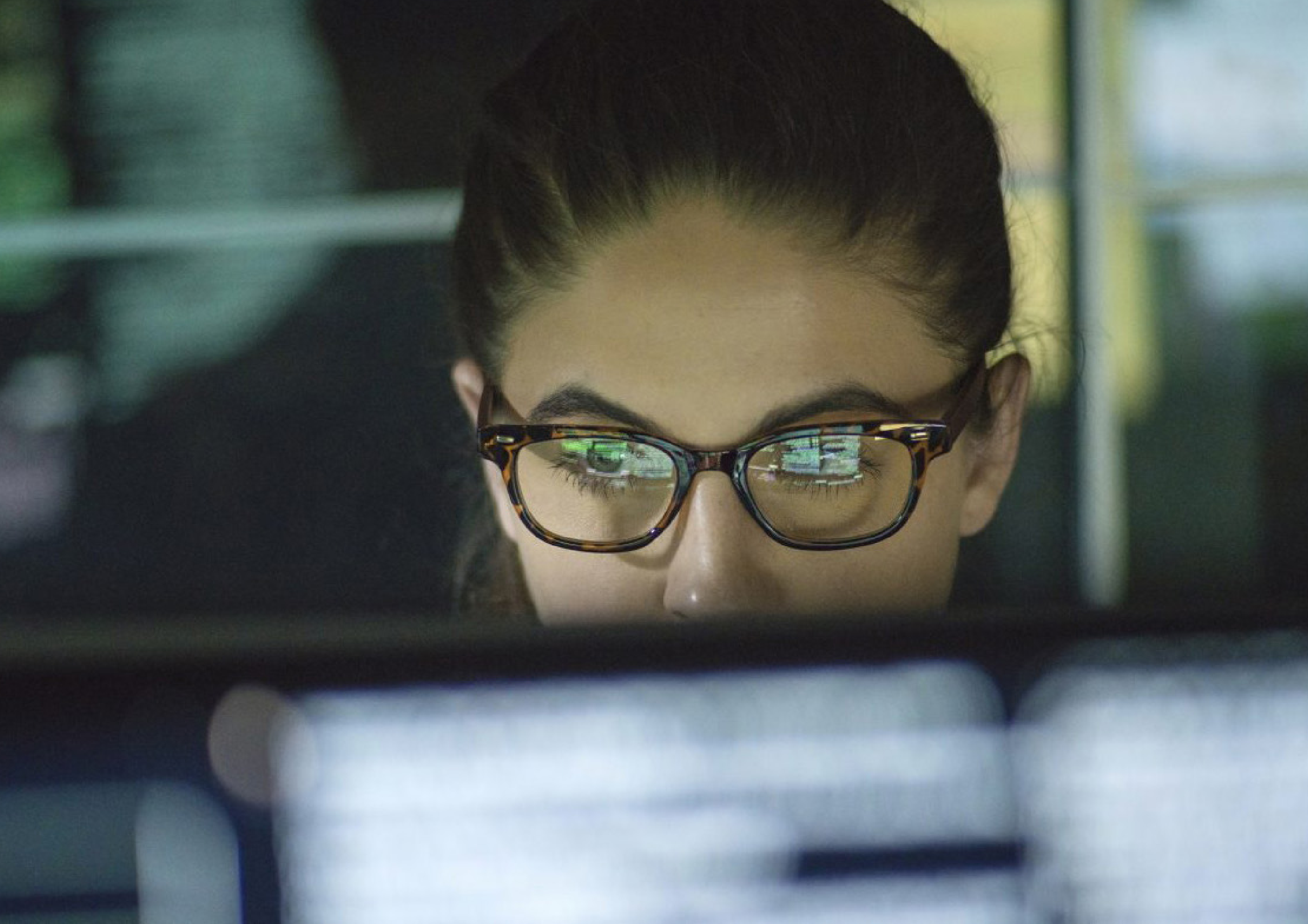

Monthly market blueprint

Investment management service

June 2022

mazars

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Foreword

The GDR (Great Dose of Reality) crisis

Ostensibly, everything about the latest rally in equity markets screams "Bear Market rally". After all, how can we call an end to the Bear Market when Quantitative Tightening, the great process to unwind some of the Fed's recent purchases, hasn't even begun?

However, we should not forget that the Fed continues to be the "only game in town", and that asset managers lost the right to cry "Bear Market Rally" in 2013, when everyone was certain that Quantitative Easing would come to an end and markets would revert to crisis form.

If we compare the point at which S&P 500 rebounded (near 4150 points at the end of May), and where the Fed's assets are projected to be (assuming full quantitative tightening) by next summer, we can see that markets have effectively already priced in a year's worth of quantitative tightening.

Nevertheless, one can't say for certain that we have reached a bottom. The S&P could well fall another 800 points, towards significant technical levels which coincide with level of assets held by the Federal Reserve before the latest round of QE.

In other words, markets have priced in some quantitative tightening, but not a full reduction of assets to pre-Covid level. For that to happen, we would need to see a significantly more hawkish Fed, and the minutes from the latest central bank meeting suggest that this is not yet the case.

The rebound in bonds after the US 10-year reaching 3% means that markets have priced in this year's rate hikes (and possibly next year's rate hikes as well). Notably, the global bond benchmark yielding 1% over long-term inflation is certainly reason for pause.

We are now moving to the phase of the cycle where at least some of indicators of a financial recession begin to flash red warning signals, but the economic recession has yet to come.

By now, members of the Federal Open Markets Committee will know that even their most constrictive policies will have little effect on inflation and that the labour market is very tight. Therefore, their principal concern will be growth. The quarter's results by Amazon and Wal-Mart were disconcerting enough to raise some red flags in the Fed. Meanwhile, the US housing market continues to lose steam while prices remain sticky - the usual mark of a disconnect between buyers and sellers imminently before prices eventually cave.

So, markets have retrenched enough to price in some quantitative tightening. At the same time, economic news has taken a sufficiently pessimistic turn to, at the very least, sow the first seeds of dovishness that should kick off the next cycle.

Calling the latest rebound a "dead cat bounce" might be a misnomer. Dead cats don't bounce. On the one hand, what we are seeing might very well be a "bear market rally". Stocks can further retrench as a result of bearishness, forecasts and algorithmic trading. But we have reached a level in the equity and the bond markets where markets stop for pause.

This doesn't mean the beginning of a new cycle. Things going in the right direction is not enough. A strong theme is needed for a new bull market, and that will probably not come until inflation eases and central banks perform an about-turn and stop quantitative tightening.

George Lagarias
Chief Economist, UK

Market performance

The month in review

May was a mixed month for asset class returns following the falls seen across equity and bond markets year-to-date.

Economic data remains concerning, with consumers globally being squeezed by higher cost inflation and higher interest rates. However, questions are being asked as to whether central banks, especially the Fed, are likely to raise interest rates as far and as fast as markets had started to price in.

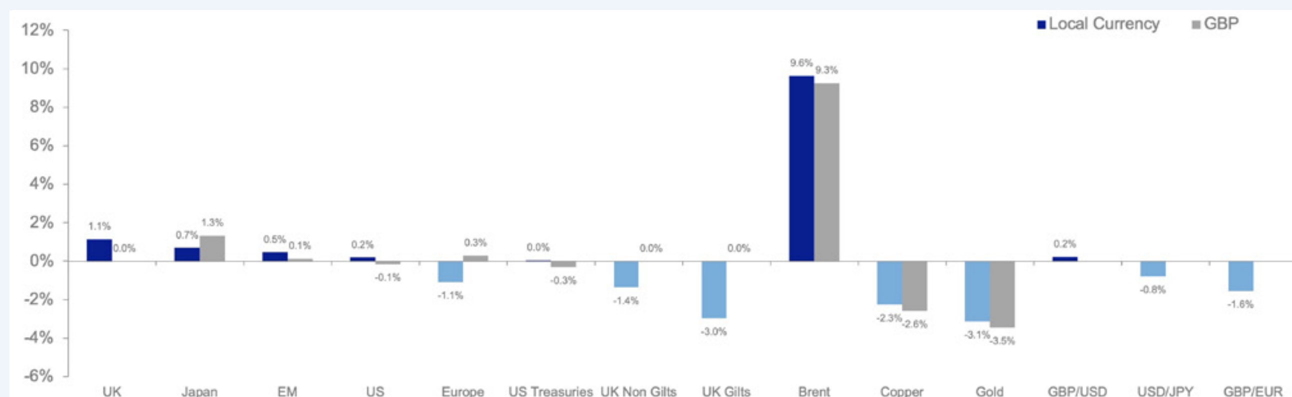
Global equities ended the month -0.3% lower in Sterling terms, although this figure was skewed by another negative month for US equities, down -0.2%. It was another month where higher valuation multiple stocks in the technology, consumer staples and consumer discretionary sectors lagged. Nevertheless, falls were relatively minor and performance within sectors was much more stock specific. Meanwhile energy stocks, both in the US and worldwide, had another stellar month as oil climbed another +9.5% in US Dollar terms.

Other regions saw gains in Sterling terms. UK and Japanese equities have had contrasting years, however these were the standout markets in May, up +1.1% and +1.4% in Sterling terms respectively. UK indices again benefitted from a heavy weighting to energy stocks, while in Japan the gradual re-opening of the economy is starting to lift the equity market.

European equities were slightly positive in Sterling terms, however this was down to Euro strength, with returns in local terms down -1.1%. Meanwhile, emerging market equities were slightly positive in both local and Sterling terms.

It was also a mixed picture in the fixed income markets. Both Gilt and Bund yields continued to climb, with the 10Y yields for each up nearly 20bps for the month. UK 10Y yields are now at 2.1% as the BoE continues to express hawkish opinions. As a result, Gilts returned -3% in May. However, more dovish tones from the Fed saw 10Y Treasury yields fall 10bps to 2.85% over the month, falling from their peak for the year of 3.14% early in May. Emerging market bonds were also positive, with hard currency returns up nearly +2% in Sterling.

Basic asset classes



Charts Source: Mazars Calculations

Asset allocation

Changes in our Strategic Asset Allocation

Asset Class	Stance	Comment
Equities	Neutral	We believe equity volatility will continue throughout the year. However, we also see the post-Covid recovery continuing and therefore keep equity weight at neutral to participate in economic growth. Within our equity allocation we include positions in value equities and dividend paying stocks in order to tilt the portfolio away from the sectors more sensitive to economic growth and rising interest rates.
Fixed Income	Underweight	We believe that the bond re-rating has further to go. Interest rates will continue to rise and inflation may persist for at least the rest of the year. Fixed income has limited scope to provide its hedging benefits to equities within a portfolio. We are particularly underweight investment grade corporate bonds which offer little protection against rising rates and inflation.
Alternatives	Overweight	Given that we are in a central bank tightening cycle and equity market valuations remain elevated we see an overweight to alternatives as a suitable hedge within portfolios. We express this through overweight positions in gold, infrastructure and asset backed securities.

Outlook and portfolios

In April our Investment Committee voted to keep our overall asset allocation unchanged yet we increased the defensive nature of our equity exposure. We maintain a neutral position in equities, an underweight position in fixed income and an overweight position in alternatives.

Much of the discussion in the Investment Committee was focused around the ever-growing inflation numbers, the commitment of central banks to hike rates, elevated commodity prices and the pressure on consumers. While current forecasts still predict healthy economic growth this year, the ability of central bankers to raise rates without eventually bringing about recession is yet to be seen. Therefore, we see room for the narrative around economic growth to worsen.

Given the point in the cycle, we think that the equity market will experience a flight to quality, as some of the more speculative areas of the market are sold down and replaced with companies with resilient earnings that trade at a reasonable price. Within fixed income we favour reduced duration, given that interest rates rising cycle has only just begun in the US and the UK. Our committee also noted that given geopolitical tension and a more febrile global economy there is scope for the USD to strengthen relative to other developed market currencies.

At this meeting, within the equity portion of the portfolio we reduced our European exposure and added to our US value fund, Dodge & Cox US Stock. We also reduced our broad GBP-hedged equity exposure in favour of an unhedged global equity income fund, Fidelity Global Dividend. We made no changes to our alternatives or fixed income portions, given that we had positioned those more conservatively over the previous 2 quarters.

Risks
Growth under fire

2022 is yet another year of great uncertainty and a wide variety of outcomes – the third year in a row. High inflation and central bank hawkishness bring the possibility of a second recession, a year after the recovery has started, and a downturn in the Chinese economy significantly exacerbates this possibility. As a result, financial markets are tumultuous, and the global economy is in danger of further destabilisation.

Exactly two years after the emergence of the last exogenous crisis, the Covid-19 pandemic, and before a full recovery was achieved, the global economy is now experiencing renewed convulsions as a result of inflation following the war in Ukraine.

Global supply chains, which were under pressure even before the war, are now facing another unprecedented shock. Global inflation is rising fast, and growth will likely be affected. So will corporate earnings. The confluence of risks is significant.

While risks from the pandemic have seemingly abated, we can't rule out the possibility of another variant.

Meanwhile, fresh Chinese lockdowns add further pressure to an already slowing economy resulting from a clamp down on the real estate market.

At the current juncture, our top area of concern is slower growth. The potential of runaway inflation and the Fed's inability to fight a war on two fronts (price pressures and market volatility). Slower growth could result in a stagflationary environment lasting 1-3 years.

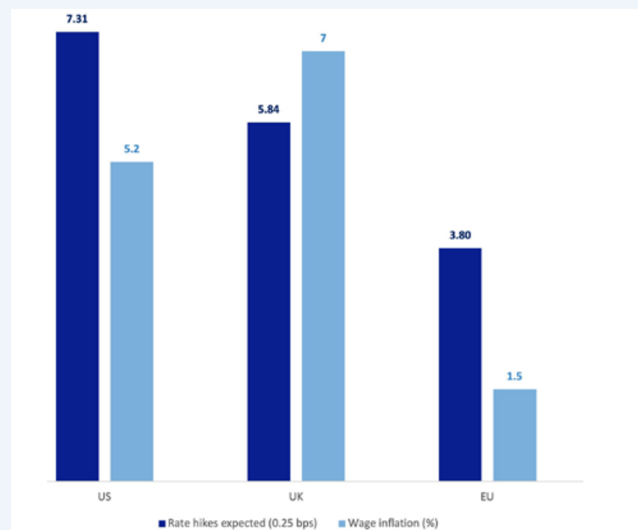
Upside risks, however, also exist and are not priced in. Russia could retreat from Ukraine or inflation might slow down as supply chain managers work through the current bottlenecks. In addition, the Fed may yet tilt towards a more dovish path as concerns over global growth mount.

The Fed's focus on inflation means that all the above risks could have a bigger impact on risk markets than previous years. We now begin to doubt even the core risk investing mantra of the past 22 years, the Fed Put. Simply put, the central bank safety net for markets is not that certain anymore. Priced in, this could significantly elevate risks.

We expect macroeconomic and market volatility to last well into 2022.

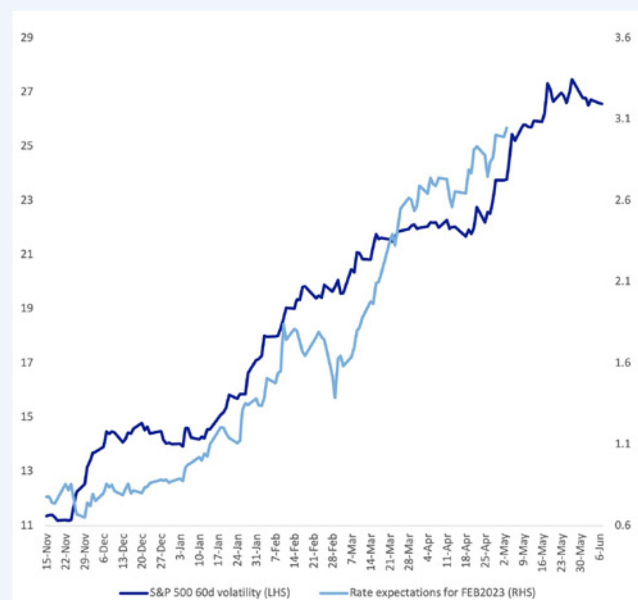
Markets are now pricing in seven more US hikes in 2022

Market rate expectations, as of 6 June 2022



Volatility is rising as Fed becomes more hawkish

Rate expectations, US equity 60 day volatility



Charts source: Mazars Calculations

Macroeconomic backdrop

Global

Economic pressures are rising across the globe, as the post-pandemic recovery is hitting significant roadblocks. The worst inflationary pressures in decades are preventing central banks and governments from shoring up a weak economy as supply pressures re-intensify. As a result, probabilities of a global recession are rising.

Market Performance: For the period, global stocks rose by 0.1% (0.3% in GBP). The highest performing sectors were Energy and Utilities while the worst performers were Cons. Staples and Cons. Discretionary. Equities were trading at 16.28x times forward earnings, 4.4% above long-term average. Gold fell 3.1% and oil prices rose 9.5%.

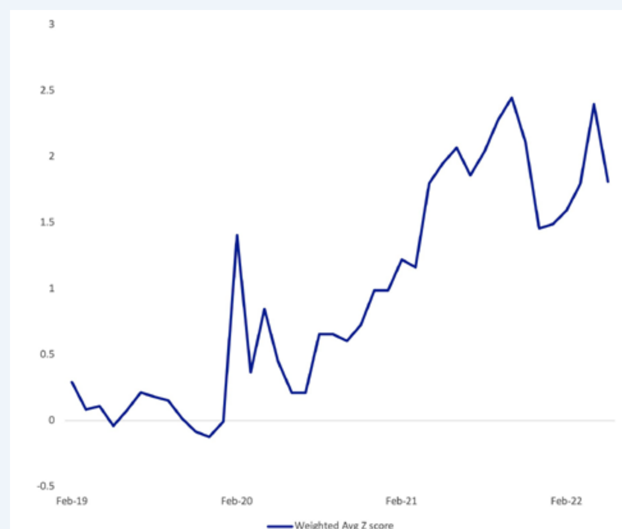
The global economy: Nominally, the global economy continues to expand above its pre-pandemic rate, albeit in an unbalanced and possibly unsustainable manner. In the run-up to the Ukraine wars, supply-side inflation pressures were abating and mutating into demand-side inflation, as persistently higher prices have fed into wage demands.

However, the Ukraine war threw the post-pandemic economic calculus in disarray. Soaring commodity pressures put further pressure on prices, consumption and central banks. Additionally, Chinese lockdowns and a "stealth" economic slowdown feed inflation and further exacerbate supply chain pressures globally. Policy makers have opted focus on hiking rates and risk the economic recovery to make sure inflation does not persist. We believe this will impact global growth for 2022.

Outlook: We believe that macroeconomic and market risks are greatly elevated. Global supply chains will have to adapt to a new geopolitical order, one of more division. Given the rapid rate of change, some consequences are simply unforeseeable. In recent past, the danger of a recession because of such events would be mitigated by central banks. However, because of high inflation and a huge post-pandemic debt overhang, authorities are now hard-pressed to soften the landing with monetary or fiscal measures. In this environment, we believe that recessionary risks are rising and that further growth downgrades are probable. High inflation and lower valuations means that equities are still the preferred asset class, but we would still require more certain market direction before considering a long-term overweight.

Supply chain pressures are re-intensifying

Z-score of eight key supply indicators



Global output is slowing down

Global manufacturing and services PMIs

Charts Source: Mazars Calculations

Macroeconomic backdrop

UK

The UK economy, traditionally one of the most open economies in the world, is particularly sensitive to global trade trends and convulsions. We expect UK economic performance to be closely correlated to other western economies and possibly lag.

Market Performance: For the period, UK stocks rose by 1.1%. The highest performing sectors were Energy and Telecoms while the worst performers were IT and Utilities. Equities were trading at 10.49x times forward earnings, 26.6% above the long-term average and 35.6%below the MSCI World. 10y bonds rose 20 bps at 2.101%.

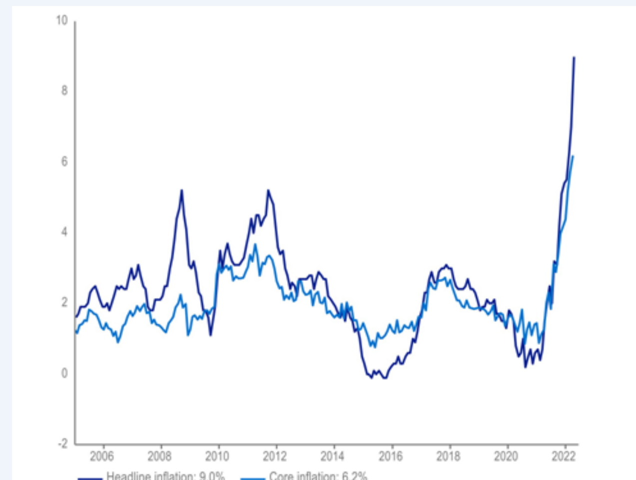
Economy: The post pandemic economic rebound is, by and large over. Pressures from inflation have led to the suppression of real (ex-inflation) incomes. Fiscal and economic policy could remain constrictive as inflation persists. Economic growth for 2022 was projected to be 4.8% last year. It is now assumed that the UK economy will grow a percentage point less, around 3%. Meanwhile, inflation could top 10% in the coming months . Despite pressures on growth, post-Brexit labour shortages should keep unemployment levels low. The media projection for UK unemployment in 2022 and 2023 is 4%.

The UK's smaller reliance to energy imports (33% as opposed to 60% for Europe) and current labour market structure, would correlate performance closer to the US than Europe. However, Brexit's repercussions on labour availability and trade, complicate the picture and suggest that UK economic performance may lag that of its peers, both on the downside and the rebound. In a pre-Ukraine world, economic interests and ties between the US and Europe prevailed over British interests and the 'Special Relationship'. Nevertheless, Britain's stance as a NATO's premier bulwark in Europe, is expected to give British interests a boost on the post-Brexit negotiating table.

Outlook: We believe that macroeconomic and market risks are greatly elevated. Brexit is adding to economic pressures. High debt levels mean that the government will be hard pressed to increase fiscal support to cover the cost-of-living crisis.

Soaring inflation puts pressure on UK consumers

UK headline and core inflation, YoY increase, %



Consumer expectations grow increasingly pessimistic

UK consumer confidence, personal financial and general economic situation

Charts source: BLS, B&A

Macroeconomic backdrop

US

The narrative adopted by Federal Reserve over the last month has become increasingly hawkish over fears of sustained, widespread inflation. However, cracks are materialising in the picture for domestic demand, and much of the current inflation continues to be imported due to supply constraints.

In May, US stocks rose by 0.2% (in GBP). Equities traded at 18.16x times forward earnings, whilst 10-year US Treasury yields fell 9bps to 2.844%.

Federal Reserve officials have made it clear that they intend to continue tightening policy to combat inflation. Minutes from the most recent Federal Reserve meeting revealed that officials are prepared to proceed with multiple 50bps rate hikes, and noted that their policy stance may shift to one which would be 'restrictive' to growth.

On the surface, inflation does appear to be easing. In April, the US inflation year-on-year inflation rate fell to 8.3%, from a rate of 8.5% a month before. However, persistently higher energy and food prices are likely to keep inflation elevated.

US Economic data has been somewhat mixed. The manufacturing sector performed well in May. However, the sector continues to face considerable headwinds moving forward, resulting from weakening global demand and a stronger US dollar.

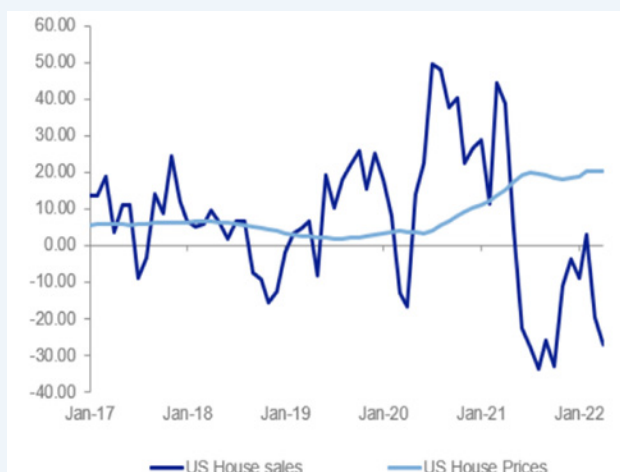
The housing market is also showing signs of a cooldown, as housing sales continued their downward trajectory. Nevertheless, this fall in sales is not yet reflected in house prices, which rose by 3.1% in May, and construction statistics, which show that homebuilding is at levels not seen since the Global Financial Crisis.

On the other hand, personal spending and employment have remained strong. In the face of free-falling levels of consumer confidence, personal spending increased by 0.9% in April. Retail sales also remained robust, rising by 0.9%. In light of the strength of these areas of the economy, it is unlikely the Fed will be swayed from its path.

Outlook: Given weakening economic data and a hawkish Federal Reserve, we expect that US growth will be considerably slower in the coming months.

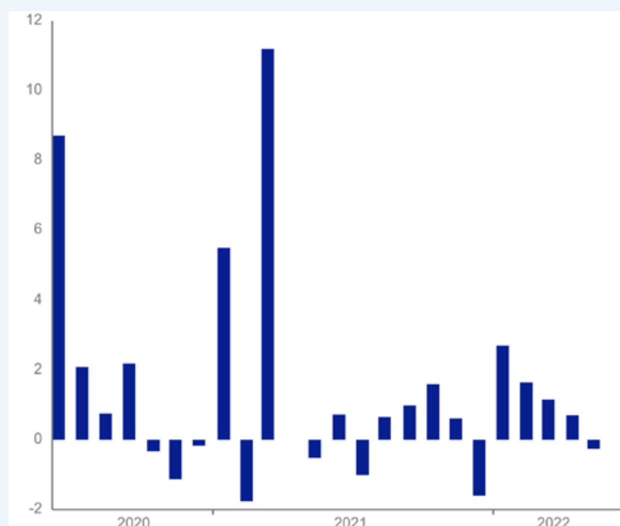
US house sales have dropped, but prices remain sticky

US New Home Sales, Case-Shiller 20-city YoY house prices



US consumers continued to spend despite high inflation

US retail sales, month-on-month % change



Charts Source: Mazars Calculations, Refinitiv Datastream

Europe

Inflation continues to run rampant across Europe and the latest restrictions imposed on Russian energy are unlikely to alleviate these pressures any time soon. As a result, the ECB's hand is being forced. The end of an era of quantitative easing draws near in Europe and the central bank is expected to implement their first interest rate hike since 2011, despite weaking European growth prospects.

Whilst April saw the growth prospects of European economies deteriorate, May was laden with unwelcome news surrounding inflation. The calls by economists that inflationary pressures would ease are unheeded thus far, as inflation in the Eurozone (as measured by HICP) is anticipated to rise to an unprecedented 8.1% in May. To make matters worse, this headline number did not solely result from an uptick in energy prices. Noticeable price rises for both goods and services helped fuel the inflation fire.

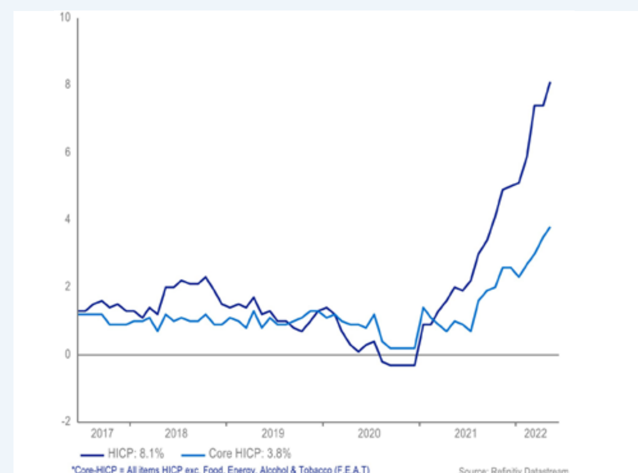
But what does this mean for the European consumer? Rising food and fuel prices have already forced consumers to review their spending decisions. Retail sales in Germany fell -5.4% month-on-month in May as inflation's demand destruction capabilities are beginning to be realised. In the same vein, the partial embargo on Russian oil agreed at the end of May will likely worsen energy security, encourage further energy prices rises and impact demand, pushing struggling European economies closer to recession.

This has forced the ECB to change it's tone repeatedly over the last few months, as it grows increasingly hawkish in an attempt to tame inflation prospects. Rumours of a 50bps rate hike in July have also begun to circulate in markets and the ECB, who have adopted a mantra of flexibility, are capable of revising their current rate hike schedule. However, policymakers face a tough set of choices ahead, as their responsibilities to the heavily indebted nations of the European Union must be weighed-up against the political objectives of countries such as Germany, who are becoming increasingly anxious of the burden of record inflation.

Outlook: We anticipate economic fundamentals to further deteriorate across Europe as policymakers attempt to wrestle with inflation without shattering growth prospects. The current stagflationary environment and hawkish tone adopted by the ECB is likely to incite further volatility in European assets.

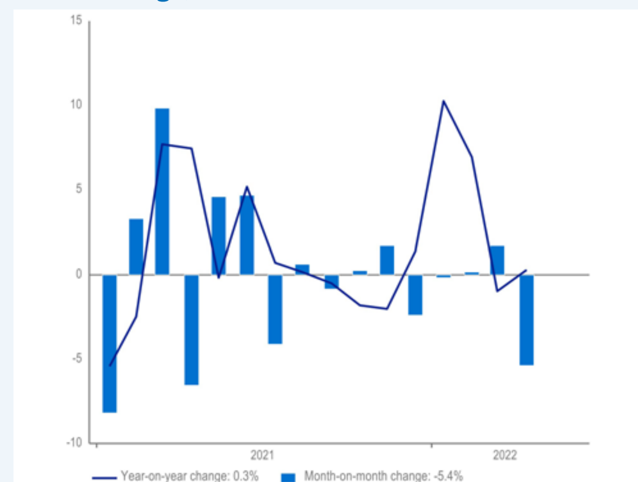
Eurozone inflation rises sharply to record levels

Eurozone HICP & Core* HICP flash, year-on-year change, %



Retail sales fall as consumers feel inflationary pressures

Germany retail sales, year-on-year and month-on-month change, %



Charts Source: Refinitiv Datastream

EM and Japan

Evidence is mounting that the Chinese economy is contracting at a fast pace, due to the impact of Covid-19, business restrictions and the country's transition towards a more consumer-centric model. On the other, hand, the economic situation in Japan appears to be improving.

Market Performance: For the period, Japanese stocks rose by 1.4%. The highest performing sectors were Energy and Utilities while the worst performers were Cons. Staples and Financials. Equities were trading at 12.38x times forward earnings, 16.8% above long-term average and 23.9% below the MSCI World. Emerging market stocks rose by 0.1%. The highest performing sectors were IT and Energy while the worst performers were Healthcare and Financials. Equities were trading at 11.87x times forward earnings, 6.3% above long-term average and 27.1% below the MSCI World.

Economy: In China, the economic downturn remains severe, a result of both the lockdowns and the wider economic transition. Shanghai alone has seen a 60% drop in manufacturing over the last few months. The forward-looking PMI indices suggest that economic activity has slowed down significantly. Employment weakened further. While outstanding business grew, business costs remain high. Supply chains remain disrupted and delivery times are still very long.

Conversely, Japan is seeing some improvement in the private sector, despite longer backlogs, as demand has been picking up. Thanks to a robust service sector, activity over the next few months seems to be strengthening, despite headwinds in the form of higher prices. Rates remain low and the central bank has not followed the example of its western market peers, maintaining an ultra-accommodative monetary policy stance.

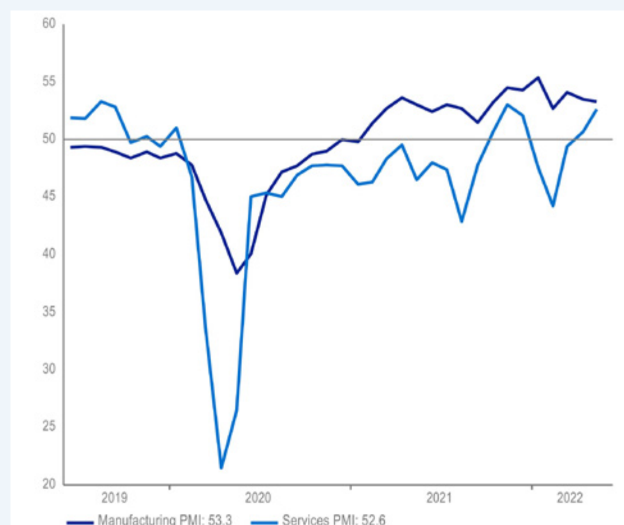
Outlook: In Japan, the improvement is marked. Along with monetary accommodation, the optimism is reflected in risk asserts. However, we feel that the current economic performance of its biggest trading partner, China, will weigh heavily on the near-term outlook for the Japanese economy. Consequently, we are neutral on Japanese risk assets. Meanwhile, we remain sceptical about the course of the Chinese economy, both in terms of the realised impact of the current economic slowdown, and its effect on the global economy.

Chinese output improving, but still contracting fast

Markit Services and Manufacturing PMIs

Japanese output is expanding

Japan Manufacturing and Services PMIs



Charts Source: Refinitiv Datastream

Our themes

Macro theme 1
A global recession

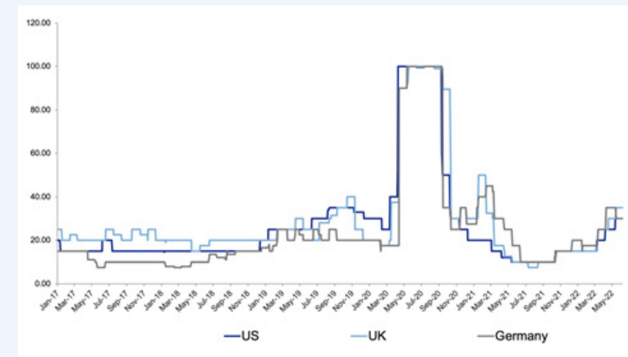
More often than not, it takes a confluence rather than individual risks to cause catastrophe, as any veteran of the Global Financial Crisis will attest. As we enter the second quarter of 2022, we believe that there’s a mounting probability that we are seeing such a confluence of risks now, one that could significantly derail growth:

1. A weak economic backdrop: Last year, policymakers assumed that supply chains were robust and global supply would quickly snap to when post-lockdown demand picked up. The only thing that snapped was factory capacity. Lead and delivery times grew significantly. As a result, orders multiplied because merchants wanted to build inventory. This led to chaos. Materials became scarce, delivery times grew exponentially, and orders were simply left unfulfilled. This erratic demand pattern caused inflation to spike. Yet, in early February, nearly a year after vaccinations became available, we were seeing evidence of a nascent economic recovery. It was fragile and data was anything but conclusive, however the broader picture suggested a gradual reduction of stresses. In Europe, inflation pressures had shown evidence of peaking. The overall backdrop was improving but remained weak and fragile.
2. Broad-based high inflation. The war in Ukraine and the concomitant sanctions on Russia have amplified inflationary pressures. Global supply chains are still very weak, and heavy sanctions on a key energy and materials provider are re-igniting inflation. The fact that these inputs are at the origin of supply chains exacerbates the problem, as the impact of shortages will branch out. Scarcity in energy affects almost every product. Scarcity and high prices of wheat and corn mean that costs will go up throughout the food chain, affecting nearly all products, irrespectively of whether they are produced locally or they are imported.

This means that prices for meat, for example, will rise, even if the livestock comes from just a few miles away. Thus, unlike the previous inflationary bout, which focused on some sectors experiencing shortages, like cars, this one will see even higher prices and will be significantly more broad-based. That will be of particular consequence to lower income households across developed and emerging nations. In this environment, consumers will have to curtail costs.

Recession risks rising

Bloomberg Poll: What is the probability of recession in 12m?



Due to these challenges, consumers will seek higher wages, asking their employers to share their costs. Skilled labour shortages have moved pricing power to employees, thus by and large, average wages begin to grow. This increases the cost of goods produced, and manufacturers further raise their prices.

3. Policy mistakes: At this point, the economic rebound and inflation have become competing targets. This puts policy makers in a bind, raising the probability of policy mistakes on either side. Policy mistakes can come from central banks and governments.
4. The final element for this recession perfect storm, but perhaps the most important, is the potential of a profound Chinese economic slowdown. Official GDP growth has often been questioned because of its virtual linearity (as opposed to the volatility experienced by other economies across the globe), and its impeccable proximity to 5-year planned targets. We are also skeptical about Chinese CPI, currently at below 1% whilst the rest of the world is experiencing 5-8% increases. Price controls mean that the burden is transferred onto the state and producers.

For more detailed analysis, read our Quarterly Outlook: Is globalisation going in reverse?

Macro theme 2
Risk assets and geopolitical risks, central bank reactions

The invasion of Ukraine has given policymakers a reason to reassess their current stances on both inflation and global growth prospects. Russia and Ukraine both have important roles the global economy as a noteworthy exporters of important commodities, including oil, natural gas and wheat. This has had a detrimental impact on global supply and severely impacted commodity prices, which, in turn, is forcing input costs higher in developed nations that are so dependent on these natural resources.

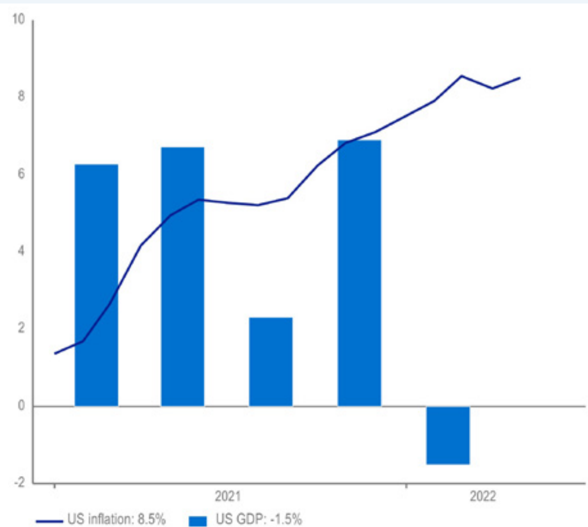
In addition, the 'zero-tolerance' approach adopted by China is taking its toll. Lockdowns and tightening Covid-19 restrictions, in response to the outbreaks of the virus across several regions of the country, have further increased global supply chain pressures and severely hampered demand in the world's largest manufacturer of goods.

Naturally this confluence of macroeconomic uncertainties has paved the way for a widely anticipated deterioration of global growth. In April, the International Monetary Fund (IMF) slashed global growth prospects for 2022 to 3.6% from their previous forecast of 4.4% in January.

This poses a challenge to a Federal Reserve that is already facing down the barrel of rampant inflation, currently at a staggering 8.3%. Nevertheless, tackling inflation without materially impacting economic demand is a significant challenge.

How will the Fed manage growth and tackle inflation?

US inflation, CPI, YoY % change. US GDP, annualised QoQ % change



Charts Source: Refinitiv Datastream

The ECB needs to protect the periphery

10-year bond yields, spread over German Bund, %

Charts Source: Refinitiv Datastream

Whilst slamming the brakes on the economy with a series of large interest rate hikes would undoubtedly be a high-risk strategy, the Federal Reserve currently believes this is the most effective method to both shackle inflation and regain credibility following its initial plan to dismiss the current bout of inflation as 'transitory'. However, investors will note that tightening monetary policy is not a strategy typically adopted if the intention is to support asset prices.

On the other side of the Atlantic, Europe is facing weakening growth prospects in conjunction with inflation that is becoming increasingly broad-based. The mandate of the ECB to manage inflation within the Euro area and support the common currency may justify the increasingly hawkish stance that it has adopted in recent months. However, hiking interest rates has sizeable implications for the ECB, due to its additional responsibility to protecting the highly indebted countries on the periphery of Europe. Restricting monetary supply for these common currency nations could have unintended consequences for the European Union.

The adjustment to a new paradigm is likely to be accompanied by a series of policymaking errors as stagflation remains one of the most challenging economic conditions for central banks and risk assets alike. Yet, holding cash guarantees losses for as long it is as held. As such, there remains little alternative for investors. For policymakers, the road ahead is one of damage control: how do they to best combat inflation whilst limiting the impact to economic growth?

Macro theme 3

Is China facing an economic slowdown?

China was the first country to successfully emerge from the initial Covid-19 wave. People were back to the office in 2020 itself, infection rates plummeted and as a result, economic growth was stellar, beating all expectations. China emerged as the winner at a time when most western countries were still coming to terms with the Pandemic and its repercussions. The last 12 months however, have been a absolute reversal.

A real estate 'bubble' is showing concerning signs of bursting. China's Evergrande Group has rapidly become Beijing's biggest corporate threat as it wrestles with debts of more than $300 billion as a result of years of aggressive expansion. But that was just the tip of the iceberg. The total combined debt of China's major property developers is now estimated at more than $5 trillion. To make matters worse, 20 of the top 30 property firms by sales have breached at least one of three debt limits set by the Chinese government to rein in real estate speculation, meaning they're unsustainable. With property being a key driver of economic growth – contributing about 29% to China's GDP – any major real estate crash could threaten the entire Chinese economy.

To make matters worse, the Chinese regulator launched a multi-pronged crackdown on its tech, gaming, gig economy, education and cloud computing companies, leaving start-ups and decades-old firms alike operating in a new, uncertain environment. New regulations tackled issues such as high borrowing levels, data privacy and ring fencing businesses to combat anti-competitive behaviour by large umbrella corporations.

China real estate woes weaken property investments

China investment in real estate development

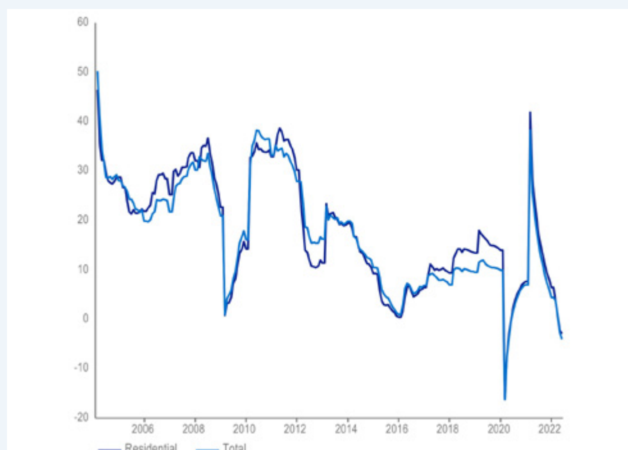


Chart Source: Refinitiv Datastream

China signals easing due to property sector downturn

China reserve requirement ratios, %

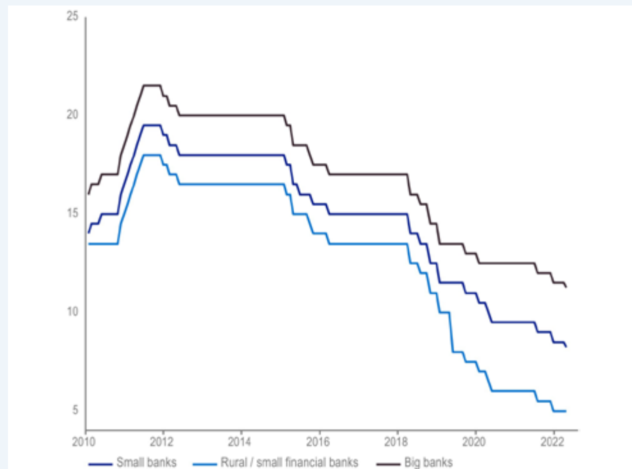


Chart Source: Refinitiv Datastream

On the macro side of things, China's manufacturing and trade heavy sectors have suffered a slowdown amid fallout of Ukraine war and new Covid-19 outbreaks and lockdowns. Factory activity slumped at the fastest pace in two years.

There is no denying that a slowdown in China is likely to have knock-on effects across the region, much of which counts the world's second-largest economy as the biggest source of trade. However, a few points worth mentioning:

- Macro metrics such as retail sales, industrial production and fixed asset investment are slowing down – but this is after a period of exceptional growth, which was never going to be sustainable.
- Most indicators are looming around their pre-covid levels – signalling strong growth followed by normalisation.
- Biggest risk to equities (over the last 6 months) has been regulation of sectors like education, banking, technology, data etc. However – this is bound to reduce investor concerns over the long term.
- China's central bank remains uber accommodative – while the West raises interest rates and tightens policy overall, China is focussed on solving its economic issues.

China has faced a slew of challenges to growth in 2021, including a power shortage, shipping delays, Covid-19 outbreaks and a crisis in the real estate sector. The central bank's rate cuts sends a signal that policy will turn accommodative if need be.

Asset Allocation spotlight
Are valuations attractive yet?

After fourteen years of focusing on the Fed, portfolio managers will now have to answer bottom-up questions again. At this point, both bond and equity valuations are low.

Equities: Bar the US, global equities are trading below their long-term averages. This is a result of an approximately 13% correction and slightly better than expected corporate earnings. US equities themselves are now near their long-term average, as prices for high-growth technology company have fallen and some, like Netflix or Facebook, have entered their more mature phase.

Bonds: Bond yields have also climbed significantly. The benchmark US 10-year Treasury bond is yielding near 3%, while global high yield bonds are yielding above 7%. In the past five years these levels have only been reached briefly in 2019 and during the initial sell-off during the Covid-19 pandemic.

However, neither asset class looks overly attractive right now, despite the recent falls.

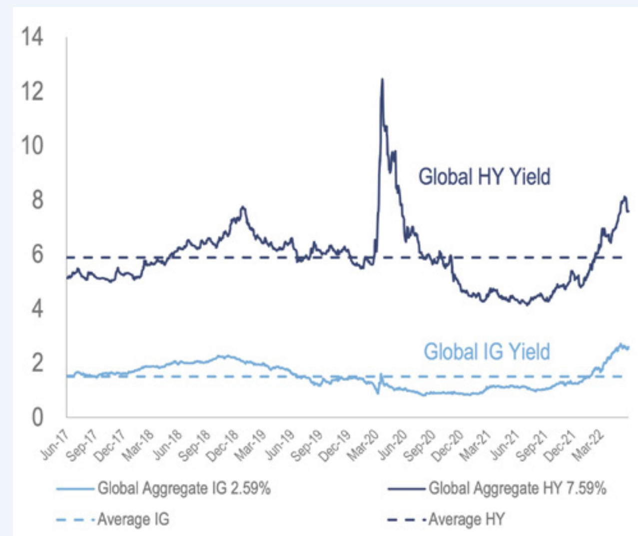
The US 10-year yield is in line with where the short-term central bank yield is projected to be in eight months time. Thus, if bonds remain at their current prices, the yield curve will remain flat or potentially invert. Meanwhile, inflation is running at close to 10%, making the asset class only slightly more desirable than cash deposits. As such we remain underweight.

Equities are generally a better hedge against an inflationary environment. However, we feel that the approach we need to take should not be top-down, since markets lack central leadership. Successful managers will be the ones who correctly identify where longer-term opportunities lie. Are Netflix, Facebook and Google valued in line with the average for US equities now mature companies, or can they still produce exceptional growth?

A post-Fed Put market means that policy, hope, memetics and momentum are giving way to increasingly important fundamental investment principles. However, it will take some time to get there. It could well be a bumpy ride and the mettle of many a portfolio manager will likely be tested.

Bond yields are higher than their five-year average

Bloomberg-Barclays Bond indices



Equity valuations have also come down

Forward earnings projected for the next 12m/5y average

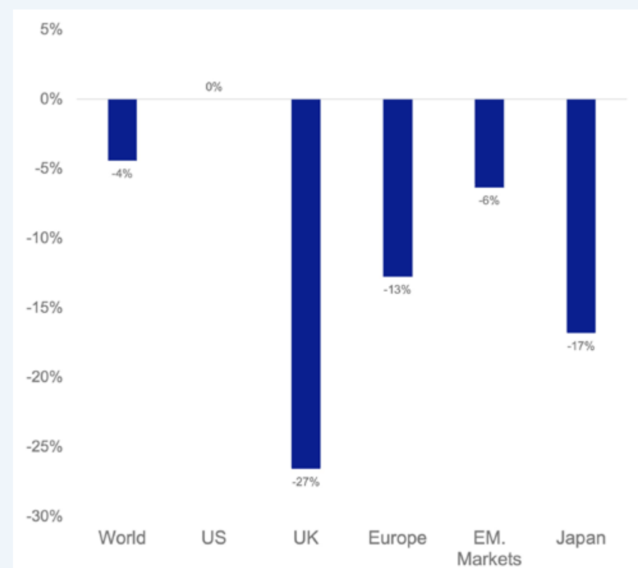


Chart Source: Refinitiv Datastream

Equity spotlight
Growth vs Value

The low growth, low inflation world of the decade post the Global Financial Crisis and, prior to Covid, was one where exciting stocks with high growth potential tended to significantly outperform stocks which traded at low multiples of earnings but were expected to grow earnings more slowly. Chief amongst these were US tech stocks, although it was a worldwide phenomenon. Funds in all regions that focused on growth stocks outperformed those that focused on value stocks.

In the year immediately following the Covid-19 outbreak this trend was further extended. After all, tech stocks that could bring products directly into your home were prioritised over traditional companies that no-one could make purchases from.

However, upon the announcement of a vaccine in November 2020, stocks that had been out of favour suddenly rallied on hopes of a re-opening economy, and this lasted until approximately the end of Q1 2021.

And then by the end of 2021 inflation then began to rear its ugly head. Whilst this has broadly resulted in poor equity performance, valuations for growth stocks have been severely impacted.

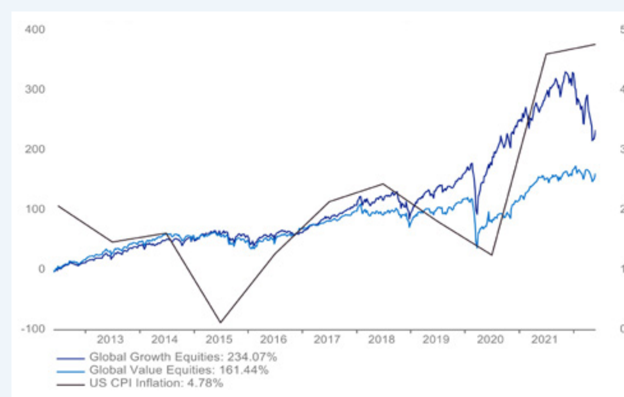
So why has the current bout of inflation been particularly bad for growth stocks? Equity valuations are based partly on interest rate levels – essentially the return if you had decided to hold your money in cash instead. If interest rates are raised to combat inflation this means that equity earnings need to perform even better to ensure sufficient compensation for the additional risk incurred. Essentially the bar is raised. Thus, if earnings expectations don't then rise in line with interest rates, then valuations will fall. This particularly affects companies who have a greater portion of expected earnings further in the future, i.e. growth stocks.

There are other, less technical arguments on why value stocks are now outperforming growth stocks:

1. Valuations on growth stocks had gotten too high and reduced confidence in markets was always gong to hit these stocks harder.
2. The outperformance in growth stocks over the past decade, which has seen the valuation gap against value stocks widen to all time highs, was always due to revert.

As inflation has spiked, value stocks have outperformed

LHS: Equity returns rebased to 100: RHS: inflation, per cent



Source: Refinitiv Datastream

In our portfolios we had been running a bias to growth stocks coming into Covid-19. In March last year we took the opportunity to add a significant amount of value exposure. In April, we added further exposure to highly stable, dividend paying stocks, which we would class as quality value.

We are very cognisant that we don't want to move too far away from growth stocks. After all, the key driver of equity returns should not be valuations but instead compounded earnings growth. When economic conditions stabilise and begin to improve, there is still a preference to pay slightly more for a company with great growth prospects, than paying slightly less for a company that needs to undergo a complete turnaround

Alternatives Spotlight
Is the Dollar about to weaken?

Rarely do we take a stance on currencies. However, one issue we cannot ignore is recent US Dollar strength. The greenback has increased in value over the last few months, mostly as a result of the hawkishness of the Federal Reserve, compared with the relatively more dovish policy of other central banks in developed economies.

However, we feel that the tide may be turning regarding central bank support for their currencies.

For one, the Federal Reserve is adopting an approach that is slightly less hawkish than that currently priced in by market participants.

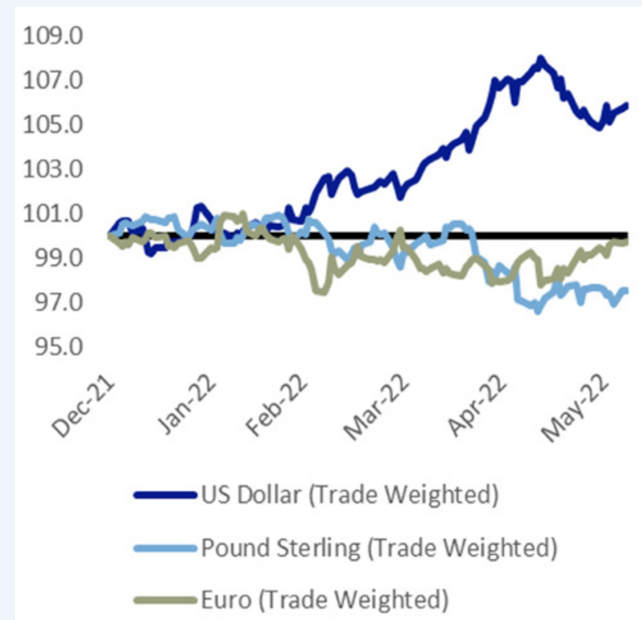
Additionally, the European Central Bank is currently more inclined to raise interest rates than it has previously been.

Meanwhile, we observe that US Dollars as a percentage of global reserves have dropped below the 60% threshold, for the first time in nearly thirty years. While this is a long-term metric, it could imply a diminished desire to hold Dollars as reserves, and therefore reduced demand for the American currency.

We feel that, on a technical basis, the US Dollar is facing significant headwinds. For the next few months, we don't think that a stronger dollar is necessarily the prevalent scenario. However, historically, the Dollar has performed strongly during recessionary period and our view is that the possibility of a recession in the US is growing significantly.

Bond yields are higher than their five-year average

Bloomberg-Barclays Bond indices



Source: Mazars calculations, Refinitiv Datastream

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