Asset Class Commentary
July 2022

While markets are down and are now firmly in "bear" territory, after every bear market in history markets have recovered and have risen above their previous level. What is unknown is how long the duration of the bear market will be, and how long any subsequent recovery will take.

Since 1945, compounded annual returns from the S&P 500 would have been around 11%, and this is taking into account the bursting of the dot com bubble, the 2008 financial crisis, the Covid pandemic and many other market damaging events.

Although markets may have further to fall, the biggest factor affecting markets at present is the likely path of future interest rate rises and these are now largely priced into stock market values. The magnitude of any short-term fall is therefore likely to be less severe than those we have recently seen.

Market dynamics are constantly changing and this is a common theme we are seeing each month as Central Banks, economists and investment managers all change their outlook to take account of a worsening situation. The chances of a recession two months ago were low; now many investors are pricing it into their forecasts.

What has changed? Not much, the situation in Ukraine is ongoing, inflation is rising, the US Federal Reserve is overly aggressive and the effects are playing out as they should. For now, investors will just need to be patient.

Major economies are battling slowing inflation and trying to avoid a prolonged period of stagflation (where inflation is high and growth is sluggish). On top of this, Europe is seeking to develop a new monetary policy tool to help overly indebted countries such as Italy avoid a debt crisis when interest rates begin to rise.

While returns over the past 3 months in the UK, Europe and the US are in negative territory, returns in China are in positive territory. This is mainly due to the loose monetary policy boosting equity values that had been hit hard over the past few years.

Just like the Central Bank rhetoric of last year slowly changing to meet the reality they are so far behind, this is again happening. The US Fed Chairman Jerome Powell's words are changing from assuring investors the Fed can achieve a soft landing to admitting there is a possibility of a recession, as there are market forces at work which are outside their control.

UK Chancellor Rishi Sunak stated they have all the tools and determination to bring inflation back down. While the tools referred to are the BoE's monetary policy and government taxation, these will not necessarily be the solution, with external factors playing a large part. Consumer demand can only be reduced so far.

The ECB's tone on monetary policy is becoming more aggressive as they realise rates need to rise and their bond-buying programme is reduced.

Regardless of whether economies fall into a recession, in our view the effects are now mostly priced in. A recession will allow excess capital to be reallocated and for structural changes to help support sustainable growth, and in the long-term this will help boost equity performance. Investment philosophy should not change and the long-term view is still the most important objective.

Areas of Focus

- Chinese equities have outperformed all other major indices as weaker monetary policy boosts valuations.
- US Government Bond yields have fallen as investors move to Treasuries as a safer asset in light of increased recession risks.
- Crypto currencies such as Bitcoin have tumbled in value as investors move away from such a speculative asset.
- Economists expect property sales globally to continue to slow and in the coming months, price growth to slow or even turn negative. We are seeing that already in countries such as Australia and Canada.
- The healthcare, consumer staples and energy sectors continue to outperform sectors such as technology and consumer discretionary.
- German equity markets are one of the worst performers as energy shortages are hitting the region the hardest.
- Several Eurozone countries including Italy are experiencing decreased government bond demand as interest rate rises pose issues.
- Large cap stocks are expected to fare better than their small cap counterparts.

UK

Consumer confidence in the UK has continued to plummet, falling to its lowest level since records began. Inflation reached 9.1% in May, marginally higher than the 9% in April. Although this is not currently at the 11% level the BoE predicts by the end of the year, the headline CPI figure is expected to jump further in June as rising fuel prices are taken into account.

The biggest contributor to CPI in May was rising food prices, which increased by 1.5%.

Social unrest over demand for wage increases has spread across sectors in the UK as employers resist compensating workers for the fall in living standards. This is likely to be exacerbated later this year, with workers' disposable incomes set to be hit again in October when energy prices rise.

That being said, wage inflation is a component in spiralling inflation and the BoE will be relying on slow wage inflation to help cool the economy. In the harsh words of US Senator Elizabeth Warren "the Fed can slow demand by getting a lot of people fired and making families poorer".

In investors' minds the UK faces the highest probability of any major economy of falling into a recession. This is because the UK has been slower to increase its GDP growth since the pandemic drop in March 2020, faces increased political risk and faces higher inflation than most other developed economies. BoE Chief Economist Huw Pill said the bank was willing to accept lower growth in exchange for bringing prices down.

In the last month the pound further weakened against the dollar, adding more fuel to the inflationary fire.

Over the past month the FTSE 100 was in negative territory at over -3%. Small cap stocks performed worse than their large cap counterparts returning -6% as measured by the FTSE UK Small Cap Index. YTD the small cap index has returned -19.16% compared to 1.15% for the FTSE 100.

Large cap companies have higher purchasing and pricing powers than smaller companies and so can more easily pass on the rising prices to consumers, keeping their profits at a more stable level. Many small companies have resisted passing on increased costs but are now finding they have no option.

Going forward, large cap stocks are favoured over smaller stocks. Defensive sectors such as consumer staples and healthcare are likely to continue to outperform sectors such as technology.

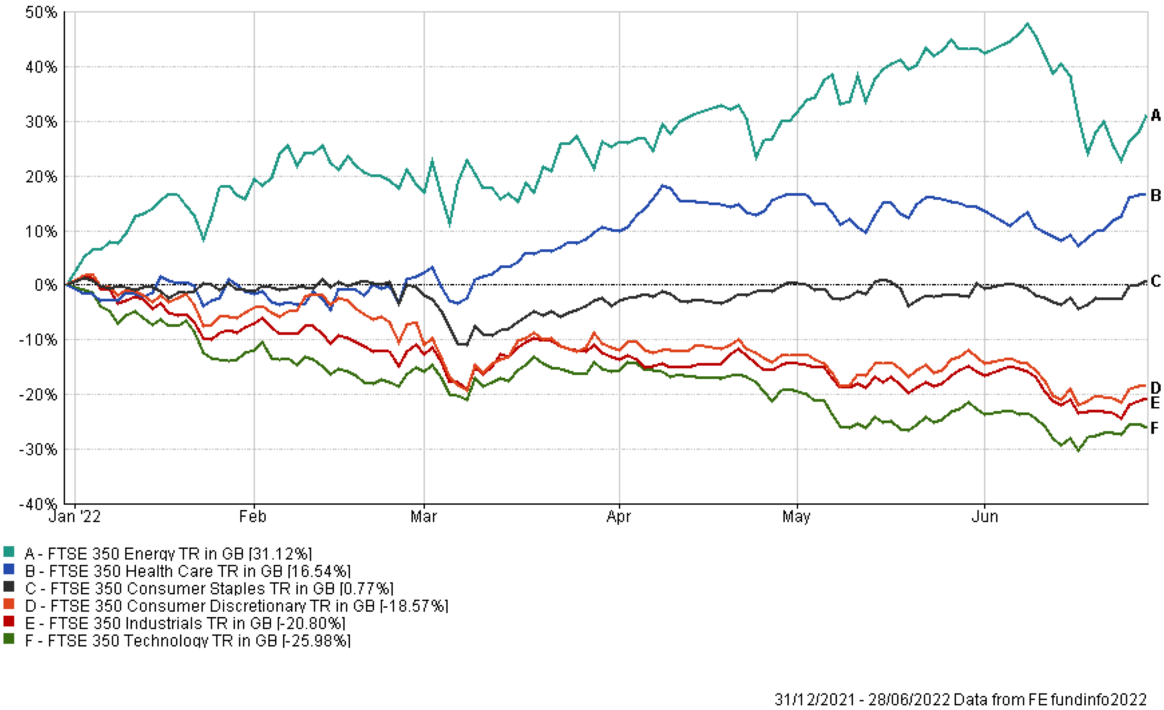

Chart showing YTD performance of different FTSE 350 sectors

Europe

As the end of the war in Ukraine looks far out of sight and high energy prices do not look to be coming down anytime soon, the ECB announced that its bond-buying program will end on Friday. Interest rate rises are expected from July with the first rise estimated to be 0.25%.

Interest rate expectations have caused bond yields to rise and this has impacted some countries more than others. The spread between German and Italian bond yields has widened to its furthest since the Eurozone debt crisis in 2013. This spread is often used as a measure of the perceived financial distress in the Eurozone.

This increased spread and concern over highly indebted Eurozone countries such as Italy has prompted the ECB to create a new policy tool which they intend to use to support bond yields and attempt to stop another debt crisis. What this tool will look like is currently unknown but many commentators are sceptical as to whether it will achieve what it intends to.

Inflation in Spain reached 10.2% this month, up from 8.7% the previous month. Other members of the bloc have seen similar increases. Economists had predicted inflation across the bloc to rise to 8.3% in June but the actual figure was higher at 8.6%.

Stock market performance in the Eurozone has now reached negative double digits this year, with the German DAX 30 returning -14%. In the last month alone the index has dropped over 7%, making it one the worst-performing developed markets.

Rising gas prices and the shortage of gas supplies is hitting Germany particularly hard, with energy rationing set to step up as winter supply backstops are nowhere near the capacity they should be at.

Chart showing the YTD performance of European stock market indices

US

While US inflation data has showed no signs of slowing, US hiring is expected to have slowed as labour market growth slows. The unemployment rate is expected to stay steady at 3.6%.

US manufacturing data showed output had fallen as companies expect demand to drop in the coming months. Supply data also showed that delivery times had eased. While this may indicate that supply issues are being resolved, it may also simply be down to lower demand (which is most likely the case).

The Fed has consistently argued in the past few months that there is room to raise interest rates aggressively, but if the data is as expected this will show there is less room than is needed to raise rates and avoid a recession.

The market had previously priced in interest rates ending the year at 3.4%. This is now expected to be 3.2%.

Economic data is pointing to a weakening US economy, with economists revising their GDP growth forecasts downwards. For example, JPM have revised their second quarter GDP forecasts down sharply from 2.5% to 1%.

Demand for US Government bonds has increased as fears of a recession increase, evidenced by yields dropping – the two-year yield has fallen to around 2.8%, down from a high of 3.4%.

Elsewhere in the US property price growth is expected to slow as property sales are down 40% from the peak in the pandemic. Research by Goldman Sachs shows a 10% slowdown in house sales is usually followed by a 2% slowdown in house price growth around 6 months later.

While there are headwinds for the property market, namely rising mortgage rates, affordability and slowing home sales, supply is still a global issue which is expected to aid in avoiding a slump in the market.

Over the past 3 months the NASDAQ 100 has still been the worst performing stock market index, returning -14%. The S&P 500 has fared slightly better, returning -7.75% (better than only the German DAX 30 index mentioned earlier).

Technology values had previously been judged to have been inflated and this market sell-off is a big correction. Many companies who can justify their values have been punished and investors have shown no discrimination in selling tech companies. When all the dust settles the quality companies will become apparent and their values will be reflected more accurately in their share price than is presently the case.

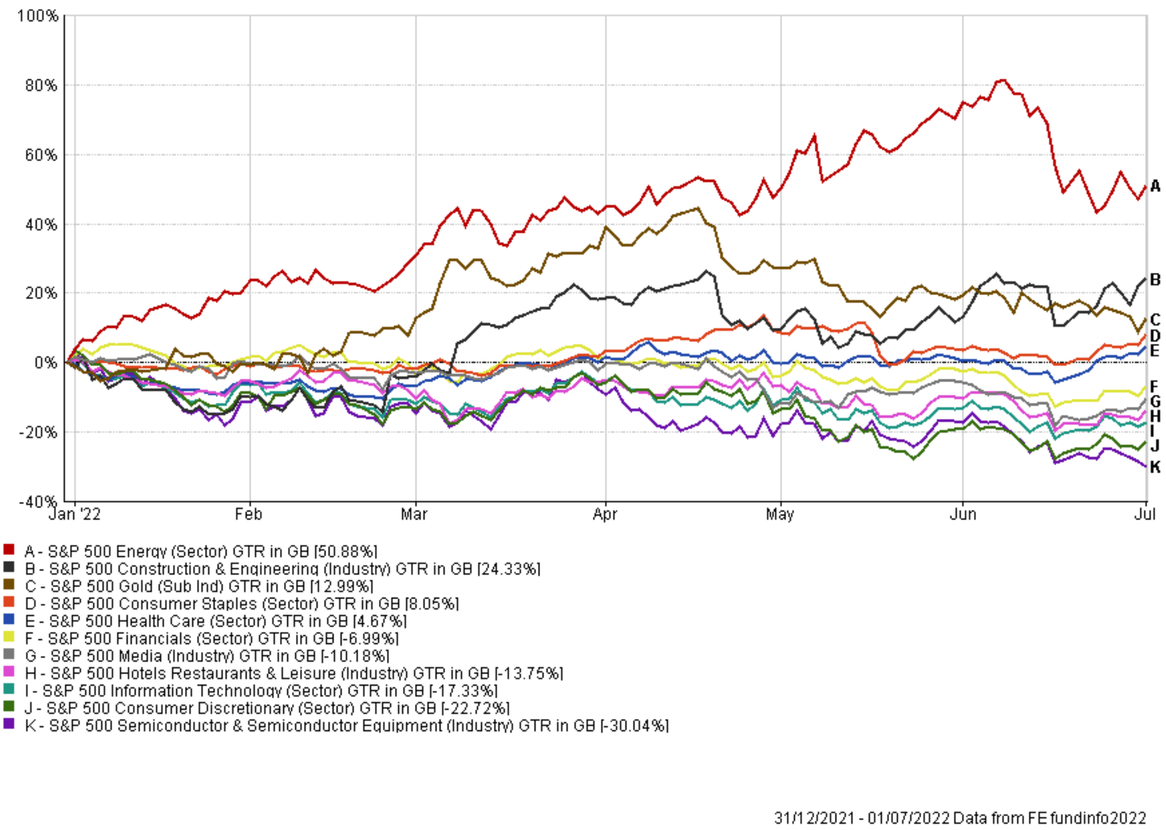

Chart showing the YTD performance of S&P 500 sectors

China

Loose monetary policy has helped to boost equity returns, with the Shanghai Stock Exchange 50 bucking the global trend by rising by over 14% in the past month. There are a number of factors driving these returns.

Presently investors are struggling to find positive returns anywhere. Loose monetary policy will tend to automatically increase stock values and investors are jumping on this. Relaxation of Chinese regulatory issues has also attracted some investors back.

It should be noted that long-term prospects for Chinese equities are still very much unknown and political risk is high.

Chinese business involvement in Russia is a big area of concern and is attracting US sanctions. Several large Chinese companies have been banned from importing from the US due to alleged involvement in supporting Russian defence companies.

A slowdown in Chinese economic growth is a global concern, with the Chinese government's zero Covid approach and a slowing housing market weighing heavily on the economy. President Xi Jinping has said that China will still reach the 5.5% GDP growth they have targeted, but this is at odds with analysts who see GDP growing at 4.1% (including a contraction in growth in the second quarter). In the first quarter, year-on-year growth was at 4.8%, and this is expected to fall to 3%.

Any shortfalls in this growth are expected to be met by further monetary easing to provide a boost for businesses and encourage consumer consumption.

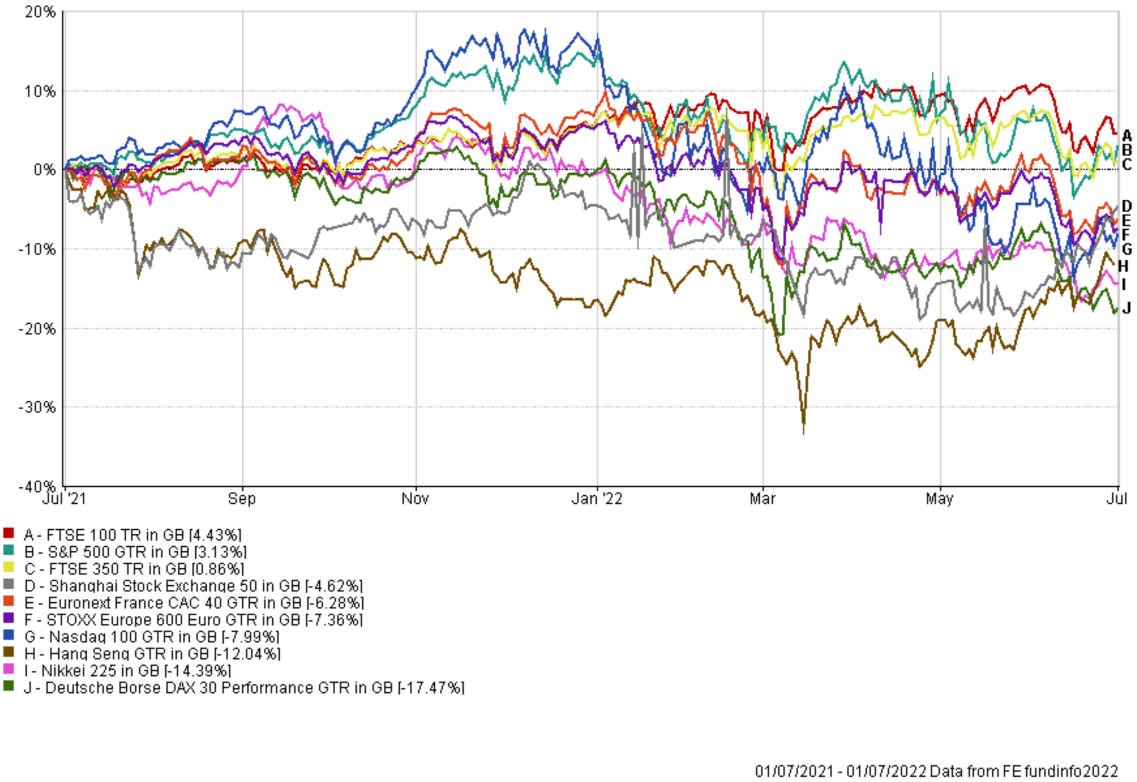

Chart Showing 1 year performance of Major Stock Market Indices

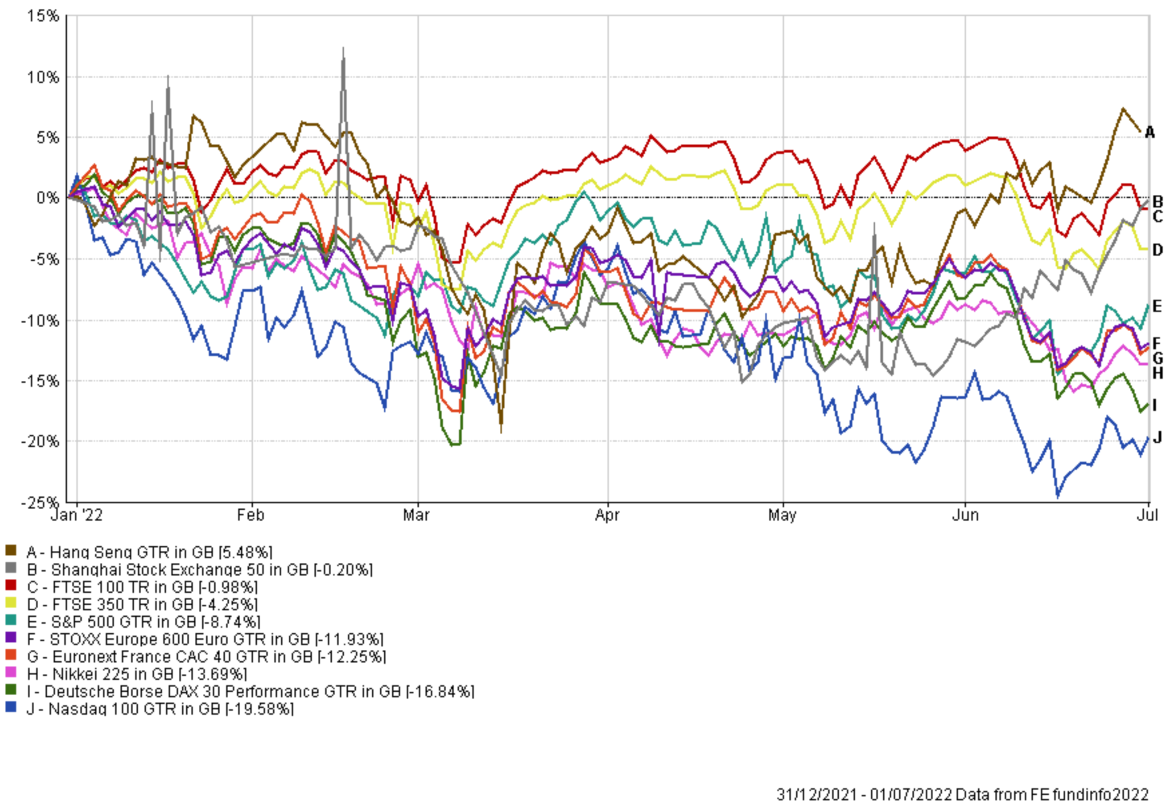

Chart Showing YTD performance of Major Stock Market Indices

Crypto Currency

As investors move from higher risk assets to safer havens, one area which has been hit particularly hard is the crypto currency sector.

As we have written about before, these assets have no intrinsic value and their "worth" is determined purely by supply and demand among investors. Unlike equities (where dividends and cashflow create real-world value) and fixed income bonds (where coupons and redemption values create value), Bitcoin has no cashflow value. The risk and volatility of these assets is extremely high.

The idea that Bitcoin and other Crypto currencies are a hedge against inflation is unfounded and is an idea that is designed to tempt investors into a highly speculative market. Take Japan in 2017 when Bitcoin traded below $1000. Small investor interest in Bitcoin rose substantially as TV adverts and billboards boasting of high returns tempted investors into a relatively unknown market.

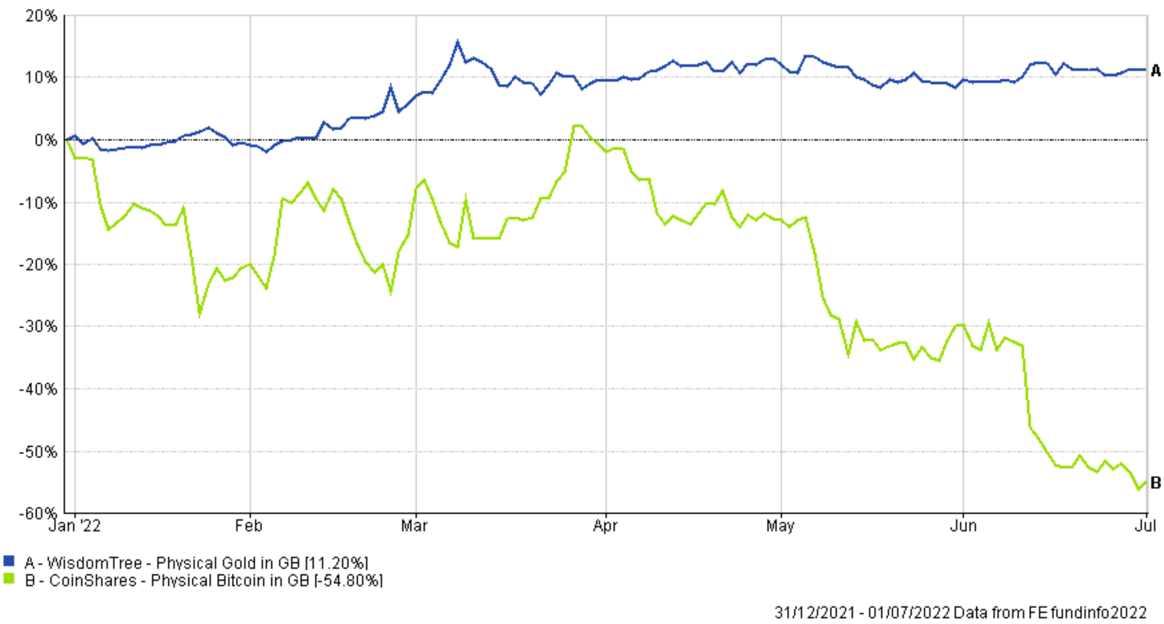

Chart comparing YTD performance of Gold with Bitcoin

Gold, which is commonly used as a hedging investment in high-inflation environments, has returned 11.20% YTD, compared with returns of -54.80% for a Bitcoin fund.

In November 2021 Bitcoin reached an all-time high of $68,700. This has since declined to $19,100, a decrease of over 72%. Why did the value of this asset rise so high? Herd behaviour, or as it may commonly be known today, FOMO (the fear of missing out). Investors see other people making money and want to join in, regardless of what the asset is and without doing any research.

The value has since dropped hugely as big investors cashed in on profits. Regulation has also impacted the mining of the digital currency and risk appetites have reduced considerably amid high inflation and rising interest rates. Some smaller investors have withdrawn their investments in Bitcoin to pay for rising living costs.

The share price of Coinbase – a crypto currency exchange listed on the NASDAQ in April 2021 – has fallen over 85%. Many exchanges are even struggling to provide investors with cash as they redeem their currencies, causing them to fail entirely.

The future of the crypto currency asset class is highly uncertain. With so many new currencies being created, the real objective of the crypto currency world is not clear but the risk level is extremely high.

Robert Dougherty, July 2022.

This article is not a recommendation to invest and should not be construed as advice. The value of an investment can go down as well as up, and you may get less back than you invested.