OUT OF THE ORDINARY

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Market reflection

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Overview
Global equity markets fell into bear market territory during June by falling more than 20% from the peak achieved at the start of this year.

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While index declines earlier in the year were more the result of a derating as a consequence of higher bond yields, more recently they have been as much driven by fear of a sharp slowdown in economic activity and the damage that this might do to corporate profitability.

The root of much of the markets' malaise is inflation, which, far from being "transitory" – as predicted by the majority of central banks – has turned out to be both high and persistent. In the UK, inflation will probably not peak until the autumn when the household energy price cap is next lifted, meaning that the Bank of England will need to continue to raise the base rate if it is to have any hope of avoiding long-term inflation expectations becoming unanchored. Should the latter outcome transpire, it could create a wage/price spiral, which would only serve to embed inflationary pressures.

The possibility of the economy entering a recession is very real. Europe and the US might well see consumer price indices peaking earlier, but the speed at which they fall will determine how soon the European Central Bank (ECB) and the Federal Reserve will be willing to ease the pressure.

Remarkably, we are making such remarks before the ECB has even started to raise rates. But the current message from central bank leaders is that defeating inflation will continue to take precedence over economic growth. Until that priority changes, equity and credit markets are likely to continue to be volatile and will find it hard to consolidate any gains that are made. The better news for investors in government bonds is that the focus on defeating inflation should limit the upside to yields, which provides some encouragement after a first half of painful capital losses.

- The Bloomberg consensus growth forecast for global GDP in 2022 continues to decline. It has now fallen to 3.2% 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.

- We are not seeing forecasts for a strong bounce back in 2023, where growth is also now projected to be 3.2%, down from 3.6% in January.

- Inflation expectations for 2022 have moved consistently higher and now stand at 6.7% globally. Expectations for 2023 have also risen to 4%.

- Despite cuts to aggregate economic growth forecasts, bottom-up corporate earnings forecasts remain resilient. Consensus analyst global estimates still suggest around 10% growth this year and high single digits in 2023. This seems optimistic given the risk to margins from a combination of rising costs and decelerating demand. Our expectation is that equity and credit markets will not find a firm floor until earnings estimates have been adjusted lower.

- We have not observed that our core equity holdings are currently failing to continue to compound value for shareholders, although the longer duration of their earnings has put considerable pressure on their share prices this year. We believe that patience will be rewarded and that now is not the time to be reducing positions.

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