Investec

OUT OF THE ORDINARY

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Market reflection

John Wyn-Evans
Head of investment strategy

Overview

Equity markets continued to suffer during May, before staging a rally in the final week. Before the respite, global equities had sustained seven consecutive weeks of losses.

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While the initial falls were driven by concerns about rising inflation and the negative valuation effect of the higher interest rates needed to tame it, losses were latterly a function of increasing worries about the effect of higher inflation and rates on the real economy and, as a result, corporate profits. Thus, the market's characteristics evolved from those associated with a "rates shock" to a "growth shock". Further evidence came from bond markets, where yields on government bonds fell back having risen relentlessly so far this year. At the same time, high yield credit spreads ballooned out beyond levels previously seen during the last pre-Covid growth scare in 2018.

From a portfolio composition perspective, this has relieved some of the pressure on portfolios that traditionally spilt their assets between equities and bonds. Whereas during the first four months of the year both the equity and bond components were experiencing capital losses (returns were positively correlated), the relationship has now switched back to being negatively correlated, which helps to dampen portfolio volatility, even if it does not guarantee positive returns overall. A lot will depend upon where inflation settles, as the correlation appears to be dependent upon the level of inflation. That, in turn, might depend upon central banks' willingness to stomach economic weakness and possibly higher unemployment. We remain of the opinion that the short-term outlook for corporate margins and earnings is unclear and that more evidence of resilience will be required before adopting a less cautious stance, especially with geopolitical concerns rumbling in the background.

• The Bloomberg consensus growth forecast for global GDP has now fallen to 3.3% from a peak of 4.5% last summer and 4.4% at the turn of the year. Most of the developed world is suffering from the combined effect of higher inflation and higher rates. The emerging world is being dragged down by China where the heavy-handed response to Omicron has shut large swathes of the economy.

• We are not seeing forecasts for a strong bounce back in 2023, where growth is also now projected at 3.3%, down from 3.6% in January.

• Inflation expectations for 2022 have risen steadily all year and now stand at a peak 6.5% globally. Here, at least, there is some belief that this year will see the worst of it, with the consensus expectation being for 3.8% in 2023 and 3.2% in 2024.

• Aggregate earnings growth forecasts remain firm. However, there is a big dispersion between the sectors where we have seen upgrades (such as Energy) and downgrades (such as Consumer Discretionary), leading to big differences in relative performance.

• Markets are still negotiating a tricky transitional period, whether it be related to the exit from the pandemic, energy supplies, monetary policy or global geopolitical shifts. This suggests to us that market volatility will remain elevated and we are not yet tempted to participate in what we believe to be short-lived rallies. However, we have recommended adding to Investment Grade Credit positions based upon the more attractive yield now available in that asset class.

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