Summer 2022

market outlook.

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FINANCIAL AWARENESS

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The UK Economy

The UK economic backdrop was little changed over the quarter. Inflation remains high and will likely push higher in the coming months (as energy price caps are once again lifted in October), after which we still expect inflation to fall.

Wages have struggled to keep pace with inflation, consequently several workers' unions have been taking strike action. With the consumer squeezed, there are initial indications of price-conscious choices being made (such as trading down in supermarkets).

The drivers of inflation remain the same, specifically Covid-related supply issues, however, central banks have been more hawkish than anticipated at the start of the year, as the war in Ukraine compounded matters.

Like other major central banks, the Bank of England (BoE) is attempting to contain rising prices from becoming entrenched. Having lifted off from historic lows of 0.1% in December last year, the BoE has raised interest rates by 0.25% at each of its subsequent meetings (Feb, Mar, May, Jun) to reach 1.25% at the end of July. As previously discussed, the BoE needs to act carefully so not to derail the UK economy, as the drivers of inflation remain supply led which will not be resolved by raising interest rates.

Following Boris Johnson’s resignation as UK Prime Minister, the search is on for his replacement. Core policies from the remaining two candidates (Rishi Sunak and Liz Truss) have some major differences, although policies have been evolving as campaigning progresses.

Currently an economic slowdown is more likely than a deep recession in the UK, but how monetary policy develops, and measures taken by the next Prime Minister, will determine the underlying strength of the UK economy. From an equity market perspective, the UK remains one of the most attractive: returns have been comparatively good year to date and opportunities remain in multiple sectors for multiple economic outcomes.

The Japanese Economy

By far the most significant and historic factor impacting Japan this year has been the assassination of the architect of modern-day Japanese policy (coined 'Abenomics'), and former Prime Minister, Shinzo Abe in July (2022). Whilst the true details are unknown, violence and gun crime, especially against government officials, is largely unheard of in Japanese society. Whilst it's alleged that the individual who carried out the act did so due to Abe's affiliation with a religious group that sent his family into bankruptcy, there remains concern that it was an act against Abe's policies that are continuing to be rolled out by incumbent Prime Minister, Fumio Kishida.

Despite global inflationary pressures, and western world central banks tightening 15 years' worth of monetary policy, the Bank of Japan (BoJ) and its Governor, Haruhiko Kuroda, has doubled down on its commitment to its policy. In recent months, global markets have been non-discriminant when pricing in policy tightening, assuming all central banks would be looking to fend off inflation, seeing even the Japanese yield curve steepen. However, following decades of deflation prior to the financial crisis in 2008, and the subsequent 14 years of record breaking monetary policy/stimulus that followed, whilst it did indeed stoke inflation, even with current short-term pricing pressures, inflation only sits at 2.4%. As such, there remains a worry at the BoJ that as soon as short-term inflationary pressures ease, should they pull the proverbial rug on policy now, deflationary pressures would re-emerge. As a result, policy seems likely to remain loose for some time to come!

Following western world easing of monetary policy, we have seen strengthening of currencies relative to the Yen, in particular the USD. Whilst a weaker Yen could constitute a pickup in export demand, with profitability shaved and current supply-side constraints, this could be a strain on the Japanese economy. In addition -as we have seen year to date- the fall in the Yen has seen domestics suffer, with relative import costs for some raw materials rising. That being said, with the currency seemingly now range bound, heading in to 2023 currency pressures could even out.

With the above in mind, and given the massive short-term compressions in valuations in the domestic Japanese markets, largely driven by short-term factors, and short-term expectations of a continually aggressive western world rate rise cycle, opportunities further down the market cap spectrum appear arguably more attractive than prior. With the US Federal Reserve Bank (Fed) easing their narrative at the July policy meeting, we are already beginning to see the reversion in small cap names in Japan, as currency worries abate… and the reversion will likely be quick and strong compared to their large cap counterparts!

The Emerging Markets & Asia Economy

China's 'zero-Covid' policy has been one of the key drivers of global markets over the past quarter. Introduced in April, the initial hard line approach to closing cities began with an outbreak of the Omicron variant in Shanghai. Whilst the 'hard lockdown' of Shanghai was largely crippling for the economy, it has created market and economic anomalies. As, with the Omicron variant being less potent, mortality rates are now vastly improved. And, due to the lower potency, requirements to isolate for inbound travellers was massively reduced to 7 days in a facility (and a further 3 at home). In addition, with subsequent outbreaks in Beijing, Shanghai and Shenzhen (amongst others), lockdowns have been less intense and more localised. This suggests China's hard lockdown approach is already easing, and with lockdowns sheltering them from the global inflationary pressures, (and with them renegotiating a more attractive gas supply arrangement with Russia), the potential for both the Chinese consumer and Chinese businesses to come back online could really aid not only local markets, but also global ones. It must also be remembered that with China being the largest creditor to a large number of developing nations, its ability to ease terms on debt repayments to drive demand is largely unparalleled.

Given the above pressures, Chinese valuations in relative terms are arguably as attractive as they have ever been. Following policy and lockdown driven compressions in valuations last year that saw recent GDP data come in at a meagre 0.4%, one must remember that data is backward looking … and given the drivers of the data were largely short-term pressures, the compressed valuations make the region arguably the most attractive on a risk adjusted basis. One must remember that in amidst of hard lockdowns, the consumer in China was unable to consume most items other than food. As such, they have been largely sheltered from the inflationary pressures plaguing most other countries. It is this pent-up demand and production that looks set to drive valuations.

The Brazilian Presidential election is due in October of this year, and with incumbent leader, Jair Bolsonaro, remaining a controversial figure during his 4-year tenure, we saw him replace executive board members on some of the country's largest companies, whilst also largely ignoring the global pandemic leading to Brazil being one of the worst hit regions in relative terms. With his original appointment being seen as a 'vote against the establishment' move from the Brazilian public 4 years ago following the political scandals that went prior, the resultant lack of domestic stimulus/policy (both at a public and corporate level) has hit home. Current polling suggests the front-runner is Lula Da Silva, a former President. Lula, whilst controversially being caught up in some infamous scandals historically, is perceived to be a return to the norm for Brazil. It is this element of stability that can be seen as key for markets, as, despite a commodity driven rally at the beginning of this year driven by the war in Ukraine, Brazil has had a turbulent few years, as has Latin America as a whole. With its largest economy (Brazil) beginning to price in stable support and a business friendly environment as we head in to the elections, on the expectation Lula prevails, compressed valuations in the region begin to look attractive.

Despite the inflationary pressures, largely driven by the throttling of supply of oil and gas to the west, as a result of the war in Ukraine and the subsequent sanctions imposed on Russia, this is not a typical supply side issue. There are still adequate resources to drive prices lower; it is the distribution mechanism that has been hindered. However, we are beginning to see global distributions realign, with economies such as India benefitting. Despite western world sanctions on Russia, India -whilst condemning Russia's actions- have secured an attractive price of sub $70 per barrel on Russian oil. As one of the world's biggest oil importing nations, it was crucial to source a discounted resource to alleviate domestic energy pricing pressures. This has driven India to consuming over 18% of its oil supply from the Eurasian region (which Russia is a part of), up from a little over 3% previously. Over time, this type of global redistribution will likely ease up demand pressures from other commodity supply side regions, normalising pricing pressures.

The US Economy

Whilst it is clear that the Ukraine/Russia conflict has dominated news and markets this year, it has largely been the resulting response by the Fed, and their subsequent policy adjustments, that have driven expectation and market direction over the past quarter. However, with markets pricing in excessive interest rate rises by the Fed, we have remained resolute that they would be measured in their response, and that is what we are now beginning to see. Following the expected July interest rate increase by the Fed (taking interest rates to 2.5% at the upper bound), the narrative by the Fed Chair, Jerome Powell, was one of data dependency, seeing him state that they would move again if needed, but acknowledge the need to slow the pace of policy tightening given slowing growth. With this in mind, and with markets already pricing in a recession to some extent, this came as a relief to markets, seeing them reign in their 'hawkish Fed' expectations in line with what we have been alluding to all year. In reality, the market has been blinded by short-term inflationary pressures, but the drivers are split between shorter-term supply constraint factors, and typical economic factors. The Fed, whilst concerned about inflation, will have been aware that much of the supply side pressures would not be abated by interest rate increases, nor would they want to unduly impact the labour market to an extent where it spiralled out of control. As such, whilst they fed a narrative of inflationary concern to temper markets, their approach was never going to be as aggressive and one dimensional as the market was pricing in. And, in reality, interest rates sitting at 2.5% is still low, but gives them enough monetary policy fire power to again cut rates if required.

With US President, Joe Biden's 'Build Back Better' funding package falling at the final hurdle earlier in the year, after it was 'shot down' by democratic senator Joe Manchin, we are finally beginning to see the shoots of spending begin to emerge. With the bulk of the new package still to be approved, it tackles areas such as climate change, drug pricing and the national debt, and will be a key focus for Biden with him seeing his approval ratings fall this year. Manchin has been consulted at each stage, with the package, named the 'Inflation Reduction Act', reportedly having approval from Senate Democratic leader Chuck Schumer. This is largely supportive of the domestic economy, particularly further down the market cap spectrum. This, when compounded with the point in the cycle and the compressed valuations makes US domestic small caps look more attractive as an opportunity set in relative terms. Biden has already had some policy wins, with the Senate passing legislation approving a $52 billion 'grant and incentive' budget for local semiconductor manufacturing, in addition to pre-approval of a $370 billion package to tackle climate change.

It must be noted that a recession is a natural part of any market cycle, and in this instance could be beneficial for opportunity sets within the US. At this stage, it does not seem likely that the US will fall in to a deep recession, as the Fed will likely remain accommodative, particularly following the recent GDP data sets that show the US has now had 2 consecutive quarters of contraction which signifies a technical recession. Given the likelihood of support, and given the markets have already priced in much of the negativity surrounding a recession, any taming of inflation coupled with further loosening of Covid-driven supply chain constraints stand to be beneficial for corporates. With interest rates at an arguable sweet spot for the financial sector (in particular, banks), and the valuation compression in the growth space (in particular, technology), the outlook for the equity market is strong... this was echoed in Q2 earnings announcements, with many technology majors optimistic about the outlook.

The European Economy

The Russian invasion of Ukraine has been dominating global markets so far this year, however it can be thought that the European markets' dependency on Russian energy has made its constituent economies and markets more susceptible to the tensions. With Germany consuming over 45% of its gas supply from Russia (pre-invasion), the sanctions imposed on Russia (that include them being prevented from transacting on the global Swift system, how most global transactions are settled), have meant that not only has consuming Russian energy been made difficult, but Russia's control over European energy has arguably been weaponised. Whilst this may seem like doom and gloom, this Russian friction has not only brought forward the development of renewable energy sources, but has also highlighted the requirement for Europe to detach themselves from their reliance on Russian resources. As a result of this, and of Russian-owned gas producer, Gazprom, restricting flows via the Nordstream pipeline, Germany have approved the recommissioning of offline coal plants. Whilst this can be seen as a step backwards in terms of their climate change goals, it will aid in reducing their reliance on Russian gas, and in alleviating energy pricing pressures and inflation until alternative arrangements are made.

The European Central Bank (ECB) has remained largely adaptive to the prevailing market environment, battling on two fronts, having to deal with both inflationary pressures over multiple member countries, as well as being mindful of the currency from a trade perspective. With the US and the UK both beginning to increase interest rates in a measured way, the ECB has been cognisant of a weakening Euro from a trade perspective and as such, given rates have been sat in negative territory for an unprecedented 8 years, July's move to hike rates took the bank from -0.5% to par, at 0%. So, whilst not life changing, the axing of the negative interest rates was a meaningful statement and aided in tempering Euro/USD expectations. In addition, as mentioned above, policy needed to remain fluid given the prevailing situation in Ukraine and the European dependence on Russian energy. In line with this ECB head, Christine Lagarde, remained adaptive to the prevailing market environment, seeing the bank inject a new supportive stimulus package into the market. The new 'Transmission Protection Instrument' (TPI) appears a more measured approach to Quantitative Easing, but largely is a statement that the bank will remain supportive and data dependent in what could be a volatile period for some EU member countries.

With the impact Covid 19 has had on economies, as well as on people's lives over the past couple of years now beginning to wain slowly (not belittling the tragedy and significance of what happened) the issues that were inherent within the European economies are beginning to raise their heads once again. Whilst the ECB will likely remain supportive, and whilst the current cyclical shift could be viewed to favour the asset class, given the 'value' tilt to the makeup of its economy, one cannot be complacent to the macroeconomic factors plaguing the region. As mentioned above, the energy dependence on Russia remains inherent, but so too is the mass growth in debt to GDP (gross domestic product/economic growth). This was an issue that was debated pre-pandemic, with Italy specifically reaching a debt to GDP level of approximately 125%. This lead to frictions between Italy and the ECB, and whilst the Pandemic masked these underlying issues, it too has aided in worsening the debt burden, with the problem not only raising its head once again, but magnifying it… seeing current Italian debt sitting at 150% of GDP (second only to Japan amongst the G20 nations). This will remain a short-term uncertainty, as will member country central banks relationships with the ECB. When coupled with vaguity of what the TPI mechanism looks like in practice, short-term uncertainties arguably net off the cyclical bias benefits and potential valuation upside, at least for now.

Fixed Interest

Another volatile quarter for fixed income markets: we have seen rate hikes from the Bank of England, The Federal Reserve, and for the first time in a number of years, the European Central Bank. Government bonds, and Corporate bonds, continued to sell off for the majority of the quarter. Despite recovering somewhat in recent weeks, yields are high in comparison to recent history.

With reporting season well under way, it is comforting to see corporate balance sheets remain in robust health. We are not dismissive of the risk to corporates of a weakening economy, but so far at least, they remain well positioned for short-term economic weakness.

Some areas of the market have repriced dramatically, offering much higher yields today than at the start of the year, and now appear more attractive than they have for a number of years, even when accounting for a likely increase from the current low level of defaults.

Inflation is high - so while nominal returns may be stronger from here, real returns are likely to remain fairly weak in the medium term. There is still uncertainty on the path for rates in most major markets too, so volatility in fixed income markets could remain elevated. Consequently, we prefer equities as they are likely to offer better returns in the medium term.

If you would like to discuss this or any other aspect of your portfolio, please do not hesitate to contact us on 0800 049 2011, Monday to Friday 9am-5pm or you can email us at affinity.advise@wealthatwork.co.uk

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