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Market Update

July 2022

MARKET UPDATE

Economic Backdrop

- The latest annual CPI inflation rate in the UK stands at 9.1%, up from 2.1% a year ago and the highest since 1982. Although the Bank of England now expects inflation to reach 11% later this year, we are confident that it will fall back in 2023.
- The great unknown is where inflation will settle. With unemployment rates back to pre-COVID levels, there is evidence that inflation is now spreading to wage demands and the risk of a wage price inflation spiral becoming embedded cannot be ignored.
- Central banks are pursuing very different strategies in their efforts to control inflation. The US Federal Reserve is raising interest rates aggressively, but the Bank of England is taking a more softly-softly approach. Despite inflation raging at 8.6% in the eurozone, the European Central Bank is yet to begin.
- Rising interest rates and the cost-of-living squeeze are taking their toll on economic growth. A slowdown is already underway and there are fears that this could evolve into outright recession.

Stock Markets

- Pincered between rising bond yields and mounting fears of recession, global stock markets have suffered their worst half-year since the depths of the financial crisis in the second half of 2008. Global stock market indices are down by almost 18% year-to-date.
- The UK and Japanese markets were the most resilient, the UK helped by its heavy weightings in oil and other multinational companies with overseas revenues which benefit from a weak pound. In contrast, the technology companies which dominate the main US stock market indices have seen their valuations and hence share prices plunge as bond yields have risen.
- As in the first quarter, most UK fund managers struggled to match the main UK market indices due to their tilts towards medium-sized and smaller companies whose fortunes are more closely tied to the domestic economy.
- Although the headwind from rising interest rates and bond yields could persist, the outlook for stock markets probably now depends more on the severity of the economic slowdown and its impact on corporate profits. We are emphasising exposure to high quality companies with strong balance sheets and robust earnings in the portfolios we manage.
- We cannot promise that share prices will not fall further in the months ahead. However, anyone who invests in equity markets should be doing so for the long term and we are confident that they will recover, continuing to provide returns which are better than inflation and other mainstream asset classes over multi-year timeframes.

Bond Markets

- It was another wretched quarter for investors in bond markets as accelerating inflation and higher interest rates caused yields to rise again and prices to fall further. The broad UK gilt market was down another 7% and has lost 14% year-to-date.
- Paradoxically, index-linked gilts (in which both interest payments and the final repayment of capital are linked to inflation) performed even worse, whilst corporate bonds were undermined by fears of recession. In a nutshell, there have been very few places in bond markets for investors to shelter.
- Bond yields have, though, risen significantly since their lows in August 2020 and there is now at least some scope for yields to fall, and prices therefore to rise, if the economic slowdown becomes a recession.

Currencies

- The feature in currency markets in the last quarter was not the weakness of sterling but the strength of the US dollar. The pound depreciated by 8% against the dollar but fell by only 2% against the euro and it was up by 4% against the Japanese yen. The dollar is strong because the US Federal Reserve is being much more aggressive than other central banks in raising interest rates to fight inflation.

Alternative Investments

- Given its reputation as a hedge against inflation, gold has been a surprisingly poor investment so far this year. Its price has fallen by 1% in dollar terms and is up by 10% in sterling terms only because of the weakness of the pound.
- The second quarter saw a bloodbath in cryptocurrency markets, the price of bitcoin plunging by 60%. A speculative frenzy had seen more than 10,000 different cryptocurrencies created, making comparisons with the 17th century Dutch tulip mania instead of 'digital gold' more appropriate.
- The property fund sector has been one of the very few to provide investors with gains in the first half of the year, benefiting from the return of workers to town centres and because bricks-and-mortar property is perceived to be a hedge against inflation. However, the Regulator's much-delayed decision about the appropriateness of daily dealing liquidity for investors in property funds continues to cast a dark cloud over the sector.

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