Investment Outlook

A monthly round-up of global markets and trends

July 2022

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Investment outlook

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Markets need to deal with an inflation hangover

It's 13 years since the movie "The Hangover" was released and like the main characters in the film, investors are currently nursing an inflationary hangover. This comes following the massive global fiscal and monetary stimulus unleashed during the pandemic. The end of the stimulus party has left many investors wondering when things will get better.

In June the US S&P 500 entered a bear market – a peak-to-trough fall of 20% or more. In sterling total return terms, the MSCI All Country World equity benchmark is down 12% in the first half of 2022.[1] Stock markets have been dragged lower by sectors more sensitive to higher interest rates, including technology-linked growth stocks, which were trading on high valuations before the recent correction. In contrast, cheaper, value-related energy stocks have gained from a sharp sector rotation, with investors switching into supply constrained commodity industries.

To put this into perspective, take Zoom Video Communications, a growth stock and pandemic darling. The firm listed in April 2019, and by October 2020 it had outperformed US energy giant ExxonMobil by more than 2,200%. Fast forward today and Zoom's outperformance has slipped to just 70% higher than ExxonMobil.[2]

Equities are not the only asset class that have suffered from the punchbowl being taken away. After 40 years of equity-like returns, government bond prices have declined sharply to reflect a sudden shift in outlook from major central banks, with many now raising interest rates. In the last six months, the UK benchmark 10-year Gilt fell 15%, the worst return since 1980.[3] US Treasury bonds have had their worst start to the year since the country's constitution was ratified in 1788![4]

The current aggressive tone from major central banks (excluding the People's Bank of China) is further acknowledgment that inflation has been more protracted than they had originally expected. It's no wonder. In May, US CPI inflation reached its highest rate since 1981[5]. In Germany it's at a 72-year high.[6] Elsewhere, the Bank of England forecasts CPI inflation peaking above 11% in October, incorporating a further increase in Ofgem's energy price cap later this year.

Looking forward, it is all but certain that central banks will continue to hike interest rates to bring inflation down. At its June meeting, the US Fed raised its target interest rate by 0.75% to 1.75%, marking the biggest increase for 28 years.[7] Meanwhile, the Federal Open Market Committee (FOMC) members' forecasts show that US interest rates could well reach 3.4% by the end of 2023 with expectations the Bank of England will get to around 3% in the next 12 months.[8] The ECB also took a more aggressive tone recently to pave the way for interest rates to rise over the next couple of months.

Economic growth is under threat from higher interest rates and falling consumer confidence. Despite a solid labour market, the US University of Michigan consumer confidence index fell to a 50-year low in June, driven by the rising cost of living.[9] Should consumers materially reduce spending, the US could well slip into a recession, raising the risk of a global downturn. While a global recession is not our central view, investors will want to see signs inflation is topping out before stock markets can stabilise. If inflation remains elevated, then interest rates could rise further making it more difficult for central banks to engineer a 'soft' economic landing and avoid a recession.

Three reasons to remain upbeat on stocks

Given all these headaches, it can be difficult to remain positive on stocks. Nevertheless, we see three reasons to stay the course and remain invested.

First, there are signs that US inflation will peak soon. Unlike inflation of the 1970s, the US dollar has risen in value compared to other currencies. That should lower the cost of imports, keeping prices down. Job vacancies have started to drop which should reduce pressure on wages and therefore inflation. Providing that inflation peaks, central banks will be more inclined to dial back their aggressive tone, particularly if real interest rates turn positive thereby acting as break to slow down the economy.

Second, global GDP growth remains relatively robust and company earnings continue to be supported by high profit margins. In contrast to the monetary and fiscal tightening implemented in advanced economies, Chinese policymakers are pumping more money into the economy and cutting interest rates to drive growth. Against this backdrop, company earnings' forecasts for this year are being revised up.

Third, valuations look reasonable as much of the post-pandemic froth has now gone. Global stocks trade on a price-to-earnings ratio of 15 times, which is broadly in line with the long-term average and down from a peak of 20 times which we saw towards the end of 2020.[10]

In summary, equities appear in a good position to recover from current levels, assuming inflation will peak soon. Company earnings remain relatively healthy, and valuations are more attractive. The main risk for investors is whether inflation remains high and leads to a more protracted hangover.

Sources:

[1,2,3,5,6,7,8,9,10] Refinitiv/Evelyn Partners

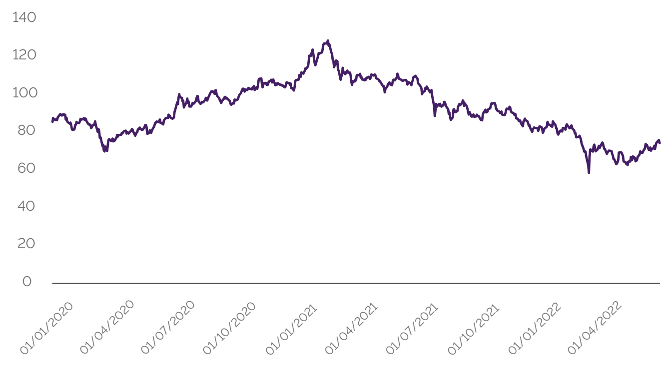
[4] One of the worst years on record… so far…, Jim Reid, Deutsche Bank, June 2022

Market highlights

Equities

Having performed incredibly well during the first year of the pandemic, Chinese stocks have reversed those gains over the last 18 months. Lingering concerns about a potential collapse in the property market, onerous regulations imposed on the technology sector, and concerns about the Government's ability to control more infectious variants of Covid-19 have led investors to withdraw capital from the country. However, last month the Chinese stock market was the only major market to record positive growth. Could this be the start of a turnaround in the country's fortunes? It seems that investors have become more constructive on China given its reopening following recent Covid lockdowns, as well as positive noises coming from the Government about easing policy. When coupled with cheap valuations, it looks like the market could be set for more interest in the second half of the year.

MSCI China price index

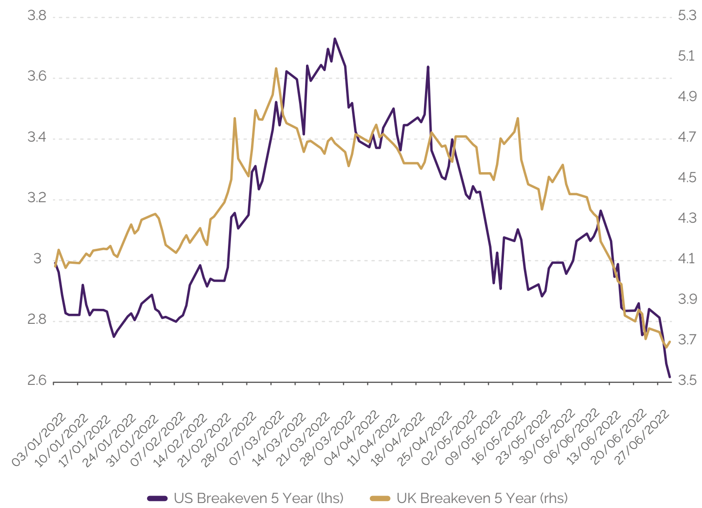


Source: Refinitiv Datastream, Evelyn Partners Investment Management LLP, data as at 30 June 2022

Fixed Income

While the headlines report inflation at 40-year highs in both the US and the UK, the bond market is painting a slightly more optimistic picture for the future. Breakeven rates, calculated using the difference in yields between nominal government bonds and their inflation-linked counterparts, represent the bond market's estimate of future inflation. These estimates for the next 5 years have fallen from 3.7% at the end of March to 2.6% at the end of June in the US and from 5.0% in early March to 3.7% now in the UK (UK breakeven rates are based on RPI, which tends to be higher than CPI used in the US). This fall in expected inflation has led to the underperformance of Treasury Inflation Protected Securities (TIPS) and index-linked gilts. Nonetheless, a slightly more benign inflationary outlook is good news for economies and investors alike.

UK and US breakeven rates of inflation

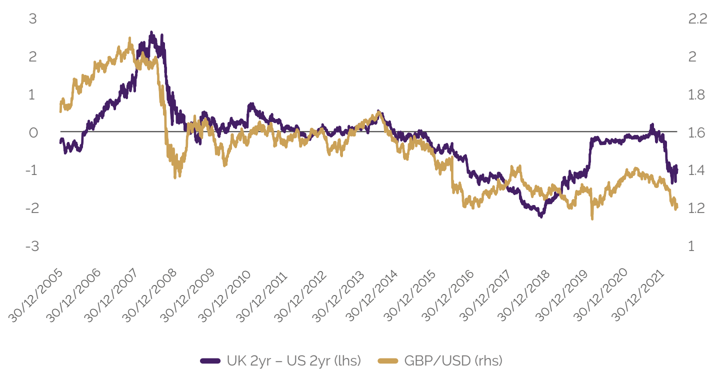


Source: Bloomberg/Evelyn Partners Investment Management LLP, data as at 30 June 2022

Commodities and FX

This year sterling has performed relatively poorly against the dollar. The chart on the right goes some way to explaining this. It shows the relatively close relationship between the GBP/USD exchange rate and the gap (or spread) between US and UK 2-year interest rates. In other words, when 2-year interest rates are higher in the US than in the UK (i.e. below the line), sterling depreciates because investors move capital to the US to benefit from higher interest rates, strengthening the dollar. We can see that this has been the case since the start of 2022 — the gap between US and UK interest has increased sharply, leading to dollar appreciation. However, this isn't necessarily a bad thing for UK-based investors with US assets. As the dollar has strengthened this has increased sterling-denominated returns.

UK 2yr – US 2yr government bond interest rates vs GBP/USD



Source: Refinitiv Datastream, Evelyn Partners Investment Management LLP, data as at 30 June 2022

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	-4.9	-8.4	-3.7	53.8
MSCI UK	-5.2	-2.9	9.2	19.8
MSCI UK Broad	-5.8	-4.5	3.7	17.0
MSCI USA	-4.8	-9.8	-0.8	81.9
MSCI Europe ex UK	-7.0	-8.2	-9.8	23.7
MSCI Japan	-4.4	-7.4	-8.6	18.8
MSCI Pacific ex Japan	-4.8	-6.8	-3.1	25.9
MSCI Emerging Markets	-3.0	-3.9	-14.7	21.3
Bonds				
iBoxx GBP Gilts	-2.0	-7.9	-14.3	-3.6
iBoxx USD Treasuries	2.9	4.0	3.4	11.0
iBoxx GBP Corporate	-3.6	-7.8	-14.5	0.5
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-6.6	7.0	52.7	140.3
Gold ($/ounce)	-2.1	-6.9	2.4	45.3
GBP/USD	-3.6	-7.8	-12.1	-6.5
GBP/EUR	-1.3	-1.8	-0.3	2.0
EUR/USD	-2.4	-6.0	-11.8	-8.3
USD/JPY	5.6	11.9	22.4	20.9

Market commentary

Once again inflation and interest rates have been the focus for investors and dominated markets in June. The US equity market entered a bear market, as falls this month took the peak to trough performance down below 20%. Europe ex UK led their peers lower returning -7.0% including dividends and in sterling terms. The UK also ended the month on a less positive note and was down 5.2% for the month. The US market performed only slightly better and ended the month 4.8% off, with the strong dollar versus the pound protecting UK investors from larger losses. UK government bonds ended the month with little change despite exhibiting volatility. The UK 10-year gilt yield crept up marginally to 2.2%, while the yield on US 10-year treasuries spiked around 3.5% before falling back 3.1%. Markets remained challenging for much of the month as inflation fears remained front and centre, although for the second month in a row we saw a late rally at the end of the month.

Key macro data	Latest	2022 Consensus forecast	Spot rates	30-Jun	Yields (%)	30-Jun
UK GDP (YoY%)	8.7	3.60	GBP/USD	1.21	MSCI UK	4.2
UK CPI Inflation (YoY%)	9.1	8.25	GBP/Euro	1.16	MSCI UK broad	4.1
Bank of England Base	1.25	1.90	Euro/USD	1.05	10 Year Gilt	2.2

The market commentary, values and charts as at 30 June 2022. Total returns in sterling.
Returns are shown on a total return (TR) basis i.e. including dividends reinvested (unless otherwise stated).
Net return (NR) is total return including dividends reinvested after the deduction of withholding tax.
Source: Refinitiv Datastream/Bloomberg

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