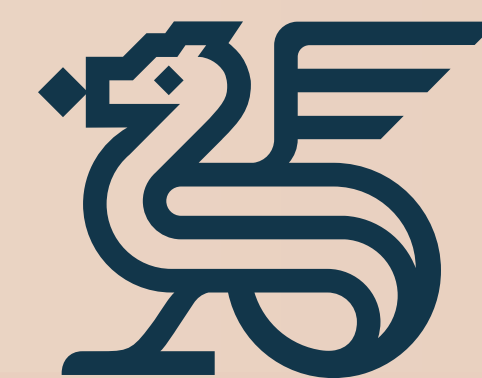


Investment Views



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Winter is Coming

Fixed Income:

Fiscal Policy Pressuring European Bond Yields

Equities:

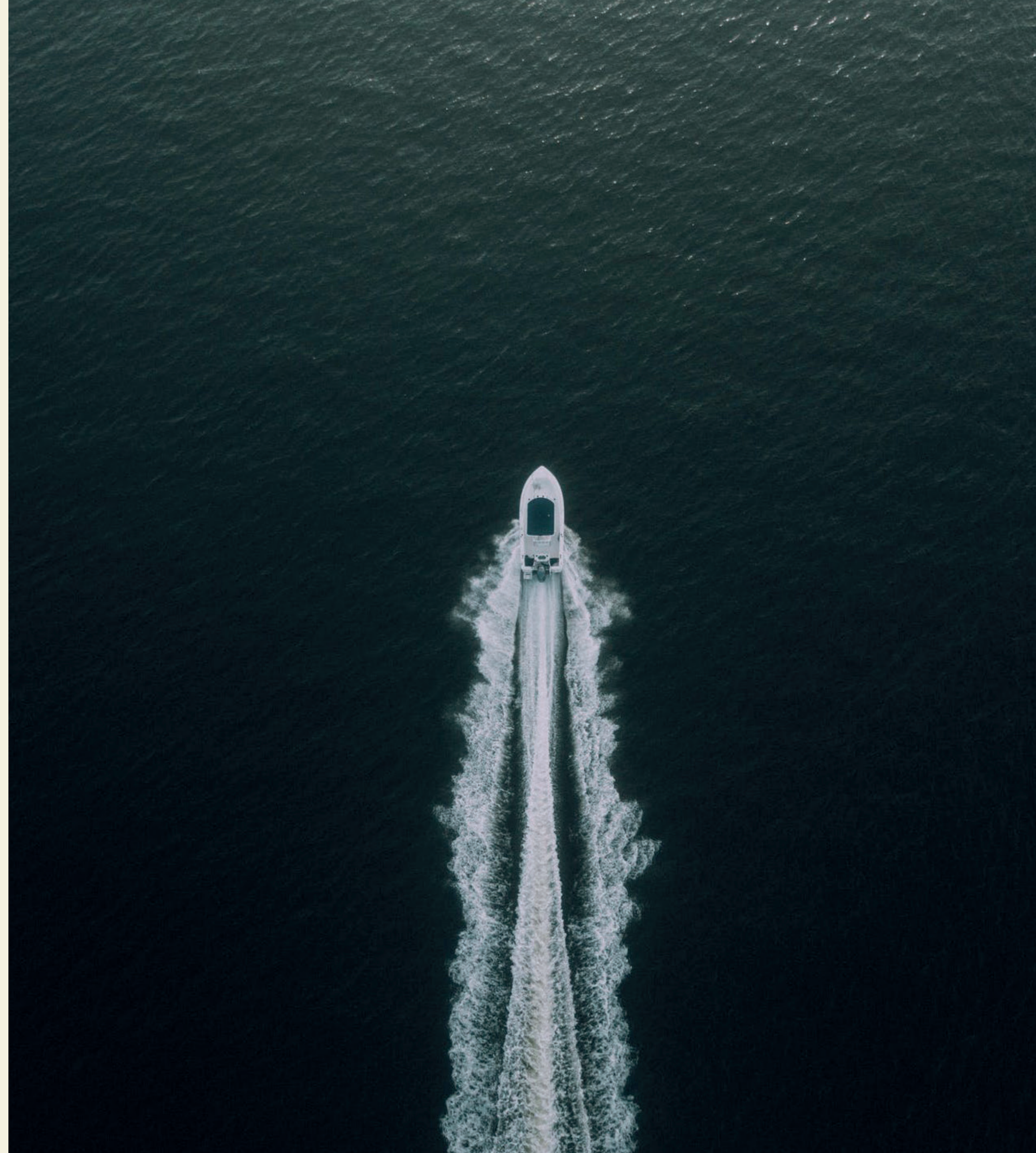
Higher Rates Hurt Equities

Winter is Coming

Bond and equity markets struggled again in August and the theme this year continues to be inflation.

Inflation rates in many Developed Markets are now so high that central banks view the nuance around the drivers as secondary to getting the inflation rates lower, and in an attempt to achieve this they are using the main tool at their disposal, raising interest rates.

However, under the surface of headline rates, there is a lot happening across different geographies. This has important implications for investors. In the US, inflation has primarily been driven by strong demand, as generous fiscal support throughout the pandemic saw significant growth in the money supply. Other factors, such as people leaving the labour force, shifts in demand due to the pandemic and dislocated supply chains, have been important but, overall, it has been a case of too much money chasing too few goods.



In contrast, inflation in Europe has been driven far more by the supply side. Although European countries provided generous monetary and fiscal support throughout the pandemic, as a percentage of their economies it was generally less than America. Inflation in Europe has broadened out this year, but rising energy prices have been at the centre of the recent rise in inflation. To put the extent of the inflationary pressures into context; over the past 20 years, year-over-year, eurozone inflation has averaged 1.8%, with a pre-pandemic high of 4.1% and a low of -0.6%. The current rate is 9.1%.

Higher energy prices have been caused by a combination of the sanctions imposed by the West on Russia following their invasion of Ukraine, with markets pricing a risk premium on energy prices, and Russia's retaliatory measures which have curtailed the flow of energy supplies. This is a highly complex issue for Europe as different countries are affected differently depending on the mix of energy use, the structure of the markets and the role of regulation. Europe has done a good job of increasing energy held in storage, where storage exists, as imports from the Middle East and the US have helped fill the gap left by lower imports from Russia. It is estimated that energy storage in Europe will be over 90% full by the end of October.

In response to the crisis, governments have been busy designing policy responses to ease the cost burdens on households and businesses. Energy inflation in France has been lower than many other European countries due to a "tariff shield", which has allowed households on regulated electricity and gas tariffs to see their electricity bill rise by no more than 4% in 2022 and the gas bills have been frozen at their October 2021 level until December 2022. Almost two-thirds of households are on the regulated electricity tariff and those households not on the regulated tariffs also benefit because of tax cuts to all residential customers.

9.1%

The current rate of eurozone inflation.

90%

Estimated European energy storage by the end of October.

Higher energy prices have been caused by a combination of the sanctions imposed by the West on Russia... and Russia's retaliatory measures which have curtailed the flow of energy supplies.



£150bn

The estimated cost of
UK support programmes.

STRATEGY

France's energy regulator CRE estimates that the regulated electricity price, if not capped, would have increased by 45% this year.

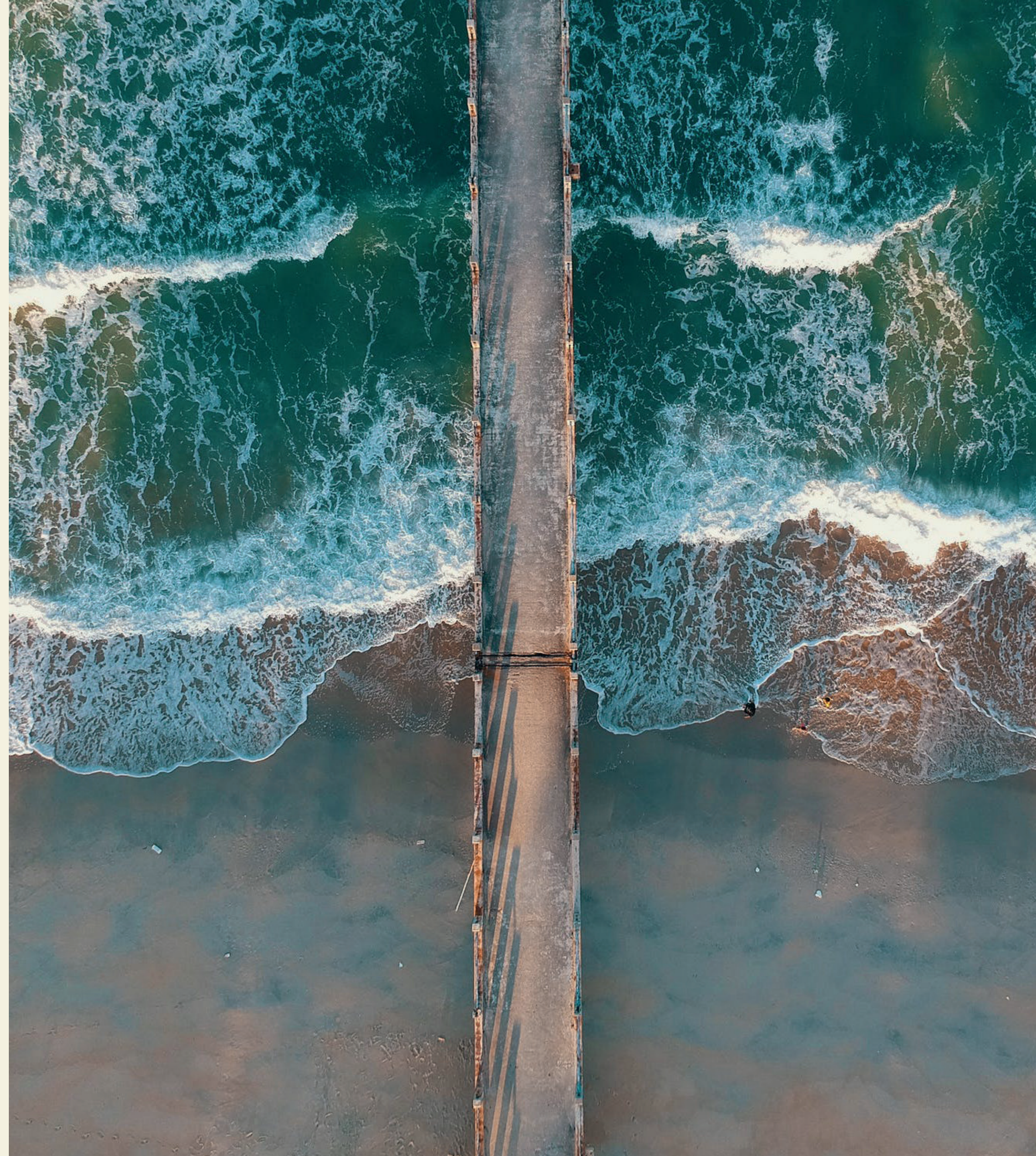
The UK has followed suit. The government recently announced an energy price guarantee, designed to limit the price suppliers can charge customers for a unit of gas, meaning a typical household will pay no more than £2,500 a year on energy bills. This represents a significant reduction given estimates for a typical bill next year, using the current formula, rise above £5,000. Furthermore, the government announced that businesses would receive equivalent support to households for six months, after which ongoing support would focus on vulnerable industries.

Alleviating the economic pain from high energy costs via fiscal easing will support economic growth, but is no free lunch, as it implies sharp increases in public borrowing. The support programmes in the UK are estimated to cost up to £150bn and bond and currency markets have moved quickly to price this in; 7-10yr UK government bonds returned -7.1% in August, the second worst month for gilts since 1986, and the pound fell 4.5% against the US dollar.

While the euro and sterling have struggled under the weight of the energy shock, the US has been far more insulated given the strength of the energy sector. The fracking revolution has been a gamechanger for the country's energy trade balance over the past decade and this has been reflected in the US dollar. The winter is going to be difficult for Europe, but medium and longer term, the Energy transition, away from both hydrocarbons and Russian supply, is an opportunity for new investment, which means economic activity. As the saying goes, necessity is the mother of invention.

Fiscal Policy Pressuring European Bond Yields

The traditional bout of summer holiday illiquidity continued in August, with market volatility amplified by the ongoing energy crisis in Europe. The moves witnessed during July were almost completely reversed, giving way to a renewed correlation breakdown between global bond, credit and equity markets.



With natural gas prices rising to levels that make a recession hard to avoid, European politicians are scrambling to protect their citizens and looking to the bond market to borrow billions to stave off a contraction in consumer spending. As a consequence of these plans, bond yields rose dramatically, led by movements in real interest rates, including in the US, where yields on US two-year inflation protected Treasuries rose by +140bps during August alone. The year-to-date movement in real yields across the world - with the US digesting +350bps at the short end of the curve - is historic. Markets have very rarely seen central banks act so aggressively, with weak growth and elevated risks.

As we mentioned last month, we remain neutral duration versus our benchmarks. Although bond yields have risen during August - with the 10-year US Treasury rising to 3.20% - we remain confident that the current stance of central banks across the world is at odds with the weakening global growth outlook and slowing inflation pressures which are now developing. In addition, elevated bond supply, as we are now seeing in Europe, tends to only impact bond yields on a short-term basis, unless longer term fiscal conservatism is abandoned, which is admittedly a risk. Simply put, the brakes are being applied to the global economy via a rapid increase in real interest rates, which together with surging energy prices are highly likely to keep global growth, sentiment and terminal rates (now 2.85% in the US) constrained. This can be most clearly seen by the rise in the 30-year average fixed mortgage rate in the US, which has breached 6%. Leveraged economies cannot function with borrowing costs at these levels for long and growth or monetary policy has to give.

Putting doom and gloom aside, we are seeing some positive trends emerge. China and Japan both registered strengthening economic growth in August although this was from a low base - especially in China where COVID-19 lockdowns still remain. Inflation also showed signs of weakening in China and the US, where the

+140

The amount (bps) yields on US two-year inflation protected Treasuries rose by in August alone.

\$3.83

The price of gas per gallon at the end the month.

Markets have very rarely seen central banks act so aggressively, with weak growth and elevated risks.

significant appreciation of the US dollar this year is helping to contain imported inflation costs. The US consumer has also been boosted by further declines in gas prices, which ended the month at \$3.83 a gallon. This is partly due to the drawdown of the US strategic reserve (now at its lowest level since 1984) and Chinese city-wide lockdowns.

Entering September, we remain cautious on risk assets and have taken further steps to reduce potential volatility in our US Dollar bond funds, reducing exposure to longer-dated, low-rated corporate credit and increasing exposure to short-dated US Treasuries, with 2-year yields at a very attractive 3.50%. We would continue to be sellers of risk assets on any rallies for the remainder of the year, as weakening global growth trends and the high velocity moves in monetary policy across the world favour a defensive allocation at this time. Within risk-free assets, European and UK Gilt yields rose by nearly 100bps across the curve in August, pressuring global bond yields higher and raising the bar for equity market returns.

Higher Rates Hurt Equities

Global equity market volatility continued in August, with Developed Markets gaining +3.5% in the first half of the month, but finishing down -4.0%. Emerging market exposures provided diversification and outperformed, with China rising +0.7%, India +4.2% and Brazil +6.6%.

The strong start at the beginning of the month continued a rebound in the S&P500 which started in mid-July from market lows. The market bounce was initially fuelled by companies reporting better-than-feared second quarter results. Earnings grew faster than analysts expected at the start of reporting season with both margins and sales contributing to the upside surprise. The rally was further fuelled by more investors embracing the view that the Fed would pivot and the economy will achieve a soft landing.





EQUITIES

+5.4%

The technology sector rose during the first half of August.

The rebound closely resembled the typical 'bear market rally'. While performance around bear market rallies and the end of Fed hiking cycles look similar, ultimately the path of both inflation and growth will likely determine the market's trajectory through year-end.

The market's turn back down in mid-August followed the release of minutes from the Fed's July meeting, which showed the central bank is prepared to continue raising interest rates until inflation subsides substantially.

-9.2%

The amount Apple fell on the US equity market in the second half of the month.

Fed Chair Powell then reinforced this in a concise and carefully worded August 26 speech which emphasised the Fed's determination to beat inflation. His speech warned against easing restrictive monetary policy too early as prolonged inflation could induce businesses and workers to automatically add a certain inflation rate into their wage and price calculations. This could cause high inflation to become a self-perpetuating cycle, lengthening the time needed for higher interest rates to bring down inflation.

Powell said it would be better to slow the economy enough to bring down inflation right away before this can happen. He did note the Fed would ease its rate hikes at some point in the future, but that one or two months of lower gasoline prices would not be sufficient for the Fed to change its course. Broader slowing of price rises would be required to indicate easing of underlying inflation momentum.

EQUITIES

One of the main components of consumer services prices is rent, which has been rising strongly because of the housing shortage. Higher mortgage rates are already having an impact on house prices, but rent increases tend to lag behind home prices, so take longer to cool inflation.

Every sector except Energy finished the month of August in the red. Technology, the largest sector in the US equity market, experienced a particularly volatile month, with a bruising second half. The sector rose by +5.4% in the first half of August, followed by a -10.7% fall in the second half (which included declines of -10.7% in Microsoft and -9.2% in Apple). The strong US dollar, supported by its safe-haven status amidst war in Europe and anxiety about a global recession, as well as the aggressive rate hikes in the US, has had a negative impact on revenues of multinational companies which sell internationally and exchange those sales revenues back to US dollars. Though second quarter earnings exceeded expectations, the strong US dollar was seen to be a growing drag on several multinationals, including the mega caps Apple and Microsoft. While non-US sales represented only 18% of revenues for Russell 2000 small cap companies, they were 39% of revenues for Russell 1000 large cap companies.

-10.7%

The amount the technology sector fell in the second half of August.

The rally was further fuelled by more investors embracing the view that the Fed would pivot and the economy will achieve a soft landing.



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