



## An atypical combination

30 June 2022

The first half of this year has not been easy for investors, who have been faced with a myriad of headwinds and uncertainties. Notably, inflationary pressures (which are persistent rather than transitory); tightening monetary policy; concerns over slowing economic growth; the Russia Ukraine war; and China's Zero-Covid approach.

Equities	Level	May-22	YTD	Yields, FX and commodities	Level	May-22	YTD
MSCI World	2,791	-0.16%	-13.64%	10Y US Treasury Yield	2.84	-0.09	1.33
MSCI Emerging Markets	1,078	0.14%	-12.53%	US Dollar Index	102	-1.17%	6.36%
MSCI AC Asia ex Japan	688	0.20%	-12.84%	Gold (\$/oz)	1,837	-3.14%	0.45%
S&P 500	4,132	0.01%	-13.30%	WTI Crude Oil (\$/bbl)	115	9.53%	52.47%
Nasdaq comp	12,081	-2.05%	-22.78%				
FTSE 100	7,608	0.84%	3.02%				
Eurostoxx 50	3,789	-0.36%	-11.85%				
SMI	11,611	-4.27%	-9.82%				
CSI 300	4,092	1.87%	-17.18%				
Nikkei 225	27,280	1.61%	-5.25%				

Figure 1: Data as at 30.06.22 (local currency returns)

It has been an extremely volatile start to the year for financial markets. The volatility (VIX) index started the year at a level of ~17, to finish June at a level of ~29. In fixed income, we have seen bond yields rise significantly (US 10-year Treasury yields have more than doubled YTD, from 1.5% to over 3%), leading to some of the largest bond losses in 40 years. In equity markets, equity indices have fallen significantly: the S&P 500 index is down ~21% YTD, which is the index's worst first half since 1970. These equity market falls are in stark contrast to the strong returns we saw last year. Additionally, the cryptocurrency space has been under significant pressure; with Bitcoin falling from a level of ~\$46,000 in January, to just under \$19,000 at the end of June; with many analysts concerned that it will be difficult to break above this low level.

Focusing back on the macroeconomic front, we are currently experiencing an atypical combination, whereby whilst markets adjust to a new era of monetary tightening (many major central banks have raised interest rates this year; and many are also reducing their asset purchase programmes); this is happening at the same time as the global economy is slowing down.

Therefore, central banks, particularly the US Fed, have been walking a fine line between trying to rein in high inflation, without damaging economic growth. The Fed's 75 basis point rate hike in mid-June (the biggest raise since 1994) increased worries over the risk of a recession, and growth remains a paramount concern currently. Whilst the US labour market dynamics remain strong, consumer sentiment has been falling this month. On June 29<sup>th</sup>, a lacklustre US consumer confidence report came in significantly lower than forecast; and additionally, US Q1 2022 GDP growth was revised down to 1.6% (a stark change from the 6.9% increase in Q4 2021). Therefore, economic indicators such as these have fuelled worries about a higher risk of a recession.

Investors are now debating the extent to which weakening economic data (and recessionary concerns) may change the course for central banks' plans to raise rates aggressively. Importantly, we have seen a repricing of longer-term interest rate and inflation expectations in the last two weeks. When the Fed raised rates by 75 bps in mid-June, many policymakers indicated another 75 bps rise in July. However, since then, futures markets now indicate that the US Fed's benchmark rate will go to 3.5% by early 2023 (falling from 3.9% in mid-June). This change in the futures market may signal that the US Fed could reduce the number of interest rate rises in the next few months; and as we enter the second half of this year, both inflation levels and economic growth indicators will be closely watched by investors.

## Our summary recommendations

The investment environment has certainly become more challenging over this year. Given the widespread market uncertainty for the road ahead, we continue to recommend caution, flexibility, and diversification in portfolios.

We are now transitioning from the last decade which was characterised by low inflation and low interest rates, to a new regime characterised by high inflation and increasing interest rates. Therefore, the traditional 60/40 portfolio (60% allocation to equities for capital appreciation; and 40% allocation to fixed income for income and risk mitigation), needs to be rebuilt as we enter this new investment paradigm. We believe that it will be key to add an allocation to alternatives to the mix. Alternative assets such as real estate and infrastructure are becoming increasingly attractive, as they provide an alternative source of income (and some protection against inflation and interest rate risk) to portfolios, along with diversification due to their low correlation with equities and fixed income. Thus, we agree with the adjusted allocation that an increasing number of asset managers (such as BlackRock) recommend<sup>1</sup>, with a 40/30/30 portfolio split (made up of equities, fixed income, and alternatives); which will be more suitable in this changing investment landscape.

Within a portfolio's equity allocation, diversification by region and style continues to be important. So far this year, we have seen the value segment of the market outperforming growth significantly, and the valuation gap between the two equity styles remains considerable. It is likely that value's outperformance may continue this year, as we are now in a new inflation and interest rate phase. For example, more cyclical areas of the market such as financials will likely benefit from higher interest rates (what they are charging). Therefore, we favour some exposure to quality value stocks that offer resilient dividends, such as energy and utilities; along with some exposure to quality growth stocks with strong balance sheets (which are more resilient during weaker global growth). We will keep a close eye on second quarter earnings, to see the extent to which inflationary pressures and weakening consumer sentiment, affect companies' earnings. [↗](#)

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<sup>1</sup> BlackRock weekly highlights, week of 27<sup>th</sup> June 2022

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