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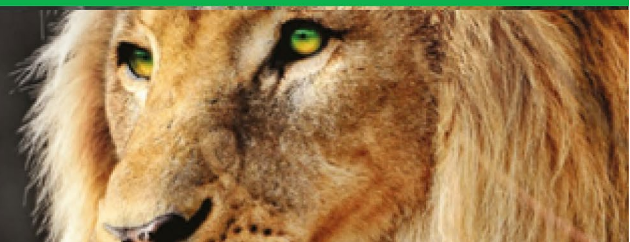

Market review: June 2022

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- **Volatility expected to continue through summer, with central bank activity depending on inflation**
- **Rising fears around stagflation, with UK predicted to suffer a tough 2023**
- **More opportunities emerging for active managers to add value post-indiscriminate selling**

As expected, central banks lived up to their name and played a central role over June, dictating sentiment in another volatile month during which markets dipped into bear territory again before rallying in the final week.

In the days leading up to the June Federal Reserve meeting, a 75 basis point (bps) interest rate hike – the largest since 1994 – was well trailed and had been fully priced in by the time chair Jay Powell made the announcement. With hiking so widely anticipated at present, focus tends to move very swiftly from the rise in question to the timing and scope of the next one and when we might potentially see the much-desired peak hawkishness. At his press conference, Powell acknowledged this latest hike was unusually large and he is not expecting such moves to be common, but also confirmed something similar for July unless price rises soften. The dot plot has shifted to suggest aggressive tightening is likely to continue for the next few meetings and also revealed officials to be unanimous in thinking the rate needs to get above estimates of neutral by year end.

Highlighting the Fed's sink-throwing mindset, downward revisions to growth and employment in the latest Summary of Economic Projections (SEP) showed policymakers admitting their actions will likely have a detrimental impact on both. 'We never seek to put people out of work,' Powell said, 'but you really cannot have the kind of labour market we want without price stability.' He also acknowledged the task of engineering a soft economic landing is 'very challenging' in testimony to the Senate.

Thus far, economic growth certainly appears to be moderating but an inflection point in inflation is yet to follow. As a small point to keep in the back of people's minds, the last time the Fed pushed through a 75bps rise, in November 1994, it was back in rate cutting mode just seven months later.

Despite fears this action from the Fed might spook other central banks, the Bank of England continued its early and steady approach, with a fourth consecutive 0.25% rise. Consensus is no longer as solid as it was, however, with three of nine members of the Bank's Monetary Policy Committee voting for 50bps. Again, this latest hike was fully priced in after inflation hit 9% in April, with the level expected to climb above 11% by October.

Elsewhere, the European Central Bank cast off any lingering dovishness over the month and prepared the market for its own hiking cycle to begin in July. Following the path laid by the Fed, the ECB has not committed to 25 basis point increments beyond July and a 0.50% rise is now the base case for September, with inflation unlikely to moderate before then. Another Bank seeing the need to move into whatever it takes territory, the ECB has not provided guidance on the ultimate rate ceiling or neutral level and plans to hike until medium-term inflation stabilises around its target.

To give a couple of noteworthy, and opposing, last stops on our central bank world tour, June saw the Swiss National Bank fall into line with a hike, its first in 15 years, whereas the Bank of Japan has maintained its position as an increasingly isolated dove by sticking to ultra-loose monetary policy. Despite sharp falls in the yen, the BoJ said it will continue its programme of buying huge amounts of government bonds and expects to keep short-term interest rates at current or lower levels (currently -0.1%).

Against this backdrop, sentiment and macro consensus are clearly starting to turn more bearish, with a record net 73% of investors expecting the global economy to weaken over the coming year and stagflation fears at their highest since 2008, according to the latest Bank of America fund manager survey. Investors are particularly

negative on Europe, with 54% predicting recession over the next year, up from 28% in May, while 83% expect above-trend inflation and below-trend growth over the coming 12 months.

Meanwhile, work from the World Bank has compared the current state of the global economy with the stagflation-blighted 1970s. Predictions from its economists suggest the slowdown in growth between 2021 and 2024 is on course to be twice that of the period between 1976 and 1979.

To highlight the parallel, recovery from the high inflation that followed the oil shocks of the mid to late-1970s required steep increases in interest rates, which played a prominent role in triggering a string of financial crises in the early part of the subsequent decade. That period of stagflation was also sparked by persistent supply-side disturbances fuelling inflation, preceded by highly accommodative monetary policy in major advanced economies. In terms of differences, the dollar is stronger today, the percentage increases in commodity prices are smaller, and the balance sheets of financial institutions are generally much healthier. More importantly, central banks in advanced and many developing economies now have clear mandates for price stability, and, over the past three decades, have established a track record of achieving inflation targets.

The World Bank said subdued growth is likely to persist throughout the 2020s because of weak investment in most of the world and even if a global recession is averted, the pain of stagflation could persist for several years – unless major supply increases are set in motion. Against this backdrop, the UK looks set to be a particular lowlight: OECD figures suggest GDP is expected to stagnate in 2023 amid persistent supply chain shortages and rising inflation, with only Russia in worse shape in the G20.

One thing to consider in this increasingly pervasive gloom, however, is that the idea of a 'global' slowdown only goes so far: in reality, the three largest economic blocs – the US, eurozone and China – face very different challenges in nature and scope, which will have implications for both any downturn and subsequent recovery.

Taking the US first, activity has actually remained fairly solid over recent months, in contrast to financial market turmoil, and while higher rates are expected to put the brakes on growth over the second half of the year, many economists are predicting the slowdown will be confined to the most rate-sensitive parts of the economy. As would be expected, President Biden is continuing to say recession is not certain but a number of chief executives are starting to bow to the inevitable with job cuts: Tesla is reducing its salaried workforce by roughly 10% over the next three months or so, for example, with Elon Musk admitting the company grew too fast in some areas, while JPMorgan's Jamie Dimon has warned a hurricane is coming our way.

While the US is expected to benefit via its relative energy self-sufficiency, the eurozone, meanwhile, has far deeper ties to Russia and remains a large net importer of energy, and has therefore suffered a far more severe deterioration in its terms of trade as global energy prices surged. As outlined earlier, this situation has forced the ECB to move to a more hawkish stance and policymakers are wrestling with the questions that have been perplexing other central bankers: whether to support the real economy or rein in inflation.

Finally, China is facing a more complex set of problems, grappling with a zero-Covid policy as well as a range of more cyclical hurdles: the country's recovery from the first wave of Covid was aided by a surge in construction but debt issues crippling many of the property giants have left them struggling to finance projects. While activity may rebound as the government gets on top of Omicron and lockdowns are lifted, and recently announced support measures come into effect, longer-term recovery could be more muted.

What all this suggests is that the coming decade is likely to be very different from the last one in terms of sources of investment risk and return; we are currently looking at rebalancing with this in mind and will give more detail in future commentaries.

Shorter term, with stocks having derated so far, pricing in aggressive policy tightening, we see a buying opportunity in markets; as ever, however, we will take a patient approach as we move towards our target asset allocation. UK equities remain cheap and even the S&P 500, long the poster child of overpriced tech giants, is trading slightly below its 10-year average after recent selling, at around 16 times forward earnings.

Talk about bear markets is becoming increasingly frantic but there are a few things to contemplate: we may already be more than halfway through the decline (which tend to last nine to 12 months) and while the average peak to trough of 30% to 40% suggests more room to fall for the S&P 500, for example, most bear periods also include sharp short-term reversals so attempting to move in and out is as ill-advised as ever.

Given the key role of central banks and their focus on – hopefully softening – inflation figures to direct policy, the summer months and beyond are likely to be volatile. Our view is that post-corrections, markets should move beyond indiscriminate selling and focus more on what the earnings cycle is actually telling us. And this is typically an environment where our favoured active managers can prove their worth in assessing how inflation is affecting companies around the world and which are best placed to thrive.

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