



THE FRY
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Quarterly Investment Update

JULY 2022



Turbulent Times

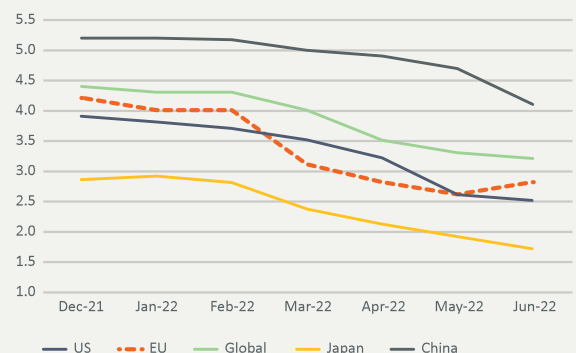
The second quarter of 2022 was a tumultuous period of negative returns for most asset classes. The world faces a structural change and it is no longer the case that well-behaved inflation will allow central banks to provide virtually free liquidity to pump up asset prices.

In the first half of the year, the key change in sentiment amongst economists and central bankers has been the marked deterioration in their outlook for inflation. As Chart 1 overleaf shows, inflation has continued to significantly surprise (to the upside) through the first half of 2022 and - despite all the negative news - growth surprises have only just started to turn down. The third quarter may suffer from a realisation that growth is much weaker than expected and that inflation is more persistent. The only part of the world with a more positive story has been China where authorities have recently provided more widespread support for the economy. The stringent lockdowns in major cities such as Beijing and Shanghai appear to be abating,

boosting sentiment, and helping set the stage for a much- anticipated growth revival.

The second quarter of the year saw a steady pattern of downgrades to global growth forecasts by most of the major groups, including the IMF and World Bank. However, it was surprising that economists only started to cut their forecasts deep into the second quarter.

Consensus growth forecasts for 2022
have only recently been cut back markedly



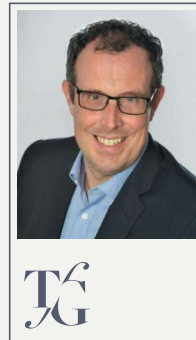
Source: Bloomberg



Indeed, the marked difference between the second and the first quarter of the year was the substantial increase in the number of people concerned about the risk of a recession.

With central bankers increasingly turning hawkish in their monetary policy stance, the fears of a potential US or global recession have grown, although this is certainly not a foregone conclusion, and central banks may decide to keep policy looser in trying to avoid this outcome. Virtually every major central bank has increased interest rates or signalled that they may markedly increase policy rates in the coming months. The futures market has gone from implying a year-end Fed funds rate of 0.8%

at the start of the year, to currently building in a rate of 3.3% by year-end. As has been the case throughout 2022 so far, inflation continues to dictate market narrative and this will likely be the case over the second half of the year too.



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Market Focus

Global fixed income

Unlike equities, bonds witnessed a consistent sell-off throughout the two first quarters of the year. The Global Aggregate index saw sell-offs of almost equal size in both quarters. However, some parts of the bond market performed much worse; Global high yield and emerging markets that tend to have a high correlation with equities had outsize losses in the second quarter.

At 2.88%, the US 10-year government bond yield ended the quarter just below 3%, a long way below the 3.44% peak in yields seen in mid-June. Currently, the market is betting on central banks acting in moderation on interest rate policy, lest a too high policy rate plunges their respective economies into recession.

Much will depend on the path of inflation and there was good investor buying when the US 10-year bond yield approached 3.5%. Investors took the bet that long-term inflation would be at worst around the long-term Fed target for inflation of 2.0%. Hence, 10-year government bond yields around 3.5% implied an attractive 1.5% real yield.

Global equities

Fear has truly gripped the equity markets with losses accelerating significantly in the just-concluded quarter. Global equities returned -14.3% in the quarter.



US

The pivot of the Fed to more aggressive tightening and the concerns about a potential recession in the US led to some significant losses through the quarter. The losses were across all sectors, although technology stocks lost out the most as liquidity left the sector.



UK

The UK's heavy weighting of oil stocks saved the market with a gain of 1.7%. However, losses were seen in sterling as the prevarication of the central bank in raising interest rates only undermined the currency, leading to significant losses against the dollar. With even the Bank of England forecasting 11% inflation in the fourth quarter, it is difficult to see a sharp recovery in sterling with a less than credible central bank.



Europe (excluding UK)

Europe, as the epicentre of the Ukraine war and where inflation has probably surprised most to the upside, suffered heavy losses both in the equity market and on translation into other currencies. The ECB was very late to the game of tightening monetary policy to offset the inflation risk. However, investors are very cognisant that higher interest rates alone will not solve Europe's inflation problems.



Asia (excluding Japan) / Emerging Markets

Emerging equity markets performed relatively well in the second quarter, only selling off by half the losses seen in the developed markets. However, the weakness of emerging market currencies meant that performance in dollar terms was a little less convincing.

The recovery of the Chinese equity market is providing some help to the EM bloc. Asia ex Japan has performed well, helping a broad re-opening of economies and greater mobility post COVID restrictions. The key factor to look out for is currency weakness that prompts their respective central banks to tighten monetary policy more than local economic conditions would warrant. As the quarter ended, some of the smaller countries started to see a pick-up in currency volatility. This will have to be monitored.



Japan

The Japanese equity markets in local currency terms was one of the better performers, down only 5.9%, however the market was down -20.3% in USD terms. As things stand, the main talking point has been the Bank of Japan's decision to stick to its ultra-loose monetary policy, a clear divergence from other central banks and a key reason behind relative Yen weakness.

Currency

Dollar's status as a safe haven in times of market stress, as well as the more aggressive policy stance being adopted by the Federal Reserve, has only exacerbated losses for dollar-based investors. The Japanese equity markets is a good case in point – in JPY terms, it was only down 5.9%, but the slump was more drastic – 20.3% – in USD terms. The UK was up 1.7% in local currency terms. Whilst concerns over global growth continue, dollar strength is likely to remain.

Commodities

Energy was the only major sector to record gains in the first half of the year, managing to shake off most of the losses seen in the broader markets. However, as the quarter ended investors became anxious that the risk of recession could lead to challenges for oil companies, irrespective of the fact that the market remains in marked short supply. Amongst industrial metals, copper – widely seen as a gauge of economic activity – dropped below \$8,000 a tonne as mounting fears over the global economy took hold.



Conclusion

Year to date both global equity and bond markets have fallen substantially, so valuations are now more attractive than they were back in January.

The equity market will look for a lessening of inflationary pressure before moving back up. But this could take some time, with inflation remaining elevated, and continued market volatility.

Currently, central banks led by the Fed, are heavily committed to tightening monetary policy in the form of raising interest rates. In the event that central banks foresee economic recession, they could reverse their policy stance in an attempt to ease financial conditions. Governments could also spend money to try and achieve the same outcome.

The best scenario is a short sharp increase in interest rates, the resulting volatility providing a potential buying opportunity, whilst the global economy resets to lower growth and inflation.



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