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OUT OF THE ORDINARY

01 August 2022

Market reflection

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Overview

Global equity and credit markets rallied through July as investors concluded that they might have become too pessimistic about the economic outlook and the extent to which central banks will be willing to raise interest rates. Indeed, futures markets are pricing in interest rate cuts in the major developed market regions, during the first half of 2023. Government bond yields and inflation expectations have also fallen, providing renewed support to the higher growth sectors.

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There had been concern that the second quarter earnings season would catalyse a meaningful downgrade to full year earnings estimates. However, with around half of companies having reported, the overall pressure has been limited, although there have been several individual casualties. These belong primarily to 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.

Consumer confidence remains well below average levels, although spending in some sectors, especially travel and leisure, has been supported by the excess savings built up during the pandemic. It remains to be seen how resilient spending can remain in the face of rises in the cost of living. The tension between inflation, slower economic growth and monetary policy decisions by central banks will continue to drive market sentiment over the summer and markets will remain reactive to data releases. So will the central banks, which have shifted away from providing clear forward policy guidance. Our stance continues to be cautious, although not fearful, and we continue to seek better value or more clarity before raising risk budgets again.

- The Bloomberg consensus growth forecast for global GDP in 2022 has declined further. It has now fallen to 3.0% from a peak of 4.5% last summer and 4.4% at the turn of the year. High inflation and high interest rates are depressing demand and China's zero-Covid policy in response to the Omicron variant is another drag on activity, from both a demand and supply perspective.

- The outlook for 2023 has also worsened, with growth now projected to be 2.9%, down from 3.6% in January.

- Market-derived measures of inflation expectations have retreated in the face of tighter monetary policy and weaker growth forecasts. This has raised hopes that the central banks can execute a "soft landing", by which they will rein in inflation without causing a recession. However, the landing strip is very short and narrow. The risk of recession is greater in Europe and the UK owing to the higher exposure to elevated energy prices as a result of supply disruptions.

- Geopolitics continue to be an important factor for investors to consider. Russia's attitude towards exporting gas and oil to Europe will be a key determinant of both sentiment and economic outcomes and it is a situation over which we have limited clarity. Closer to home, the race to become the new leader of the Conservative Party has seen the candidates whittled down to the final pair. The choice before party members appears to be between a more fiscally stimulative approach (Liz Truss) and a greater conservatism (Rishi Sunak). But both will need to offer support to hard-pressed consumers.

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