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Market Pulse

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MARKETS RALLY: INVESTORS EXPECT A WEAKENING GLOBAL ECONOMY WILL SLOW RATE RISES

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Stocks and bonds rallied in July. A perceived policy pivot from the US Federal Reserve (Fed) led markets to lower interest rate expectations, pricing in interest rate cuts from major central banks in early 2023. This supported risk assets and allowed investors to recoup some of their heavy year-to-date losses across both equities and bonds. Across Europe, ongoing fears of an energy supply cut-off from Russia led to a further spike in European gas prices, which hit €215/megawatt-hour intra-month. The US Fed and European Central Bank (ECB) delivered 0.75% and 0.50% interest rate hikes respectively as they sought to bring inflation back to their 2% targets. The euro fell below parity against the US dollar intra-month; risks to the eurozone economy were heightened by an ongoing weaponisation of Russian energy supplies and political uncertainty in Italy.

Inflation

US headline inflation beat expectations at 9.1% year-on-year (y/y). Eurozone inflation also surprised to the upside, rising to a new high of 8.9% y/y as food and energy prices continue to drive prices higher. The peak in eurozone inflation is expected over the coming months as utility price increases are implemented, with further upside expected if Russia continues to squeeze energy supplies to Europe. In the UK, inflation rose to 9.4% y/y with the peak expected in the winter at over 12%. With prices rising faster than wages across multiple regions, the costs squeeze on households is only expected to intensify in the coming months.

Economic data

July economic releases provided further signs of a slowing in the global economy. The US economy entered a technical recession as it contracted for two consecutive quarters. US GDP declined at an annualised rate of -0.9% in the second quarter (Q2), following a fall of -1.6% in Q1. European recession risks were visible in intra-month currency moves as the euro briefly fell below parity with the US dollar.

Corporate earnings

In the US, over 50% of S&P 500 companies have reported earnings, with over 60% of these beating earnings estimates. Earnings beats by some large growth names such as Microsoft and Amazon have boosted sentiment among investors. In Europe, 40% of companies have reported earnings, with earnings surprising to the downside by -0.5% as several companies have missed expectations.

Central bank policy

The US Fed voted unanimously to raise interest rates by 0.75% at its July meeting, following the same rise in June. This brings the target range for the federal funds rate to a range of 2.25%-2.50%. Fed Chair Jerome Powell reiterated the bank's commitment to bringing inflation under control and did not rule out another 0.75% hike at the Fed's next meeting in September. However, he indicated that the Fed would slow the pace of rate increases at some point and that monetary policy would be data dependent. These comments were welcomed in markets, with bonds and equities both rallying, as investors reduced bets of further aggressive interest rate hikes for later this year. The ECB increased base interest rates at its July meeting for the first time in over a decade, with a 0.5% increase. The bank also announced a new mechanism called the Transmission Protection Instrument (TPI). The TPI aims to protect against fragmentation risks across eurozone countries and prevent a significant widening of the spread between the yields of German bunds and the government bonds of eurozone countries in the periphery, particularly Italy.

European gas crisis

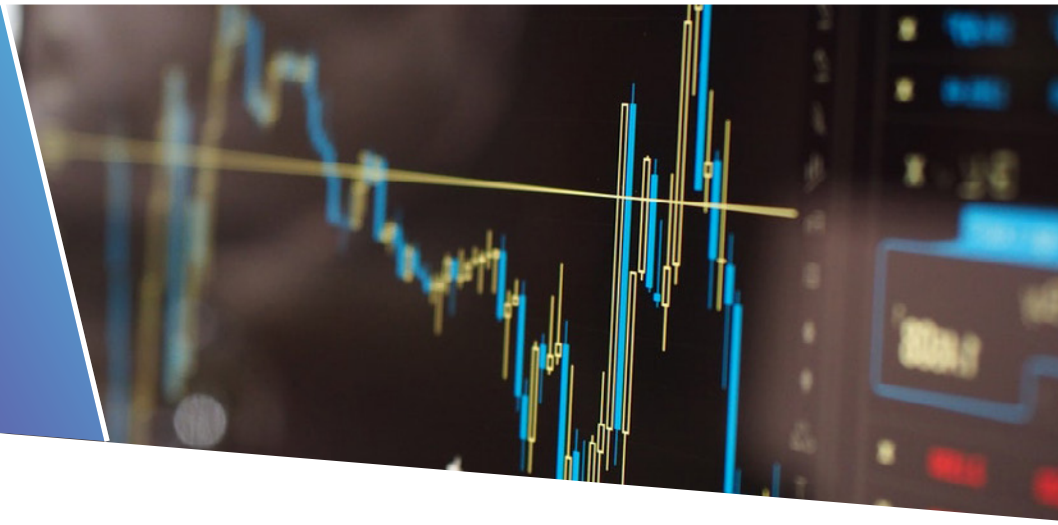
The ongoing war in Ukraine remains a significant downside risk to the global and, in particular, the European economy, especially as Russia has begun to cut energy supplies via key pipelines. The impact of the supply squeeze can be seen in European gas prices, which are now up close to 190% year-to-date to the end of July; significant further upside is possible if energy supplies from Russia were to be disrupted to such an extent that it led to rationing for firms and households. To shore up domestic supplies, the European Commission requested that countries look to reduce their consumption by 15%, although this was met with disagreement from several members of the bloc.

Politics

Political uncertainty was heightened in Italy, following the resignation of former ECB Chief Mario Draghi as Italian Prime Minister in July, with an election pencilled in for 25 September. Draghi's decision to quit came after he failed to win the support of his coalition partners in a vote of confidence in parliament.

In the UK, Prime Minister Boris Johnson resigned after he lost the support of his parliamentary party following a slew of scandals. The Conservative leadership race is now being fought out between two candidates: Rishi Sunak, the former chancellor, and Liz Truss, the current foreign secretary. The new Conservative leader is expected to be announced on 5 September.

MARKET ROUND-UP



Equities

Over the month, the MSCI AC World equity index rose 7.1% (9.7% in euros). US equities outperformed, rising 9.3% (12.1% in euros), as falling bonds yields supported equity markets. The UK underperformed following several months of outperformance, rising 3.5% (6.4% in euros), as energy and commodity stocks were relatively weak as oil and commodity prices fell over the month. Japan rose 4.0% (8.4% in euros) as weakness in the Japanese yen supported equity markets. The Pacific Basin rose 2.8% (6.5% in euros) as weakness in commodity and energy prices led the region to underperform the broader market. European equities were strong, rising 7.0% (8.0% in euros), as the ECB unveiled its new anti-fragmentation tool.

Bonds

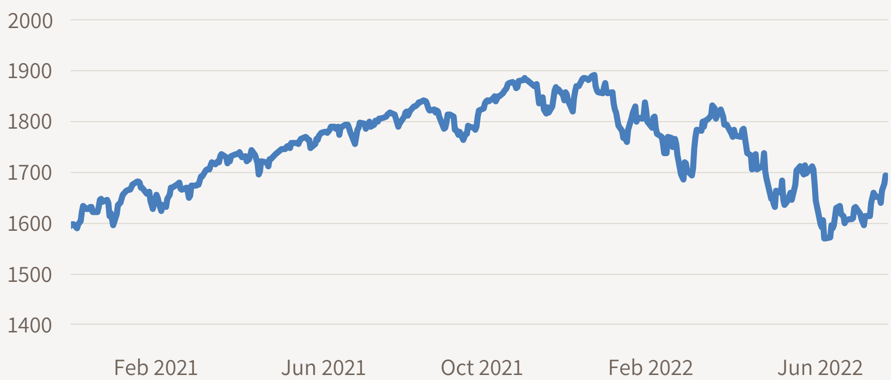
The Eurozone >5-year bond index rose 5.9% as yields fell on intensifying growth fears and comments from the US Fed on slowing the pace of rate hikes. The German 10-year yield fell over 0.5%, ending the month at 0.82%. Italian and Spanish 10-year spreads widened against Germany to 219 basis points (bps) and 110bps respectively, despite the unveiling of the ECB's new anti-fragmentation tool. Investment grade corporate bonds rose 4.7% as spreads narrowed 29bps to 182bps while yields fell 78bps to 2.31%. High yield corporate bonds rose 5.8% as yields fell 1.12% to 6.82% and spreads narrowed 91bps to 445bps. Both emerging market (EM) local and hard currency debt returns were positive for the month, benefiting from a fall in yields across major fixed income markets. EM hard currency debt was the better of the two, rising 3.2% (5.8% in euros), while EM local currency debt returned 3.0% with EM currencies weakening against the US dollar.

Currencies and commodities

The euro fell -2.5% against the dollar to 1.022 as risks to the eurozone economy were heightened by an ongoing weaponisation of Russian energy supplies and political uncertainty in Italy. Commodities were flat (2.5% in euros), bringing their year-to-date return to 35.7% (51.4% in euros). A fall in oil prices and broad-based weakness across many commodities was partly offset by a very sharp rise in European gas prices. Crude oil was down -6.8% amid slowing global growth, while European gas rose 32.1% as Russia cut supplies via Nord Stream 1. Pressure on food prices eased as Russia, Ukraine, the United Nations, and Turkey signed a deal to reopen three Ukrainian Black Sea ports – which have been closed since Russia's invasion in February – for grain. Gold fell -2.4% as risk appetite returned to markets following a perceived policy pivot by the US Fed.

CHART OF THE MONTH

Global Equities



Source: ILIM, Bloomberg. Data is accurate as at 1 August 2022.

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	MTD Return (%)	YTD Return (%)	2021 Return (%)
MSCI Ireland	9.8	-23.0	17.1
MSCI United Kingdom	6.4	5.5	27.5
MSCI Europe ex UK	8.0	-10.2	25.4
MSCI North America	11.9	-3.5	36.6
MSCI Japan	8.4	-5.8	9.8
MSCI EM (Emerging Markets)	2.4	-8.1	5.2
MSCI AC World	9.7	-4.5	28.1

10-Year Yields	Yield Last Month (%)	2021 Yield (%)	2020 Yield (%)
US	2.65	1.51	0.91
Germany	0.82	-0.18	-0.57
UK	1.86	0.97	0.20
Japan	0.19	0.07	0.02
Ireland	1.46	0.24	-0.30
Italy	3.01	1.17	0.54
Greece	2.96	1.34	0.63
Portugal	1.84	0.47	0.03
Spain	1.92	0.57	0.05

FX Rates	End last month	2021 Rates	2020 Rates
U.S. Dollar per Euro	1.02	1.14	1.22
British Pounds per Euro	0.84	0.84	0.90
U.S. Dollar per British Pounds	1.22	1.35	1.37

Commodities (USD)	MTD Return (%)	YTD Return (%)	2021 Return (%)
Oil (WTI)	-6.8	31.1	55.0
Gold (Oz)	-2.4	-3.5	-3.4
S&P Goldman Sachs Commodity Index	0.0	35.7	40.4

Source: ILIM, Bloomberg. Data is accurate as at 1 August 2022.

THE ILIM VIEW – LOOKING AHEAD

The outlook for equity markets over the next 12 months is dependent on several factors, including central bank policy, growth, inflation (both expected and realised) and the evolution of the Russia/Ukraine crisis.

Equities have declined year-to-date as central banks have tightened policy, bond yields have risen, and growth forecasts have fallen. Post the falls, equities now look attractive on an absolute valuation basis, trading on a 12-month forward price-to-earnings (P/E) multiple of 15.0x against a long-term average of 16.0x.

If consensus economic and earnings forecasts prove to be correct and we are just in a mid-cycle slowdown, there is double-digit upside in equity markets on a one-year view. A moderation in inflation with no additional policy tightening beyond what is currently discounted in markets would also be supportive.

However, equities continue to face several headwinds. Due to the persistence of high inflation, central banks continue to tighten policy and withdraw the policy accommodation that has been supportive of equity markets in recent years. Given the significant rise in bond yields, equities are no longer cheap on a relative valuation basis and are expensive on some measures versus bonds. Earnings are at risk of being downgraded due to margin pressures from input and labour costs.

For equities to begin to recover from their year-to-date falls, investors need to believe that we are at the peak of policy tightening and that growth risks are fading. Given the risks around inflation and central banks' policy responses, potential downside in growth and earnings forecasts, the failure to find resolutions to geopolitical issues and the removal of the undervaluation of equities versus bonds in the higher yield environment, we see risks in equities as still being skewed to the downside.

Navigating equity markets is difficult, even in a benign environment, but it has become more arduous in the current backdrop with heightened uncertainty on many issues. As a result, the increased volatility evident this year is likely to continue. While our outlook for equity markets suggests limited upside in the short term, the outlook remains positive over the medium to long term, with upside of approx. 5% per year expected on a 5-10-year view.

THE MONTH AHEAD

Economic data releases

5 August	US Non Farm Payrolls (July)
10 August	US Inflation Rate YoY (July)
12 August	GB GDP MoM (June)
16 August	GB Unemployment Rate (June)
17 August	JP Balance of Trade (July) GB Inflation Rate YoY (July)
19 August	GB Consumer Confidence (August)
26 August	DE Consumer Confidence (September)
30 August	DE Inflation Rate YoY Prel (August)
31 August	EA Inflation Rate YoY Flash (August)

Source: ILIM, Trading Economics. Data is accurate as at 31 July 2022.

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