MARKET COMMENTARY - AUGUST 2022

QUILTER CHEVIOT

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Past performance is no guarantee of future returns.

July marked an impressive recovery for global stock markets, with the MSCI All Country World Index gaining 7% to post its best monthly return since November 2020. Although aggressive interest rate hikes were announced, government bond yields, on the whole, declined, as a clear softening in economic data stoked concerns of a forthcoming slowdown.

This has been viewed positively by equities as investors increasingly expect it will expedite the process of ending the hiking cycle and, in the US at least, lead to interest rate cuts next year. Cuts in 2023 after inflation has been successfully reined would be a favourable development, but we remain a little cautious and believe the market is currently a little overly optimistic in this regard.

US equities outperformed in July with broad-based indices adding more than 9%, despite another 75 basis point increase from the Federal Reserve (Fed) which leaves the Federal Funds Rate at 2.25%-2.50%. Growth stocks outperformed value stocks and small-caps were broadly in line with large-caps. More than half of large-cap firms have reported earnings for the second quarter, and the results overall have been pretty solid. The ratio of companies beating forecasts versus those missing has fallen, but the big picture remains better than some feared. That said, the results are backward looking and there are signs that economic activity has slowed since then which explains the downward revisions in earnings estimates. The Fed has also raised interest rates by 1.5% since the period reported on and the impact of this will likely be seen in the results for the third and fourth quarters of the year.

The world's largest economy is now in a technical recession after the US advance GDP for Q2 showed a 0.9% contraction quarter-on-quarter. While this satisfied the definition that two consecutive quarters of negative growth signals a recession, other metrics, such as a fall in personal income or lower employment, are yet to be met. The US 10-year Treasury yield fell from just over 3% to 2.65% by the end of July. The gap between two-year and 10-year bonds is now as deeply inverted as it has been in 16 years, around 30bp. Inversions of this segment are commonly seen as a sign that the economy is expected to slow.

Leading economic indicators also point to a slowdown in activity, although recent data points have shown some resilience. The ISM manufacturing purchasing managers index (PMI) fell to a two-year low of 52.8 in July, albeit marginally better than the expected 52.3. The 50 level denotes the line between expansion and contraction. Encouragingly, the prices paid figure fell sharply suggesting some price pressures are easing.

Overall, the labour market remains in rude health, with the latest employment report showing another 372k jobs in June and the unemployment rate remaining at 3.6% - its lowest level of the cycle. There has been a slight rise in recent weekly jobless claims figures, but it should be stressed that this is coming from a very low base and is not yet seen as anything more than a potential early warning sign.

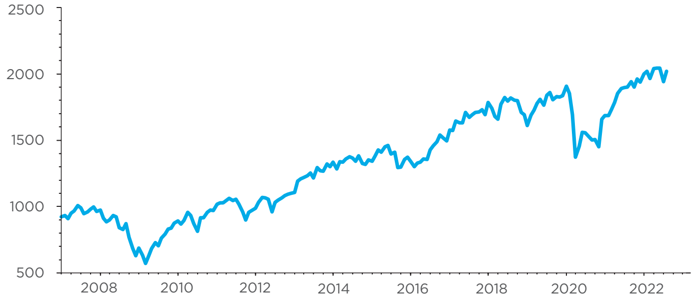
ECB lift-off

The European Central Bank (ECB) has finally joined its peers in tightening monetary policy, delivering a 0.5% interest rate hike. The size of the move was at the higher end of expectations and the bank also announced a new bond-buying tool called the Transmission Protection Instrument (TPI), aimed at mitigating market fragmentations during the hiking cycle.

Eurozone business activity recorded a surprise drop for the first time in over a year last month, into contraction territory. Inflation in the bloc continues to run hot with the latest reading showing the consumer price index (CPI) jumped 8.6% year-on-year. The impact of a surge in the price of a specific and narrow set of inputs can be seen by the fact that the core reading, which excludes food, energy, alcohol and tobacco, was only 3.7%.

The threat that Russia could cut off energy supplies continues to loom large but despite this, the undesirable mix of recent economic data and the ECB tightening policy, European shares enjoyed a strong bounce in July. European stock benchmarks gained around 7.5% in July, taking the year-to-date loss down to approximately 11.2%. Surprisingly, given the views expressed in most commentaries on the market impact of the war, since the Russian invasion of Ukraine began in late February, European indices have actually outperformed global, US, Asian and emerging market benchmarks.

MSCI UK IMI

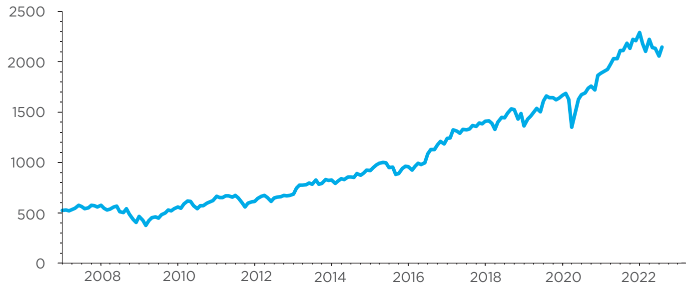


Source: Refinitiv Datastream 02/08/2022

iBOXX STERLING GILTS

Source: Refinitiv Datastream 02/08/2022

MSCI ALL WORLD £ - TOT Return



Source: Refinitiv Datastream 02/08/2022

In the fixed interest space, the German 10-year yield dropped around 50 basis points on the month, ending at 0.83% having traded as high as 1.93% in June. Thus far, the TPI appears to be having the desired effect with the spread of peripheral bond yields over core equivalents remaining fairly steady. The resignation of Italian prime minister Mario Draghi in the days before the ECB meeting caused the spread to widen, though this reverted upon the TIP announcement.

A wave of MP resignations spelled the end for Boris Johnson's tumultuous tenure as UK prime minister. Former chancellor Rishi Sunak and foreign secretary Liz Truss are in the leadership race to replace him, with the winner scheduled to be announced early September. The political manoeuvrings have not had any lasting market impact so far.

UK shares lagged behind peers during July, rising around 3.7%. The gain moved the benchmark back into positive territory for the year and the recent underperformance can be attributed to a near-term reversal of the prevailing trends of 2022 that have caused UK stocks to outperform year-to-date. In the last month growth stocks have performed better than value shares, while bond yields have declined along with the price of oil – all these developments represent near-term reversals counter to the prevailing moves over the preceding six months.

The UK 10-year gilt yield fell by just under 30 basis points in the last month to trade around 1.81%. Inflation in the UK hit a new 40-year high with the UK CPI reaching 9.4% year-on-year. Other UK data was fairly positive with another good set of employment figures, retail sales topping estimates and the latest set of PMIs coming in better than expected. GDP also beat economists' forecasts, showing a 0.5% increase month-on-month for May. The Bank of England is expected to raise rates at least 50bp in August.

Equity markets have been helped by short-covering as corporate results came in no worse than expected. While this is pleasing it doesn't mean the danger of at least a mild consumer recession later this year/early next is off the cards, especially as labour markets remain tight. For many countries - but not the UK - inflation may well be passing its peak, but the reversion to 'normal' could take longer than the market hopes. Some caution is still warranted over the coming months.

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