Investment Outlook

A monthly round-up of global markets and trends

September 2022

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Investment outlook

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To pivot, or not to pivot, that is the question for the Fed

Stock markets continue to fluctuate and are being led by changing expectations for future interest rates. Even though interest rates in developed economies are likely to rise for the rest of this year, traders are already predicting that central banks will 'pivot' away from their plans to continue raising interest rates. According to money markets, which are heavily influenced by movements in short-term interest rates, the Federal Reserve (Fed) is expected to stop raising rates by March 2023.

The concern for investors is that this year's rapid pace of US interest rates increases (including two outsized 75bps hikes in June and July) raises the risk of an economic downturn.[1] Given that US real GDP contracted for two consecutive quarters in the first half of 2022 (a technical recession to some), the Fed could back down on its plans to tighten policy further. Indeed, equities recently rallied in anticipation that the US central bank will embark on a softer hiking cycle.

Of course, traders could be wrong. After all, the Fed's upper target of 2.5% for interest rates seems low when annual CPI inflation is nearly 9%.[1] Historically, it has been unwise for investors to 'fight the Fed'. Yet, it seems that some cracks are appearing in the Fed's aggressive stance. In the last Federal Open Market Committee (FOMC) rate-decision meeting, Fed Chair Powell hinted that it could become appropriate to slow the pace of increases.

Looking forward, the Fed must assess how higher interest rates feed through to the economy and the labour market. After stock market falls earlier this year, businesses are less confident in taking on more staff. The highly cyclical housing market is also a lead indicator of the jobs market. With the cost of mortgages on the up and house prices rising sharply, affordability is an issue for homebuyers. Consumer confidence and existing home sales are now on the decline, and this is likely to weigh on the economy and jobs.

There could be some good news on inflation for the US. The strong dollar, easing supply chains and falling commodity prices should help to bring down the rising cost of living. A good guide for actual CPI inflation is market-derived expectations of inflation, which have started to come down, and could be enough for the Fed to consider a pivot. However, for now, the Fed has shown that it is reluctant to ease off the monetary brakes too soon, a point made clear by Jerome Powell during his recent speech at Jackson Hole. This is understandable given current annual CPI inflation is at a multi-decade high and there's a risk that expectations of rising wages become entrenched in the economy.

On balance, it is probably too soon for the Fed to pivot away from its existing plans. Nevertheless, for investors, compared to the start of the year, the threat of surprise interest rate rises has eased. This makes equity valuations look more attractive, increasing the potential for shares to recover from oversold positions.

A bright spot amidst Europe's darkening energy crisis

On 26 July 2012, during the height of the European debt crisis, then European Central Bank (ECB) president Mario Draghi gave his famous "whatever it takes" speech. He was outlining the ECB's intention to support the euro by backstopping the financially vulnerable debt markets of Italy and Spain. This would be achieved through unlimited money printing via its Quantitative Easing (QE) tool. Those simple comments showed a strong commitment by policymakers to address the European debt crisis. But unfortunately, printing money will not help this time around.

Today's crisis comes via the energy market, which is threating to tip the European economy into a recession. In the eurozone, annual CPI inflation is at an all-time high, while consumer confidence is at its lowest level since data began in the mid-1980s. The high cost of imported energy has pushed the eurozone into its biggest trade deficit on record. There is now a risk that natural gas may have to be rationed on the continent this winter which, if realised, would restrict economic growth.

Whether rationing is required will depend, to some extent, on Europe's ability to increase the amount of gas in its storage tanks, which are currently at 80% of capacity, only slightly below where it should be at this time of year.[2] Gavekal estimates that there will enough gas in storage to cover around one-third of average winter gas consumption.[3] The shortfall will have to be made up with alternative gas supplies (pipeline flows from Norway and Algeria along with increased imports of liquified natural gas), potentially alongside some form of rationing. With businesses and households facing significantly higher costs, demand is also likely to be lower.

Nevertheless, despite high energy prices, European companies (including the UK) have produced solid company earnings. In the second quarter, the largest European companies posted Earnings Per Share (EPS) growth that rose 28% from a year ago.[4] Even excluding outsized profits in the energy sector, European EPS still rose 9% from a year ago in the second quarter.[4]

Certainly, there are plenty of risks surrounding European stocks, particularly those in the manufacturing sector. But companies continue to deliver on the earnings front, supported by strong sales from increased pricing power and a weak euro. This may provide an opportunity for investors even though market risks have risen.

Sources:

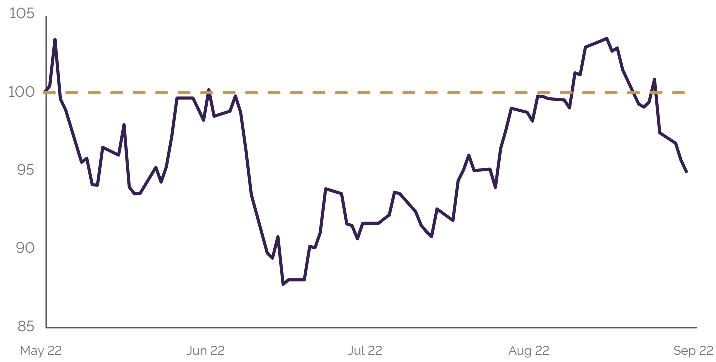
[1] Refinitiv, 25 August 2022
[2] Aggregated Gas Storage Inventory, 29 August 2022
[3] Trouble In Store, Cedric Gemehl, Gavekal, 9 August 2022
[4] Q2 European Earnings Tracker, Deutsche Bank, August 2022

Market highlights

Equities

US equities have been highly volatile over the last four months, driven primarily by uncertainty around the path for interest rates and the broader economy. In the second half of June and throughout July, US stocks recovered, fuelled by a belief that US inflation could have peaked following lower than expected inflation figures for July. Now this recovery appears to have stalled, with the market backtracking on this position. This change of view was reaffirmed at the end of August when the Chair of the US Federal Reserve, Jerome Powell, spoke at the Jackson Hole conference. He issued a hawkish message and indicated that interest rates would need to move higher and there could be more pain to come for the US economy. As a result, US stocks were sold off again, falling back below the level seen at the start of May.

MSCI USA price index, USD (Index 100 = May 22)

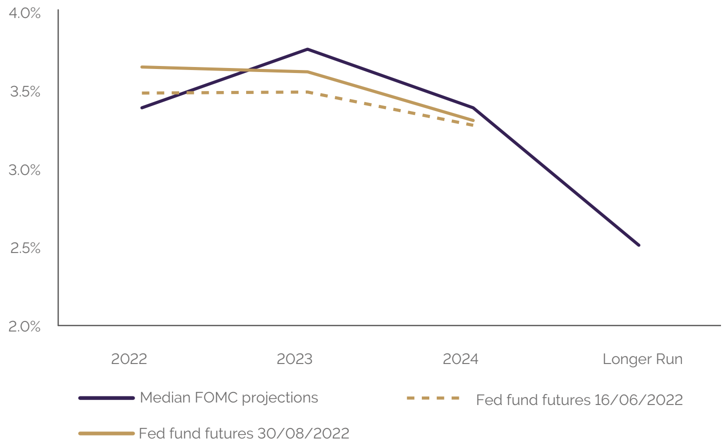


Source: Refintiv Datastream/Evelyn Partners Investment Management LLP, data as at 31 August 2022

Fixed income

Over the last few months, market expectations for future interest rates have been fluctuating. Until recently, interest rate forecasts from Federal Open Market Committee (FOMC) members were some way above the Fed fund futures, which outlines the participants expectation's for future interest rates. This showed that expectations had been for the FOMC to raise interest rates less aggressively than they were forecasting in their projections. However, the last few weeks have seen market expectations of interest rates converge closer to the Fed's projections, implying that the market is now more convinced by the Fed's hawkish stance. With the FOMC set to update its forecasts in September, investors will be watching closely to see how the market responds.

US interest rate projections

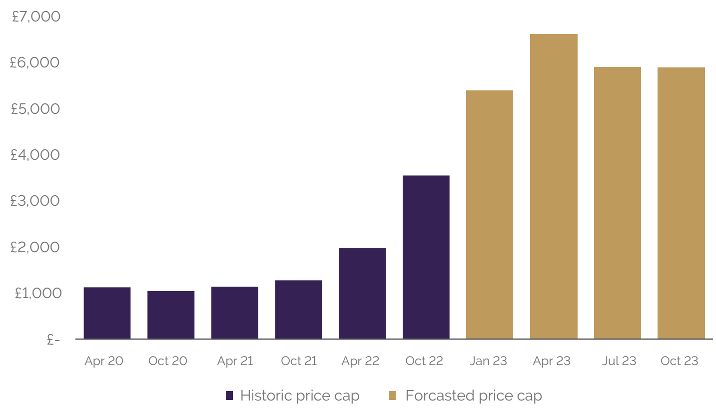


Source: Refinitiv Datastream/Evelyn Partners Investment Management LLP, data as at 31 August 2022

Currencies and commodities

Last week Ofgem, the UK energy regulator, announced its latest energy price cap for October. The headline figure, which reflects the annual energy bill for a typical UK household, was set at £3,549. This represents an 80% increase from the current energy price cap of £1,971. The increase is due to the recent resurgence in wholesale gas prices, which are currently up over 130% since the previous cap was announced in February. These price pressures can, in part, be attributed to a reduction in Russian gas supplies to Europe following Russia's invasion of Ukraine. Looking forward, Cornwall Insight, an energy consulting firm, forecast that more increases are to come in the first half of 2023, which will further weigh on consumer spending. The country will be looking to the incoming Prime Minister for guidance on whether additional support for households will be on the table.

UK Ofgem energy price cap



Source: Ofgem, Cornwall Insights, Refinitiv DataStream/Evelyn Partners Investment Management LLP, data as at 31 August 2022

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	0.8	2.3	0.0	59.0
MSCI UK	-1.3	-3.1	9.2	19.3
MSCI UK Broad	-2.1	-3.8	2.6	16.1
MSCI USA	0.5	4.4	2.8	93.3
MSCI Europe ex UK	-2.1	-4.2	-10.9	21.9
MSCI Japan	1.9	2.8	-3.8	24.3
MSCI Asia Pacific ex Japan	2.8	1.3	3.7	27.2
MSCI Emerging Markets	5.1	1.5	-7.1	16.1
Bonds				
iBoxx GBP Gilts	-8.2	-7.5	-20.7	-11.2
iBoxx USD Treasuries	1.8	6.3	5.1	12.4
iBoxx GBP Corporate	-6.3	-6.4	-18.2	-4.5
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	-12.3	-21.5	32.2	84.6
Gold ($/ounce)	-2.5	-6.8	-4.8	30.7
GBP/USD	-4.4	-7.7	-15.5	-9.7
GBP/EUR	-3.0	-1.6	-0.7	6.8
EUR/USD	-1.4	-6.1	-14.8	-15.4
USD/JPY	3.7	7.8	26.2	26.0

Market commentary

August started positively as markets began to factor in the US easing on interest rates but gave up their gains as sentiment deteriorated. The MSCI USA index remained in positive territory, up 0.5%, as did global markets which were up 0.8%, both in sterling terms. This was helped by the weak pound, which itself fell 4.4% versus the US dollar. European markets, however, struggled with the proximity of the war in Ukraine having a greater impact on the region. Concerns over energy rationing impacting economy growth and the prospect of a bleak winter sent the MSCI Europe ex UK index down 2.1%, again in sterling terms, and the UK market also fell by 1.3%. There were bright spots however as the Asian and Emerging markets delivered some strong performance – sterling return for MSCI Emerging markets delivered 5.1% over the month whilst the MSCI Asia Pacific ex Japan returned 2.8%. Oil prices eased over the month as Brent Crude fell 12.3% bringing the total fall over the last three months to 21.5%.

Key macro data	Latest	2022 Consensus forecast	Spot rates	31-Aug	Yields (%)	31-Aug
UK GDP (YoY%)	2.9	3.50	GBP/USD	1.16	MSCI UK	4.00
UK CPI Inflation (YoY%)	10.1	9.30	GBP/Euro	1.16	MSCI UK broad	3.90
Bank of England Base	1.75	2.50	Euro/USD	1.01	10 Year Gilt	2.80

The market commentary, values and charts as at 31 August 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

Important information

Please remember the value of investments and the income from them can fall as well as rise and investors may not receive back the original amount invested. Past performance is not a guide to future performance.

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