry yields on offer. Corporate bonds not only suffered from the rising yields of government bonds, but also from an increase in the yield spread over government bonds as a more negative credit cycle was anticipated. Finally, the rising discount rate undermined the valuation of equities, especially those that might be described as "long duration". These are companies whose present value is derived from discounting back to the present profits that will be generated well into the future.

Which were the worst performers?

The worst affected were those companies that currently make no profits at all, with the impact on share prices being amplified by the fact that many of these companies had been considered winners from the pandemic and had become firm favourites with retail investors. However, once those investors demanded that such companies "show me the money", there was no place to hide. It is fair to say that the peak of euphoria associated with such disruptive and innovative companies had already long-since passed, but the de-rating only accelerated in the face of rising interest rates. The investment bank Goldman Sachs has a number of proprietary trading baskets which help to illustrate the scale of the reversal without having to single out individual companies. For example, its "Non-Profitable US Tech" basket fell 52% in the first six months of the year and ended 70% below its all-time high reached as long ago as 12 February 2021. It's "Retail Favourites" basket fell 41% and 47% over the same respective periods. Losses were not confined to amateur traders. Goldman's "Hedge Fund VIP" basket, which tracks the favoured holdings of hedge funds, has fallen 32% this year.

What was the impact of the Ukraine conflict?

From a market risk perspective, Russia's invasion of Ukraine was a relatively short-lived affair. Once investors had overcome the shock of a land-based conflict beginning on European soil for the first time since 1945, and also satisfied themselves that the fighting was unlikely to spill far beyond eastern Ukraine, equity markets recovered their lost ground remarkably quickly. At least some of this insouciance was generated by research pointing out that, historically and on average, markets had been back in positive return territory within a few months of the start of such geopolitical events. We pointed out at the time that such averages failed to account for other underlying factors, such as the monetary policy environment, and took the opportunity to reduce further our equity risk exposure.

Sure enough, markets' attention quickly turned back to inflation and interest rates, with many countries reporting that headline consumer prices were rising at the fastest pace since the 1980s or even earlier. If the initial leg of inflation was driven by a combination of excess demand (generated by monetary and fiscal generosity and, latterly, the re-opening of economies post-Covid) and constrained supply (largely as a result of Covid), then the next leg could be attributed to the effects of the invasion of Ukraine. Not only were supplies of crucial commodities including grains and energy cut off by the war, but sanctions were also imposed on Russia, cutting off or reducing further exports. The biggest and most immediate effect was felt in energy supply markets, most notably natural gas and, perhaps, most visibly petrol and diesel. While there is some lag in the pricing of household energy supply contracts, the price of fuel at the pump is plain to see in huge figures on service station forecourts and lit up at night for good measure.

Such pressures meant that consumer prices were now rising much faster than wages. With interest rates also set to increase and mortgage rates already well off their lows thanks to the repricing of rates in bond markets, household disposable incomes came under pressure. As consumer confidence indices plummeted, this set off the next leg of market weakness, which we might describe as the "growth shock". Investors began to price in a corporate margin squeeze driven by a toxic combination of faltering revenue growth and rising input costs. This finally sent global equities into a bear market, which is when an index has fallen by 20% from its peak.

Remarkably, though, aggregate analyst earnings forecasts for global equities have barely moved so far, with growth of around 8% still expected this year according to Bloomberg consensus data. Part of this resilience can be attributed to the windfall profits enjoyed by energy producers, especially the oil majors. However, we also believe that it is much easier for analysts to put through upgrades than it is for them to cut forecasts. For example, much of the rise in energy prices falls straight to the bottom line of Big Oil. However, it is harder to model a squeeze on margins as management can flex inventories, staff costs or marketing budgets, for example. But even then, one company's cost-cutting becomes another's revenue loss. Analysts will tend to wait for updated company guidance. This will soon be provided during the company results season in the second quarter. It is our belief that equity markets will struggle to find a firm floor until the extent of the potential damage to corporate profits can be fully assessed.

How are central banks reacting?

Meanwhile, there is no sign that central banks are in any mood to relent. At a European Central Bank (ECB) forum in Portugal at the end of June, the heads of the US Federal

Reserve (Fed), the Bank of England and the ECB assembled on the same platform. They all professed themselves to be committed to beating inflation, with that commitment taking precedence over the growth of the economy and levels of employment. Of course, talking tough is one thing; following through with the action is another matter altogether. Markets have already lowered their peak estimates for interest rates in the United States from around 4% to closer to 3.5% and we have also seen government bond yields retreating from their highs. But, our opinion is that the central banks will only change course in the face of much weaker economies and/or equity and credit markets. We continue to await a more opportune moment to increase portfolio risk.

Markets

US

US monetary policy remains the dominant factor for global liquidity. It is transmitted to the world not only through interest rates and bond yields but also through the dollar. For example, with many global commodities being priced in dollars, a strong dollar just adds to cost pressures for those who have to buy dollars to trade. Much debt around the world, especially in Emerging Markets, is denominated in dollars, meaning that the borrowers must pay more in terms of their local currencies to service and repay those liabilities. The dollar has continued to be very strong against other major currencies this year, with the DXY dollar index rising 9.4% in the first half of the year. A good illustration of how contrasting monetary policies can influence currencies can be seen in the dollar/yen exchange rate. One dollar now buys 135 yen compared with 115 at the turn of the year. One key reason for this is that, unlike the Fed, the Bank of Japan continues to pursue a strategy of suppressing bond yields through a policy of Yield Curve Control (a form of Quantitative Easing by which the central bank buys bonds at a specific yield). However, it is a truth of the financial system that central banks can provide support to their bond market, their equity market (at least in local currency terms) or their currency, but not all three, and it is the yen that has lost out in this case. Any signs of a peak in the dollar will be extremely welcome to global investors, signalling that US rate expectations have peaked and that global liquidity pressures are set to ease.

UK

The pound's value is most frequently quoted with reference to the dollar, and through this lens it has been very weak this year, falling to levels seen in the aftermath of the Brexit referendum result. It did fall briefly below that level during the 2020 Covid panic, but that was during an exceptional period of an extreme dollar liquidity squeeze.

However, its fate against our biggest trading partner's currency, the euro, has been more benign, reflecting the aforementioned strength of the dollar. Even so, one should not be complacent about sterling. The most recent data showed that the UK's current account deficit remains huge, amounting to £51.7bn in the first quarter of 2022 (a deficit of 8% of GDP), which was well above the expected £39.8bn. A few years ago, the then Governor of the Bank of England, Mark Carney, commented that the UK is dependent upon the "kindness of strangers", meaning that the UK has to attract investment from overseas to balance the departing currency that pays for our imports, which far outweigh our exports. Attractive government policies would, perhaps, be beneficial, but the handling of Brexit and the potential for turmoil related to the Northern Ireland trade border, not to mention the losses suffered by the government in recent by-elections do not inspire confidence.

Neither does the economic outlook. Goldman Sachs's economists currently ascribe a 45% probability to the UK entering a recession within the next 12 months. For us, it is not necessarily that single number that is the most important, more that their probabilities for Europe and the US are 40% and 30% respectively. On that basis, the pound appears to carry a greater risk that the Bank of England will have to capitulate sooner.

Europe

For all the talk of tighter monetary policy and rising interest rates, the ECB has yet to raise its Deposit Rate, which still sits at -0.5%, although it has promised to do so at its next meeting. It might be a stretch to say that the "hawks" have taken control with rates still so low, but the direction of flight appears to be set. Even so, there were some nasty echoes of the eurozone crisis as traders began to contemplate monetary tightening, with the spread of Italian government bond yields (as well as those of other "peripheral" countries) rising sharply relative to those of Germany. The focus remains on Italy owing to its high levels of debt relative to other countries and also because its politics remain a concern. While the current President, former President of the ECB Mario Draghi, is seen as a safe pair of hands, we are less than a year away from a general election which might leave a less reliable leader at the helm. While emollient words from the ECB and a pledge to support Italy's bond market (dubbed "anti-fragmentation") were enough to calm market fears for now, this episode reminds us of one the inherent flaws in the construct of the euro, by which fiscal policy is devolved to individual countries. A fiscal union of some sort would potentially help to solve the situation, although it remains difficult to see the taxpayers of more fiscally conservative countries support such a development. One doubts that we have seen the last of concerns related to sovereign solvency.

Emerging Markets

There has been some recovery in market sentiment towards Emerging Markets (EM), although it is hard to see them rallying strongly until the dollar has confirmed a peak. Countries such as Sri Lanka illustrate the turmoil that can quickly ensue once foreign investors lose confidence, but even a stronger country such as India has seen its currency, the Rupee, hit record lows against the dollar as its terms of trade have suffered from the rising costs of energy. China remains the driving force for EM indices, comprising 31% of the capitalisation. Here, the zero-Covid strategy continues to play havoc with short-term economic growth as the government attempts to balance a reflation strategy against a desire to contain the more speculative behaviour of investors in both the housing and stock markets. The next big set piece will be the 20th Party Congress held by the Chinese Communist Party which will take place this autumn (date not yet confirmed). This forum will elect the senior leadership for the next five-year cycle and set out the strategic road map, as well as confirm the third term of President Xi. This event should provide greater policy clarity.

Fixed Income

As referenced at the beginning of this commentary, bond markets have not been kind to investors this year. The yield of the ten-year US Treasury bond rose from 1.51% to a peak of 3.47%, while the UK Gilt yield rose from 0.97% to 2.65%. Even German bonds finally got back to offering a positive nominal yield, rising from -0.18% to 1.76%. Capital values fall as yields rise. This was all in response to expectations of central bank policy tightening. However, as investor concerns shifted more towards a growth slowdown or even possible recession, bond yields fell from their highs, regaining their ability to deliver positive returns to investors as equities fell. They ended the quarter at 3.01%, 2.23% and 1.33% respectively. The message from bond markets is that they believe central banks will do enough to prevent inflation becoming embedded and this is reflected in breakeven rates. In the US, the ten-year breakeven rate (average expected inflation over the next decade as inferred from market prices) has fallen from 3.03% in April to 2.34%, while in the UK it has fallen from 4.63% to 3.69%.

UK Gilts have delivered a total return of -7.42% over the last three months and -13.66% over the last year. Index-Linked Gilts returned -17.64% and -16.69% over the same respective periods. Emerging Market sovereign bonds produced a total return of -4.21% in sterling over the three months to end June (-9.92% over 12m). Global High Yield bonds delivered -4.44% (-6.45% over 12m).

Conclusion and Outlook

Given that much of this commentary provides a retrospective view of events and performance over the first six month of the year, it should come as no surprise that it is negative in tone. However, markets have moved a long way towards pricing in tighter monetary policy and weaker corporate earnings. They are now trying to find some sort of earnings and valuation floor. We continue to believe that this is a typical cyclical bear market, one that is the result of central bank policy being tightened to restrain inflation. As such, we do not expect it to develop into something more pernicious, although that is somewhat dependent upon inflation not spiralling out of control. That being the case, our intended next move is to put more risk back into portfolios once we are more comfortable with the outlook, or should the market offer us value that we cannot refuse. We also believe that our favoured equity investments continue to compound value. Even if the price that the market is willing to pay for that value creation is lower today, we believe that holding such higher quality investments for the longer term will provide attractive returns.

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