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INVESTMENT SERVICES

Hymans Robertson Investment Services (HRIS)

Market Update: 20 June 2022

June 2022

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Further ratcheting up in the US Federal Reserve's (Fed) tightening makes a "hard landing", where higher interest rates drive the economy into a recession, more likely.

Since the start of this year, the market has been all-consumed with how central banks such as the Fed and Bank of England (BoE) will tackle seemingly ever spiralling inflation. The temperature was turned up once more on 10th June when the May year on year inflation reading for the US was announced to be 8.6%. Prior to this, there was a sense that inflation may have plateaued in the US, but instead inflation had continued to push upwards. Expectations for the Fed's next move at their 15th June meeting was rapidly upgraded from a 0.5% to a 0.75% hike. The shift in view played out as the Fed followed through with their largest rate hike since 1994.

The news was felt strongly across markets, the S&P 500 fell 8.7% in the five days following the inflation data was released, pushing the index into a bear market - a term commonly used to describe a fall of 20% or more from peak. The yield on two-year US government bonds, which moves inversely to its price, rose above 3% for the first time since before the Global Financial Crisis.

Similar central bank-driven market movements were felt across other developed markets. On 9th June the European Central Bank (ECB) announced plans for their first rate hike and an end to their vast bond-buying programme. Soon after the announcement however, stresses started appearing in European bond markets amongst its more indebted members, such as Italy, forcing the ECB to backtrack just days later and issue a statement, following an emergency meeting, that it was planning a "new anti-fragmentation instrument" – i.e. more bond buying.

Further rate hikes from the Bank of England and a first from the perennially dovish Swiss National Bank added to investor angst on 16th June. Over in Asia however, the Bank of Japan maintained their increasingly contrarian easing stance, weaking the yen further to a 24-year low against the dollar.

Overall, the feeling is beginning to grow that the Fed and other central banks were too slow to start hiking and this will require faster and harder tightening to contain inflation. At this week's meeting, the Fed effectively admitted that the prospect of a recession was now beyond their control. The question investors have to grapple with is shifting from "are central banks able to contain inflation?" to "how much economic damage will be sustained in doing so?"

Investors are therefore starting to focus on the outlook for a recession in the US. Leading indicators such as the housing market are beginning to show signs of a slowdown. Data from Zillow, a US online real-estate marketplace, indicates the percentage of house listings seeing a price cut is rising fast. On top of that, new home sales in the US have now fallen back to pre-covid levels, albeit from an elevated position. Consumer sentiment also paints a gloomy picture. A widely watched survey from the University of Michigan puts consumer confidence at the lowest level since the survey began in the 1940s.

There is some optimism though, that if a recession were to occur, it could be mild. Excess savings, built up during the Covid period are still high and can be drawn down in tougher times. The labour market remains extremely tight with almost two job vacancies for every one unemployed person in the US. On top of that, many businesses took advantage of low borrowing rates during the pandemic by issuing debt at longer durations. Just 10% of riskier, sub-investment grade bonds will require refinancing over the next three years.

Outlook and comment

The “everything rally” of 2021, which saw strong performance across a range of asset classes has turned into an environment where there have been very few places to hide. Shorter duration bonds and cash have dampened losses, as have value style equities and energy stocks, while growth style equities and longer duration bonds have been in the eye of the storm.

Market volatility for both equities and bonds is likely to remain high throughout this tightening cycle, at least until the market is satisfied that inflation is under control. However, history suggests that, for markets, it’s often the fear of a recession which impacts returns more than the actual recession and it can usually be more advantageous to invest during, rather than after, a recession. For investors who have the ability to stay the course through the market volatility there will always be a chance to capitalise on falling prices. Yields on government bonds have reached levels unseen for decades, credit spreads are above median levels and 10 year projected returns on equities are now c40bps p.a. higher than they were three months ago.

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