

Investment Views



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Strategy:

Consumer of Last Resort

Fixed Income:

A Critical Moment for Bonds

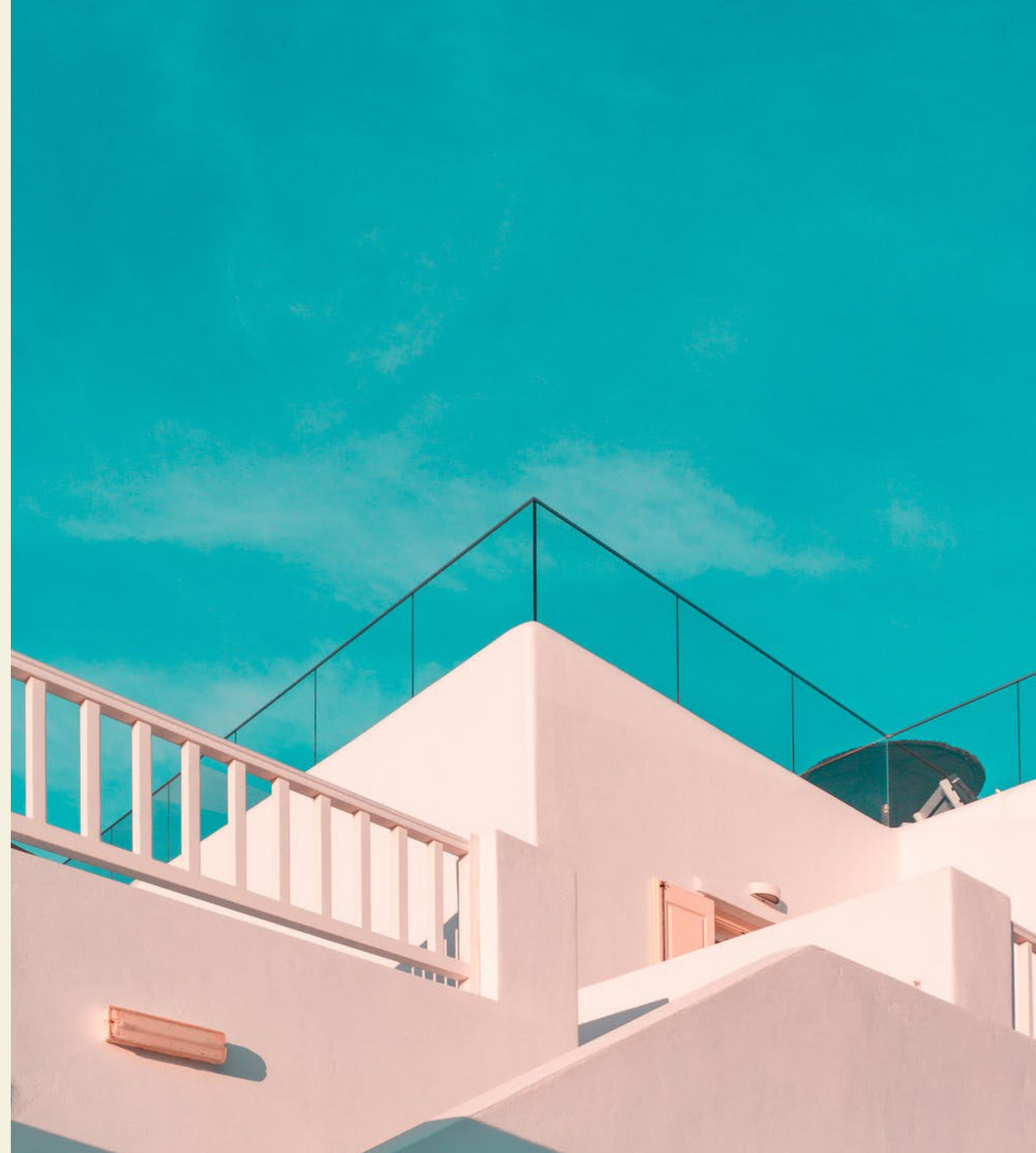
Equities:

Valuations Closer to Long-Term Averages

Consumer of Last Resort

The S&P 500 index is having its worst start to a year for over four decades, falling for seven consecutive weeks before rebounding at the end of May. The combination of central bank policy tightening together with multi-decade high inflation rates, a commodity price shock from the ongoing Russia-Ukraine war and renewed lockdowns in China, has made for a very challenging investment environment.

The pandemic has caused huge dispersions between different sectors of the economy and, similarly, inflation is having varying degrees of impact on different sectors, companies, countries and consumers. The need to shut down and reopen the economy caused unprecedented disruption and inflation is something investors in Developed Markets have not had to contend with



since the 1980s. These dynamics have been equally challenging for policy makers, with Treasury Secretary Janet Yellen admitting that she was wrong about the path that inflation would take, noting there have been ‘unanticipated and large shocks to the economy that have boosted energy and food prices and supply bottlenecks that have affected our economy badly that I didn’t - at the time – didn’t fully understand, but we recognize that now’.

With growth slowing, inflation elevated, fiscal support fading and central banks raising interest rates, worries around a global recession have increased. As the global economy has become more integrated, the global cycle has been increasingly synchronised. However, the three largest economies in the world - the US, Europe and China - face challenges that are very different in nature and scale, with important implications for their outlook.

Short-term interest rates have risen substantially in the US, putting pressure on the more interest rate sensitive parts of the economy such as housing and discretionary consumer goods. While energy prices have risen in the US, the country is no longer a large energy importer so is more insulated from the commodity price shock compared to Europe, which is heavily dependent on imported energy. The problems in China are very different. Over the last two years, the economy in China was operating normally, excluding overseas travel, and the coronavirus was kept at bay. China never resorted to the stimulus measures that the West did and inflation has therefore been much lower. Their issue is the more recent Omicron outbreak and the strict restrictions across some of the country’s biggest and economically important cities to try and control it. Restrictions are now in the process of being lifted and it appears that regular testing will be used to try and better balance health and economic objectives.

2.4m

New jobs over the first five months added to the economy.

“with so much bad news dominating the headlines, it is easy to miss more positive news flow around the strength of global labour markets, especially in the US.”



STRATEGY

With bad news dominating the headlines, positive stories about the strength of global labour markets, especially in the US, have been easy to miss. The economy has added 2.4 million new jobs over the first five months of the year and wage growth has been incredibly strong at 4-6%. While consumers have been under pressure from elevated inflation, the nominal purchasing power in the economy has remained strong. After an extended post-stimulus period of real retail sales gradually trending lower in the second half of last year, the figures have started to rebound again this year. The reopening of the economy has boosted consumption in the sectors most hurt by the pandemic with the likes of travel and leisure coming back strongly. As the CEO of American Airlines Doug Parker put it at a recent conference, “people want to get out there... there is a change in consumer behaviour and definitely moving from kind of cocooning in a house and spending on home improvement and moving out to life experiences.” Overall, second-quarter real consumption growth in the US is on track to be strong at over 3% annualised, up from an already high 2.7% pace in the first quarter.

With the US consumer again acting as the world’s consumer of last resort, it is important to closely watch developments in the labour market. Wage growth easing would be welcome as it would take the pressure off the Federal Reserve to increase rates too rapidly but, with corporate margins under pressure from inflation, there is a risk of a downturn in the job market. We are seeing early signs of this in Silicon Valley where Tech companies have shifted their focus from top-line growth to profitability. The headwinds are building after the breakneck pace of hiring that we have seen and, although we know that the labour market lags other economic indicators, strong labour markets are currently helping consumers weather this period of high inflation.

A Critical Moment for Bonds

During May we witnessed the first pause in the relentless rise in bond yields with US inflation expectations falling and US 5-year breakeven rates closing down -39bps. This was despite oil prices rising from US\$105 to US\$115 per barrel over the course of the month; a decoupling that could be signs of the initial stages of demand destruction as energy and food prices threaten to disrupt consumer spending. This can be clearly seen by the surge in US gas prices which after rising by another 15% in May now sit at their highest level on record and close to \$5 per gallon. This has implications for growth for the remainder of 2022, particularly in the consumer-led economies such as the US. After the pent-up demand splurge in holiday spending ends, there will be much lower demand. We are already seeing warning signs of this in rising corporate inventory levels and a rise in credit card borrowing by US consumers.



Economic data releases in May weakened sharply across almost every region in the world. In addition, commodities with industrial production uses such as Copper, Iron Ore and Lumber continued to weaken, although energy prices remained firm. Also, the Federal Reserve increased base rates by 50bps as expected with quantitative tightening to start next month. In the domestic economy we could be seeing early signs of a turn in employment as initial jobless claims in the US trend upwards but unemployment and the underemployment rate still remain low at 3.6% and 7.0% for now. In the US housing market, although the outlook isn't so rosy with the rapid rise in mortgage rates to a 14-year high of 5.5% severely slowing activity, new home sales and mortgage applications have effectively fallen off a cliff. Fannie Mae's Home Purchase Sentiment Index is now registering its weakest level in history and affordability falling to levels last seen in 2007.

As bond yields have continued to rise despite clear signs of slowing global growth, we are approaching a critical moment. If global growth weakens further the longer end of the yield curve should rally and thus bonds reverse some of the losses this year and add value again to a balanced portfolio. Quantitative tightening complicates this forecast somewhat, but with the US fiscal deficit closing rapidly, the impact is mitigated for the time being. This would essentially be the 'soft' landing outcome with lower bond yields leading to easier financial conditions

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15%

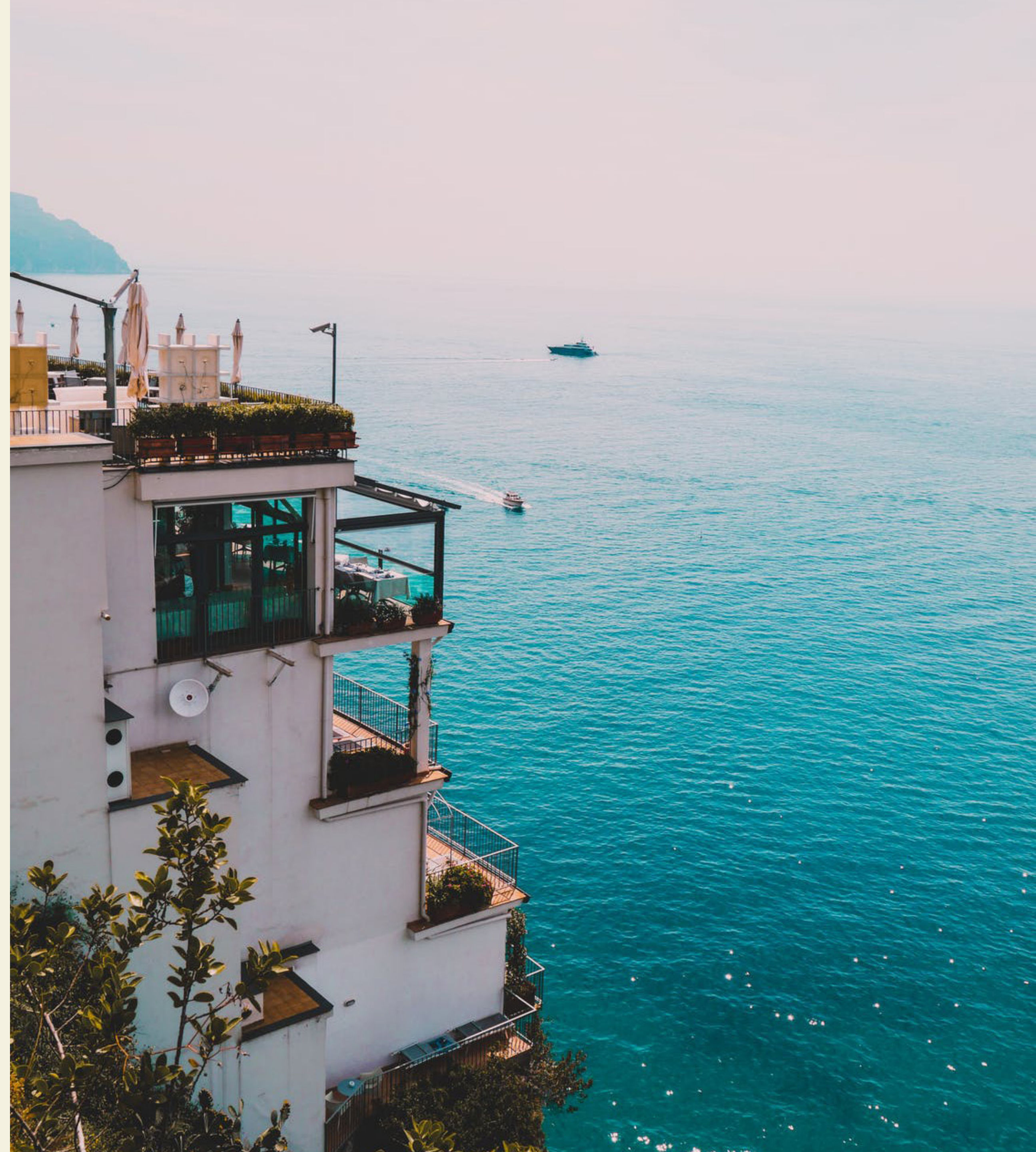
US gas price rise in May.

(mortgage rates would dip below 5% for example). The other scenario is that bond yields continue to rise even though growth is weakening as inflation remains sticky. This would be a bad outcome for risk assets as the traditional support mechanisms for the economy fail to kick in and, with the US mid-terms likely to lead to gridlock, fiscal stimulus will also be firmly off the table. For now, the 10-year US Treasury yield has fallen to 2.85%, from a high of 3.13% on May 6, positively reacting to the recent string of weaker economic releases. However, if global growth continues on its current path, a break towards 3.50% would leave risk assets and the broad economy in a very difficult position.

Portfolio positioning remains defensive with small allocations to corporate credit and neutral duration across the board. The short end of the US bond market remains priced for an aggressive rate hiking cycle with 50bps at both the June and July Federal Reserve meetings locked in and US base rates expected to breach 2.75% by year end. Credit spreads have continued to increase as risks of a recession rise, however, if inflation has peaked, the Federal Reserve would have the green light to pause after the July meeting, which could lead to a rally in risk assets. With yields above 7% in Emerging Markets and High Yield debt, we are looking at exposure closely as the risk versus reward dynamics have firmly swung in our favour since the start of the year and we have room to increase our allocation. Within FX, the terms of trade deficit, negative real yields and sentiment in the Japanese yen leave the outlook still bleak but the potential for US growth to slow over the coming months could lead to a more dovish Federal Reserve which would support the euro.

Valuations Closer to Long-Term Averages

Global equities finished the month of May at roughly the same level they started, masking a -5% intramonth decline before bouncing back in its final days. The market decline continued the prior year-to-date trend, nearing a -20% fall from peak. The weakness has been caused by the series of negative events which have unfolded: persistently high inflation, unrelenting war in Ukraine, rising commodity prices, extended lockdowns in China to enforce its zero-tolerance approach to Covid, ongoing global supply chain issues, and central banks' adamantness that they'll do whatever is necessary to tame inflation. All of these factors increase uncertainty and lower expectations for future global economic growth.





-13%

decline in the global equity market (year-to-date through May 31, including the late month bounce-back).

EQUITIES

These developments contrast with an environment of fiscal stimulus, near-zero interest rates and a growing consensus supporting TINA ('There Is No Alternative' to equities) that equity investors had grown accustomed to. Rising interest rates and recession concerns caused some investors to reassess the appropriateness of buy-the-dips and overweight/leveraged allocations to equities, and consider whether in fact there may now be reasonable alternatives to equities.

The hardest hit global equity market sectors are those most exposed to rising interest rates or to lower and more uncertain economic growth. There has been a -13% decline in the global equity market (year-to-date through May 31, including the late month bounce-back), compared to a -24% in Consumer Discretionary, and -22% in both Information Technology and Communications Services. Consumer Staples, Health Care and Financials fared considerably better at -6% to -8%. The standout sector is Energy, which is up +47%. Despite markets finishing the full month of May flat, underlying sectors largely continued their year-to-date trajectory: Consumer Discretionary -3.5%, Information Technology -1.5%, Financials +2.9%, and Energy +13.5%.

In market sell-offs investors tend to reduce exposure to their largest most liquid stocks first. In order to comply with their diversification requirements, the high market cap concentration of the largest US stocks mean that many mutual funds by default must underweight these largest stocks. A recent Goldman Sachs study noted the average US mutual fund is on track to deliver its first quarter of outperformance since Q1 2021, and that over the last five years underweight positions in the seven largest US stocks have been a -2.6% drag on the performance of the average mutual fund. The seven largest stocks (AAPL, MSFT, GOOGL, AMZN, FB, TSLA, NVDA) represent >20% of the S&P 500 and >40% of the Russell 1000 Growth indices, while the average fund holds a combined 8% underweight to these stocks. In 2022 these largest stocks have struggled, giving back all their 2021 gains, and as a result this large underweight position has been a large performance tailwind.

EQUITIES

The bounce late in the month of May snapped a seven-week losing streak in the S&P 500, fuelled by comments from the Fed that there may be a pause interest rate hikes after the anticipated 50bps hikes in both June and July. This triggered a relief rally in the market – most noticeably in large cap long-duration technology stocks which had fallen more than the market on fears that the Fed would have more persistent rate hikes as it focused on taming inflation.

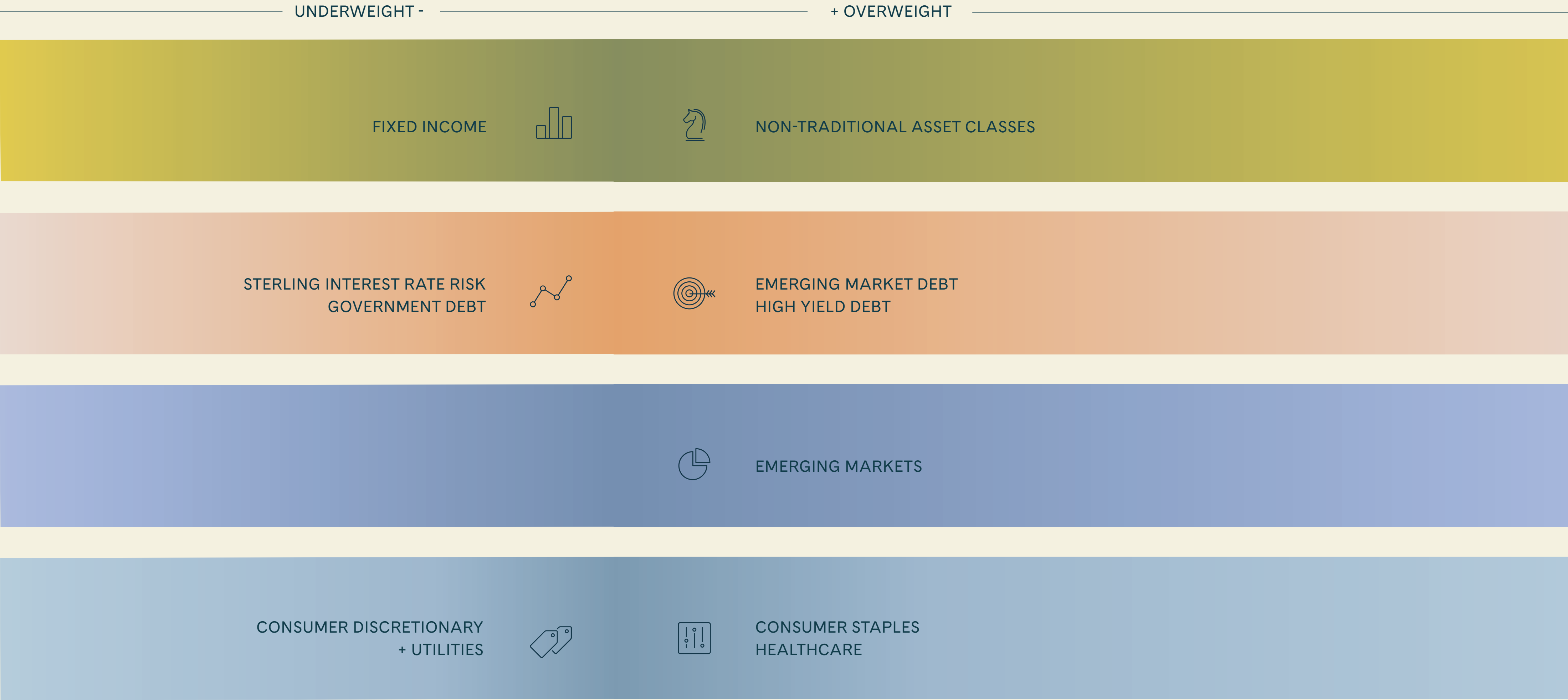
The year-to-date market decline, paired with steady (or even rising) earnings expectations, has led to a significant de-rating in market valuations. The US one year forward P/E ratio of 17.1x is now only just above the post 1987 average of 16.6x, while in Europe a ratio of 13.6x is just below their post 1987 average of 14.4x. This de-rating of multiples has varied by sector, with cyclicals (Discretionary, Industrials and Technology/Telecom) down the most and defensives (Utilities and Staples) experiencing much smaller multiple compressions. Despite this, the most expensive quintile of stocks in both markets remain as expensive as any time since 1990 apart from the TMT bubble and during the pandemic. Low real rates have supported both the economy and asset prices in recent years, but as rates have risen that tailwind has turned into a headwind.



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Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy



Asset
Allocation

Fixed
Income

Equities
Regional

Equities
Sector

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