Market Commentary – July 2022

July's highlights

- US economic growth figures were disappointing, with the economy contracting for the second successive quarter in Q2, while eurozone growth outperformed expectations in Q2, on the back of a strong tourist season.
- As a result, global growth forecasts have been revised downwards, as inflation forecasts move higher.
- Despite ongoing inflation pressures, and expectations of further rate rises in the near term, markets have dialled back the expected extent of medium-term interest rate increases and are expecting rate cuts in 2023 from some major central banks.
- An easing in medium-term inflation and interest rate expectations has supported bond prices with yields falling, whilst also taking some pressure off credit and equity markets.
- Representing a shift from the pattern seen in the first half of the year, the technology sector outperformed, and growth stocks outperformed value stocks.

Market Performance

UK	July	Year to date	2021	GLOBAL	July	Year to date	2021
UK	4.4	-0.4	18.3	**UK**			
GLOBAL	6.6	-4.6	20.0	Conventional gilts	2.6	-11.8	-5.2
North America	9.0	-3.9	28.0	Index-linked gilts	5.3	-17.9	4.2
Dev. Europe ex UK	5.1	-11.1	17.2	Corporate	2.9	-9.9	-3.0
Japan	5.3	-5.3	2.5	**GLOBAL**			
Dev. Asia ex Japan	4.1	-2.2	2.2	Government Bonds	2.1	-5.9	-1.8
Emerging Markets	-1.0	-6.2	0.7	High Yield	5.7	-9.0	4.1
Sterling v US dollar	0.2	-10.2	-0.9	Emerging market	2.0	-9.8	-5.8

Source: Morningstar. Percentage returns in sterling terms. All data as at 31/07/2022. Emerging market bond returns are a composite of 50% hard currency and 50% local currency bonds.

Economic background

Economic data released in July added to existing concerns of a global growth slowdown. While inflation continued to surprise to the upside, economic growth data underperformed expectations, and consumer and business surveys pointed to a weaker outlook. While labour market strength and consumer spending will prevent the National Bureau of Economic Research from officially declaring the US is in "recession", disappointing US growth, which saw the economy contract for the second successive quarter in Q2, will only add to concerns about the outlook. Though the outlook is even weaker in the eurozone, given disruption to gas supplies, Q2 growth outperformed expectations on the back of a strong tourism season. Meanwhile, corporates are facing ongoing supply chain issues, cost pressures, and a weaker demand environment.

US, UK, and EU headline CPI continued to rise in June, to 9.1%, 9.4%, and 8.6% year-on-year, respectively. While US and UK inflation pressures look more broad-based, owing in part to very tight labour markets, a large proportion of eurozone inflation still relates to volatile energy and food prices.

Amid ongoing upside inflation surprises, the US Federal Reserve (Fed) raised the Fed Funds rate by 0.75% p.a., to 2.5% p.a., for the second consecutive meeting in July. High inflation also pushed the European Central Bank to raise rates for the first time in a decade, by 0.5% p.a., taking the eurozone out of negative rates. Major central banks are expected to continue raising rates in the near term given ongoing inflationary pressures, but markets have increasingly moved to price in rate cuts from a number of major central banks in 2023 as growth, and presumably inflation, begin to slow.

Equity markets

Anticipation of slightly less aggressive monetary policy was supportive for equities and reversed a small degree of the valuation pressure on equity markets seen over the first half of 2022. The FTSE All World index rose 6.6%, and growth stocks outperformed value stocks for the first time this year. The easing of longer-term interest rate and inflation expectations saw the consumer discretionary and technology sectors outperform. Both sectors had underperformed markedly over the first half of the year and the change of tone may have tempted investors back to these sectors whilst also providing support to valuations.

The US, with its large technology and consumer discretionary exposures, outperformed. Weakness in the Chinese real estate sector weighed on emerging markets more broadly, which underperformed and was the only major region to deliver a negative return in July.

Developed market government and investment-grade corporate bonds

Amid growing evidence of economic weakness, sovereign bond yields fell as markets moved to price in less interest rate rises over the medium term, meaning government bond prices rose. UK government bonds rose 2.6%, while global bonds increased by 2.1%. Anticipation of further rate rises in the near term, alongside lower longer-term inflation and interest rate expectations, has seen the spread between the US 2-year and 10-year bond yield turn negative – a typical harbinger of recession in the year or so after a sustained inversion.

UK long-term inflation expectations, as measured by the difference between conventional and inflation-linked bond yields of the same maturity, remained broadly flat, although the index-linked gilts index outperformed the conventional gilt index owing to the longer duration of the bonds and therefore higher interest rate sensitivity.

Total returns in corporate bond markets were supported both by falling government bond yields and by spread tightening. UK investment-grade corporate bonds returned 2.9%.

Alternative bonds

Global high-yield spreads tightened fairly sharply, driving strong performance of 5.7% over the month. Local currency emerging market debt returned 0.3% as yields fell, offsetting a weakening of emerging market currencies, in aggregate, against the dollar. US dollar denominated emerging market debt returned 2.9% as both underlying treasury yields and spreads fell.

Jack Richards, Investment Manager

For and on behalf of Hymans Robertson Investment Services