



Market review: July 2022

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- Global equities regain some of the losses suffered in H1
- US Federal Reserve hints at easing aggressive rate hikes
- Political uncertainties will constrain markets later this year

Global equity markets went some way in July towards reversing the losses seen in the first half of the year. They saw strong returns during the month, with investors more optimistic that the Federal Reserve's hawkishness and inflation – currently at 40-year highs in major Western economies – is peaking.

The Fed enacted the most significant move of any central bank in July. With annual US inflation having risen to 9.1%, markets were unsurprised when it raised its benchmark policy rate by 75 basis points for the second month in a row. Its current cycle of monetary tightening is the most aggressive since 1981 and followed a 50bp rise in May. But inflation is also running at its fastest pace in four decades, so more rate rises are expected this year to tackle it, although Fed Chairman Jay Powell said that it would likely be appropriate to slow the pace of increases to assess their impact. This hint that 'peak hawkishness' might have passed prompted a 2.6% market rally by the S&P 500 and the two-year US Treasury yield dropped by 0.08 percentage points to 2.97%. US equities were also supported by an earnings season that beat expectations.

Technically, the world's largest economy entered recession after Q2 GDP figures were released in July. The data showed that US GDP, having fallen in Q1, fell by -0.9% in Q2, meeting the commonly used definition of two successive quarters of negative growth. However, Powell argued that this could not constitute a recession when the unemployment rate was still at a multi-decade low of 3.6% and consumer spending had also remained buoyant. Strictly speaking, a US recession is determined by the National Bureau of Economic Research, which incorporates factors other than GDP into its calculations, such as unemployment.

Recession is certainly a growing fear. Another market indicator widely recognised as a precursor to a recession is an inverted yield curve. The yield curve maps the current interest rates on bonds into the future. The interest rates tend to rise the longer the time to a bond maturing to compensate investors for the higher risk, so the yield curve normally rises from left to right on a graph. By end-July, the 10-year/two-year yield curve remained inverted, with the even more significant 10-year/three-month curve moving in that direction.

On this side of the Atlantic, the European Central Bank is committed to tackling inflation too, and it surprised many by hiking interest rates for the first time in more than a decade in July, raising them 50bps after ditching its nine-year commitment to providing forward guidance. It was an understandable response to eurozone inflation having risen to a record high of 8.6%.

The rate hike followed the resignation of Prime Minister Mario Draghi from Italy's national unity government, which triggered the need for snap elections and a sell-off in Italy's stocks and bonds. European policymakers have agreed a new bond-buying programme to counter a surge in borrowing costs for the trading bloc's more vulnerable governments, having already been impacted by the surging energy and food prices that has followed the war in Ukraine, reduced business activity and consumer confidence falling to record lows.

The ECB must deal with a political crisis in Italy and the ramifications caused by Russia using its natural gas supplies as a political tool that could spark recession, especially in Germany, which recorded its first trade deficit since 1991. The Ukraine conflict has also contributed to weakness in the euro, which reached parity in July with the US dollar for the first time since 2002. This highlighted the gulf in the economic prospects for the two regions and by raising the costs of imports, it will make the inflation challenge even more problematic for the ECB.

The Bank of England is also under pressure to fight inflation, which has now reached 9.4% in the UK and is expected to be in double digits by the autumn. UK equities have fared relatively well, though, largely thanks to their overweight exposure to the Energy and Mining sectors.

In Asia, the shock assassination of former prime minister Shinzo Abe in Japan helped the ruling Liberal Democrat Party win a landslide victory in elections for the country's upper house on a wave of sympathy. This presented the government with a historic opportunity to amend the country's pacifist constitution as geopolitical tensions in the region continued to escalate. Tensions rose between China and the US ahead of the visit of House Speaker Nancy Pelosi to Taiwan. But the sabre-rattling was a distraction from China's domestic challenges. A mounting issue for the government was a country-wide mortgage boycott by homeowners protesting developers' failures to finish their homes, which will, in turn, impact developers' ability to pay loans to the banks. The issue is highly significant because around 80% of household wealth is locked up in housing.

The rest of 2022 will likely see more volatility and markets constrained by political uncertainties. Most significantly, the US will see mid-term elections in November and China will hold its 20th National Party Congress in October. In addition, the UK's Conservative party will elect a new prime minister and Italy will hold a general election, both in September.

Investor sentiment has certainly been better: Bank of America's Fund Manager survey shows institutional investors have the lowest equity exposures since October 2008 and the highest cash holdings since 2001. Concerns are rising around slowing growth but our own view is that a protracted slowdown is less likely.

Having reviewed our funds and portfolios in the context of higher inflation uncertainty and volatility in equity and bond markets, we believe it is sensible for us to appreciate that the drivers of investment performance and risk will likely differ significantly over the next 10 years to those seen in the last 10. While we remain cautiously positioned, we can see assets that are attractively priced after the indiscriminate selling seen this year.

There are risks, including inflation, economic slowdown and geopolitical tensions, and central banks have a tightrope to walk in balancing counter-inflationary measures against weakening economies, but there will also be buying opportunities. Market declines tend to last no more than 12 months so we are likely already some way through this one. Post corrections, there should be more clarity in markets and we will be able to focus once again on fundamentals, including actual earnings.

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