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OUT OF THE ORDINARY

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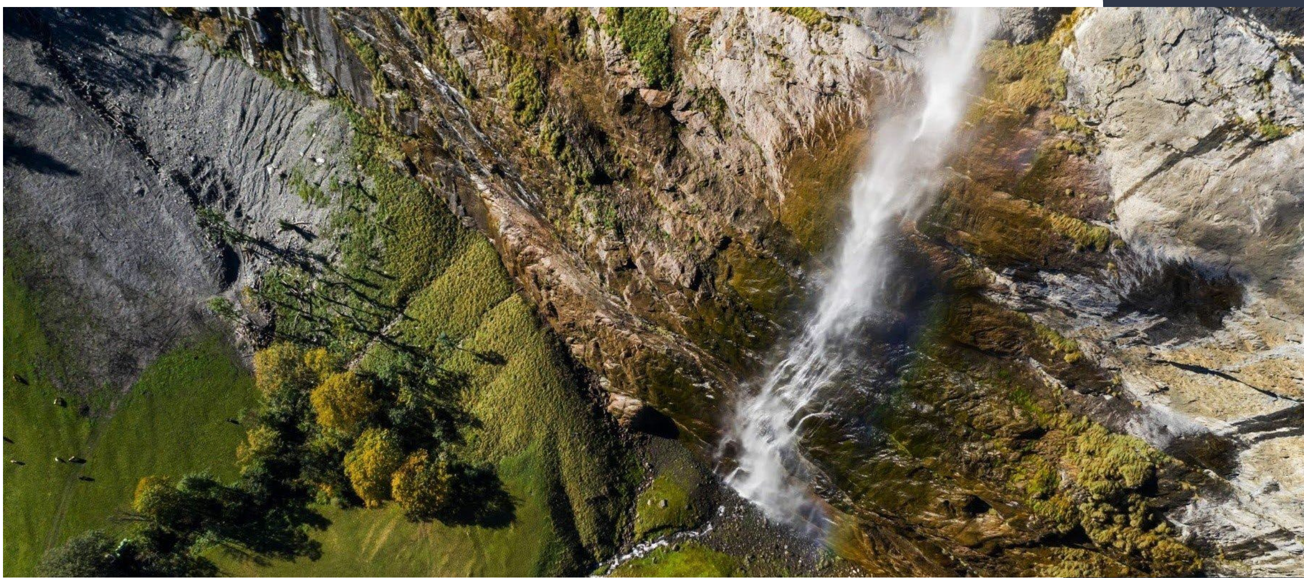
# Market commentary



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**Overview**

Last month's commentary, which provided a retrospective analysis of the first half of 2022, was undoubtedly gloomy, given the poor returns from both equities and bonds. However, we did identify some grounds for potential optimism in the facts that equities had derated and bonds offered higher yields. Even so, it is fair to say that we have been somewhat taken by surprise by the extent of July's equity market rally and by how far bond yields have fallen. We now have to ask whether these trends are sustainable.

## What might be the path for inflation?

The major debates in the market continue to revolve around the path of inflation, what that means for interest rates, and whether major economies will enter a recession. What we can infer from markets is that investors have shifted to thinking that inflation is at or close to peak levels, central banks will be able to reverse rate rises by the first half of next year, and that a recession is more probable in Europe and the UK than in the US. Indeed, for the US, especially, there is increased belief that the Federal Reserve (Fed) can execute a "soft landing" for the economy.

Despite it being "top of mind" for all market participants, there is still no consensus about the causes of the current inflation, especially with activity and data still influenced by the effects of the pandemic and, more recently, Russia's invasion of Ukraine. The trouble with not knowing the exact cause of the illness is that one might be administering the wrong medicine. Tighter monetary policy to temper demand will not improve supply chains; heavier investment in supply could exacerbate excess demand in the economy. Thus, there is persistent concern that some sort of "policy mistake" will upend the economy and markets.

## How much might interest rates rise?

Another great imponderable is how far rates might need to rise to bring demand down to levels that will alleviate inflationary pressures. The Fed currently believes that the neutral rate (R* - at which demand and supply are in balance) is around 2.5%, which is exactly where the Fed Funds rate has been raised to, but there are many who believe this to be too low an estimate. In any case, the Fed maintains that it intends to take Fed Funds above R* to slow the economy to below-trend growth, and that is discounted in futures markets, which suggest a peak rate of around 3.4% early in 2023. But with estimates of inflation stuck in mid-single digits at the end of this year, that will still constitute a very negative real interest rate, and past cycles have not peaked with real rates still negative. Here in the UK, the futures market suggests a peak base rate of 2.8%, to be reached next March, although it is not difficult to find individual economists forecasting that rates will have to head to 3% and beyond.

Another aspect of monetary policy tightening is the reduction in size of central bank balance sheets. We have observed that in the post-financial crisis world, risk assets tend to struggle in the absence of such liquidity support and especially when it is being reduced. The Fed's plan is to ramp up its monthly balance sheet reduction to $95bn in September. A year previously, they were growing the balance sheet at $120bn per month. That constitutes a negative "QE impulse" of $215bn, or more than $2.5 trillion on an annualised basis. Meanwhile, monetary aggregates are decelerating rapidly. In the UK, the Bank of England's plans for Quantitative Tightening currently only involve not reinvesting maturing bonds. So far that has amounted to £31.1bn worth of Gilts since March, with another £5.9bn due in September. After that, there is nothing maturing until July 2023. The Bank's purchases of corporate bonds were widely spread over a range of issuers and maturities and the schedule is equally benign.

This is a very different bear market to the ones that most investors will have experienced, driven, as it is, by central banks' desire to reduce inflation and to rein in future inflation expectations. In that respect it bears little resemblance to the

Covid crisis (exogenous shock), the Financial Crisis (structural, systemic shock) or the TMT bust (capex and value implosion), all of which were ultimately reversed by generous central bank policy, but, crucially, in a deflationary environment.

Another odd aspect of this bear market is an apparent lack of capitulation on behalf of the average investor. Yes, there has been substantial deleveraging and de-risking by hedge funds as well as a sizeable reduction in retail margin debt, but there has been next to no reversal of equity fund flows. One theory (put forward by Michael Hartnett, chief strategist at Bank of America) is that many investors panicked out of the market during the Covid crash and failed to re-enter in a timely manner. They do not intend to make the same mistake again. But this time they are not going to be bailed out by fiscal and monetary largesse. The Fed did not blink when the S&P 500 was down 25%, nor when High Yield credit spreads hit 600bps. And while governments have developed a taste for fiscal generosity, central banks are more likely to lean against that this time around if it perpetuates inflationary pressures (see UK section below for further thoughts about the policies of the final candidates for leader of the Conservative Party).

There is plenty of debate about possible recessions. Indeed, the US has reported a second successive quarter of negative GDP growth, and so entered a “technical” recession. However, the National Bureau of Economic Research (which rules on such definitions) might well not declare this an official recession because underlying demand remained positive. It was management of inventories that was largely to blame. We are seeing the “whiplash effect” in action, whereby companies reacted to prevailing supply and demand situations when ordering stock but now find that those conditions do not exist when the stock arrives.

The good news is that it is largely expected that any recession will be relatively shallow (at least barring unforeseen exogenous shocks). The imbalances in the private sector are not as great as in the past; the immediate transmission of monetary policy will be dampened by a greater prevalence of fixed rate mortgages (and very little of the adjustable-rate product that catalysed the rout in the mid-00s); the banking sector is extremely well capitalised. But, we are coming out of an era of peak margins at a time when input costs are increasing, workers have greater bargaining power over wages in a tight labour market and there will be limits as to how much of an increase in prices consumers can tolerate.

### How are companies faring?

While the second quarter reporting season has turned out to be relatively benign, it has delivered a number of individual casualties. Earnings surprises have been positive in the US (but no more so than might be expected in “normal” circumstances) and more negative in Europe. Guidance has been mixed, but some pressure on margins is evident. The biggest losers have come primarily from two groups of companies: those that have struggled to pass higher input costs through to customers; and those that have seen demand for their products shift to different categories, revealing bloated inventories that have had to be cleared. Some of the key winners have been big brand consumer goods companies which have been able to push through and maintain large price increases. This certainly echoes patterns we have witnessed in past downcycles, where larger, more profitable companies with deep pockets were more able to defend their market positions.

## Markets – US

The second quarter corporate earnings season in the US tends to advance somewhat faster than in other regions. By the end of July, more than half of the constituents of the S&P 500 had reported, accounting for almost three-quarters of the market capitalisation. Crucially, this included all the important mega-cap Technology stocks, which, in general, acquitted themselves well. Interestingly, aggregate earnings are up 9% versus the same quarter in 2021, but on revenues that are 16% higher. We can observe here that prices are rising on account of inflation but so are costs. In a world of more subdued inflation, earnings would tend to grow faster than revenues as result of positive operating and financial leverage. The price component of top-line growth was especially evident at some of the big brand name consumer goods companies. For example, PepsiCo achieved revenue growth of 13% based upon 1% volume growth and 12% price increases, on average. Procter & Gamble posted a 1% decline in volumes, but an 8% tailwind from higher prices delivered 7% revenue growth. Similar trends were visible in the results of Unilever and Nestlé on this side of the Atlantic. Unfortunately, such trends can send misleading messages through other channels. Retail Sales are reported in nominal terms and could appear robust in such an environment when underlying demand is much weaker.

## UK

They say that a week is a long time in politics, but it still isn't long enough to allow for the selection of a new leader of the Conservative Party nor, by extension, to reveal the identity of the next Prime Minister. Indeed, we won't know the result until 5 September. Even so, the bookmakers' odds suggest that Liz Truss is a shoo-in for 10, Downing Street, even if the party's MPs showed a distinct preference for former Chancellor of the Exchequer Rishi Sunak. Ms Truss has been throwing red meat to the party members who will decide the leadership contest. This has come mainly in the form of promises of tax cuts, more slashing of red tape and a continuation of Boris Johnson's confrontational attitude towards the European Union. The more conservative Mr Sunak has been forced to be more expansive in his promises as a result. Policies that leave more disposable income in the hands of households as the cost-of-living continues to rise are no doubt welcome, but they will support demand at a time when the Bank of England is tightening policy with the intent of restraining demand to dampen inflationary pressures. It may well be that interest rates will have to rise further as a result, with the attendant risk to other areas of the economy, notably the housing market. Nor are the country's finances especially robust, with a fiscal deficit running at around £100bn (Office of Budget Responsibility forecast for the fiscal year to April 2023) or close to 4% of GDP. Whoever wins will be faced with a tough job when it comes to balancing the books.

## Europe

The European Central Bank followed through on its promise to raise interest rates at its July meeting. Indeed, it went further than expected by raising them by 0.5%, citing the need to head off inflationary pressures when annual price increases are higher than they have ever been since the inception of the euro. And yet, at the same time, it backed off from promising further increases and said it was going to rely more on economic data as it evolved. Its predicament is not unusual among central banks at the moment. Growth is slowing sharply as a result of other stress factors, notably the energy supply crisis.

Germany is paying 17 times as much for wholesale gas as it was before the pandemic. And for a country that depends for much of its prosperity on global trade, that is handing a huge cost advantage to rivals. For example, the wholesale gas price in Germany at the end of July was seven times higher than in the US. Despite the downward pressure on activity, the eurozone economy as a whole continued to expand in the second quarter, with France, Italy and Spain performing better than feared. Their economies have been buoyed by the tourist season, especially with the euro having weakened considerably against the dollar this year. But the strains inherent within the eurozone were once again evident when the ECB formalised its new Transmission Protection Instrument (TPI), the latest ingredient in the alphabet soup of tools designed to prevent a fragmentation of the single currency system, or, in ECB-speak, "unwarranted, disorderly market dynamics". The main concerns continue to revolve around Italy and the risk that its bond yields rise far above those of it neighbours. The fact that no limit was placed on prospective purchases demonstrates the theoretically infinite capacity of this instrument to purchase debt, and, as such, the hope that it will deter the market from ever testing its efficacy and the ECB's resolve.

## Emerging Markets

Although we try to make regular detours to other Emerging Markets, China's huge gravitational force constantly draws us back to commenting about developments there. It accounts for around 35% of the MSCI Emerging Market Index, followed by Taiwan (14.5%, mainly on account of its semiconductor manufacturing capabilities), India (13%) and South Korea (11%). For all the aspirations of South America to compete as a viable alternative destination for investment dollars, it struggles to muster a double-digit index weighting (and performance tends to be highly correlated with commodity prices). China's increasing influence is both economic and political. As we write this commentary, concerns are increasing once again about the relationship between the United States and China following the visit of US House Speaker Nancy Pelosi to Taiwan. China continues to claim sovereignty over Taiwan, but Taiwan wishes to remain independent and the US has promised to support Taiwan in the event of China making territorial incursions (although the language is usually couched in terms that are deliberately vague in their level of support). From an investment perspective, the risk here is generally viewed as being one of low probability but extremely high impact, potentially much greater than anything that ensued from Russia's invasion of Ukraine. The increasingly autocratic style of government in China does not play well for investors placing greater emphasis on ESG factors. Thus, despite what appears to be an attractive relative valuation by historical standards, the bar for increasing weightings to Chinese equities seems to get inexorably higher.

## Fixed Income

We noted in the last commentary that 10-year US Treasury Bonds had suffered their worst losses in the first half of a calendar year since 1788. The rebound in July, while far from recouping all the losses, was, nevertheless, impressive. This was driven by increasing fears of recession, which in turn would lead central banks to start easing policy much earlier than previously expected. Additionally, such economic weakness would help to lower the inflation threat. Consequently, inflation breakeven rates, inferred from the difference in pricing between conventional and index-linked bonds, have fallen back sharply over recent months. Inflation expectations (as opposed to current levels of inflation) are one of the main drivers of the value of index-linked bonds, leading to the counterintuitive situation where investors in index-linked bonds have recently experienced negative returns while consumer price indices have been making multi-decade highs. For reference, the US five-year breakeven rate (inferred average of inflation over the next five years) has fallen from a peak of 3.73% in March to a current 2.79%. The same figures for the UK are 5.04% and 3.9% respectively.

UK Gilts have delivered a total return of -2.24% over the last three months and -13.72% over the last year. Index-Linked Gilts returned -7.46% and -17.49% over the same respective periods. Emerging Market sovereign bonds produced a total return of -0.06% in sterling over the three months to end July (-7.24% over 12m). Global High Yield bonds delivered +0.17% (-0.5% over 12m).

### Conclusion and Outlook

We have written previously about bear market rallies, and that there are often many over the course of a bear market, some running into double digits. Have we seen the lows for this market cycle or are we just in the eye of the storm? While we believe that we can be reasonably confident owning equities on a longer-term view, we also believe that there remains unfinished business as far as this part of the cycle is concerned. Sharp and swift rallies are a feature of bear markets when news turns out better than worst expectations and investor positioning is set up for a squeeze. The current rally fits that description perfectly.

And so, we retain a degree of caution in our risk allocation, cognisant of the fact that it has done us few favours for the last month. But it is caution rather than fear that is our overriding sense, and we maintain the desire to increase equity positions once we gain clarity over the outlook or are offered a more compelling valuation opportunity.

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