Continuing headwinds

31 July 2022

Over July, the S&P 500 posted its best monthly gain since November 2020, rising 9.1%; and the Nasdaq tech index posted its best monthly gain since April 2020, rising 12.4%. This strong performance came despite the headwinds and uncertainties which markets continue to face (as many investors believe that the current weak economic data may lead to the Fed slowing its pace of monetary tightening).

Equities	Level	Jul-22	YTD
MSCI World	2,746	7.86%	-15.02%
MSCI Emerging Markets	994	-0.69%	-19.34%
MSCI AC Asia ex Japan	642	-1.66%	-18.63%
S&P 500	4,130	9.11%	-13.34%
Nasdaq comp	12,391	12.35%	-20.80%
FTSE 100	7,423	3.54%	0.53%
Eurostoxx 50	3,708	7.33%	-13.73%
SMI	11,146	3.77%	-13.43%
CSI 300	4,170	-7.02%	-15.59%
Nikkei 225	27,802	5.34%	-3.44%

Yields, FX and commodities	Level	Jul-22	YTD
10Y US Treasury Yield	2.65	-0.44	1.14
US Dollar Index	106	1.16%	10.70%
Gold ($/oz)	1,766	-2.29%	-3.46%
WTI Crude Oil ($/bbl)	99	-6.75%	31.13%

Figure 1: Data as at 29.07.22 (local currency returns)

The Bank of America Monthly Fund Manager Survey, which covered nearly 300 money managers, reflected the negative sentiment in markets. The survey showed that investors' equity exposure was at the lowest level since October 2009, whilst investors' cash exposure was at its highest level since 2011 (9/11 attacks). In addition, the survey showed that recession expectations were at their highest since the Covid slowdown in 2020; and global growth expectations have declined to an all-time low.

Inflationary pressures have continued this month. In the US, the CPI index rose to 9.1% in June, which was its highest level since 1981. In the eurozone, accelerating food and energy prices have led to inflation hitting a new record high of 8.6% in June.

These persistently high inflation levels have led to most major central banks continuing to tighten monetary policy. This month, the European Central Bank (ECB) raised interest rates for the first time in 11 years: raising rates by 50 basis points (despite signalling a 25 basis points raise at the ECB's annual forum in Portugal). The ECB's rate rise was significant as it ends the era of negative interest rates in the eurozone. In addition, on 21st July, the ECB announced a new anti-fragmentation tool (the Transmission Protection Instrument), which aims to help more indebted euro zone countries (such as Italy), by avoiding excessive and disorderly spreads in borrowing costs within the currency bloc (preventing financial fragmentation). Additionally, in the US, the Fed raised short term rates by 75 basis points for the second month in a row, to a range of 2.25% – 2.5%, on 27th July. Following comments from the Fed chair Jay Powell on 27th July that "at some point, it will be appropriate to slow down", global equities gained (for example, the Nasdaq composite ended the day up 4.1%); due to the possibility that the Fed could slow the pace of its increases.

Although we have seen the ECB raise rates for the first time since 2011 in July, the ECB's key interest rate is still at zero. The difference between the US and the eurozone's central bank policy (in terms of the level of interest rates); along with recessionary fears intensifying in the eurozone due to multiple pressures such as the war in Ukraine and uncertainty over energy supply; has continued to fuel USD strength against the EUR. This month, we saw the EUR/USD pair cross an important threshold (parity with the dollar), and even reach levels below parity.

In terms of slowing economic growth, markets continue to be concerned over the possibility of a recession. In the second quarter, the US economy contracted at an annualised rate of 0.9%; and the US economy has now had two months in a row of contraction (US Q1 2022 GDP was -1.6%). In addition, the S&P Global Flash US Composite PMI contracted for the first time in two years in July, amid a sharp decline in service sector activity. The S&P Global Flash

Eurozone Manufacturing PMI also fell to 49.6 in July (missing market expectations of 51); and the services sector PMI fell to 50.6 (from 53 in June).

We have seen US 10-year government bond yields move lower this month, due in part to weaker economic data and mounting recessionary fears (as bond prices rise, yields fall). For example, the US 10-year treasury yield was at 2.97% at the end of June, and the US 10-year treasury yield reached a level of 2.68% on July 28th (following disappointing US GDP data). Moreover, the US yield curve remains inverted (shorter duration 2-year yields are higher than longer duration 10-year yields), which is a possible signal of a looming recession.

Over July, markets have also been closely focused on Q2 2022 earnings reports, to see the extent to which companies' earnings have been impacted by these headwinds (such as high inflation; tighter monetary policy; and USD strength for non-US earnings). Approximately a third of S&P 500 companies reported in the last week of July, and we have seen a mixture of company earnings. Companies such as Walmart indicated a slowing economy, as Walmart issued a profit warning, saying that increasing food and fuel inflation have hurt the company's sales, as consumers are pulling back on their discretionary spending (particularly apparel). In addition, Alphabet missed earnings and revenue estimates (second-quarter revenue of $69.7bn, compared to estimates of $70.8bn); which was the slowest quarterly revenue growth rate in two years (reflecting challenges such as a strengthening dollar, which knocked 3.7% off revenue growth, as dollar strength lowers the value of their international sales). On the positive side, tech companies such as Amazon beat analysts' quarterly revenue forecasts; and energy companies such as ExxonMobil reported record quarterly profits (benefitting from the surge in oil prices).

Therefore, as we continue into the second half of 2022, we anticipate more volatility and headwinds ahead, particularly as central banks face the trade-off between increasing inflationary pressures and slowing economic growth.

Our summary recommendations

As mentioned, most major central banks are rising interest rates, albeit at different rhythms. In the fixed income market, short term yields rose abruptly creating interesting entry levels. We therefore selected good quality bonds, offering in USD 3.5% to 4% yield for maturities of 1.5 to 2.5 years.

Within equity markets, following the 15-25% decline of equity indices on a year-to-date basis, we believe that low strike structured products with a coupon can offer a good level of protection. We will continue to issue such products opportunistically when volatility rises.

In the alternatives space, we continue to favour decorrelated alternatives such as trade finance and L/S hedge funds; along with less volatile solutions such as Private Equity.

With so many variables and uncertainties at play currently in markets, visibility in the short to medium term is very limited. Therefore, our current positioning relies on avoiding too many directional bets to protect investors' portfolios, without sacrificing return potential. ↗

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