Mazars Wealth Management investment newsletter

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Foreword

The dominance of the inflationary narrative and central banks' responses of higher interest rates continued to weigh on stock markets throughout the second quarter of the year. Global equities fell a further -14%, led by US markets, and in particular sell offs in sectors that were previously deemed expensive, not least technology. The strength of the US Dollar brought some respite for UK investors with global equity returns being -8% in Sterling terms, and the price of gold increasing by +2% when converted back into Pounds. As during the first quarter, the bond market continued to fall as interest rates rose, and Gilts lost a further -6%. Time to maturity on Gilts mattered enormously with longer term holdings losing around -15% of their book value, whereas shorter term debt was largely unaffected.

Having been absent for decades, the return of inflation is forcing market analysts to learn how to respond to rising interest rates and squeezes on the real purchasing power of consumers' disposable income. For many years central banks have been able to placate the financial economy through Quantitative Easing and the maintenance of very low interest rates, but when push comes to shove and inflation becomes a very real factor, the US Federal Reserve and the Bank of England at least have made it abundantly clear that bringing inflation under control is priority number one. As interest rates rise, the notion of 'There Is No Alternative' is diluted, and the prospects for a slowing economy increase, leaving valuations on risk assets vulnerable despite the recent falls.

The hope of central bankers is that by raising rates 'quickly' now, inflation can be suppressed without choking off economic growth entirely. Markets seem to have little faith in this scenario arising, and instead are focusing on the possibilities either of inflation becoming endemic, or perhaps more likely, for the economy to fall into recession as higher debt servicing costs impact company margins and consumers are pressed by the cost of living crisis. The primary sources of current inflation may be showing signs of waning. Energy prices whilst not falling aren't continuing their rises from the Spring, whilst the pressures on global supply chains are showing signs of easing particularly as China re-opens from its latest Covid lockdowns. Though this is good news on the inflation front, it is also true that there are plenty of indications that economic growth is slowing with economists roughly evenly split on whether this will result in a global recession. Consumer confidence levels are low, and forward looking indicators for manufacturing suggest a further slowdown.

Either stubborn inflation or economic recession could cause equity markets to continue their sell off, and our analysis suggests that a significant reduction in corporate earnings is not yet priced in. That said, there are numerous factors which could help markets find a floor. China is reopening and stimulating its economy, supply chains are in better shape allowing trade to flow, and central banks could yet decide not to pursue Quantitative Tightening beyond the level already discounted by markets.

At our June meeting the Investment Committee voted to maintain our neutral position in equities, and to retain the more defensive nature of the underlying holdings. Though we recognise that the current sell off will ultimately represent a buying opportunity, we do not feel that now is that time. In bonds, where we have been very defensively positioned, we closed a significant portion of our underweight position to account for the fact that markets have already priced in a number of rate rises.

I hope you find this newsletter interesting and relevant to you, and I would very much welcome any feedback you may have. Please do feel free to get in touch with your thoughts either by phone on: **020 7063 4259**, or by email on: david.baker@mazars.co.uk.

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Economies and markets in brief

Wage inflation vs CPI

High inflation figures are causing consumer confidence to fall across the western world. What is also important from a standard of living point of view is whether wages are keeping up with inflation. What is interesting, and perhaps not perceived, is that for some time in the UK, wage growth figures have outstripped the inflation rate, a factor of the very tight labour market here. If this continues then in theory people in employment are better off despite the high inflation. However in reality there are a number of issues. Not everyone is employed, with inflation particularly hurtful to those in retirement. It is also likely that inflation can remain higher for longer than wage growth, as wage growth can only continue as long as employers are willing/able to raise wages, something which is starting to show. But even if wages could remain above inflation for a long period, this risks what central banks fear the most, a wage spiral that feeds back into greater inflation.

UK wages and prices

Twelve month percentage changes, 3 MMA

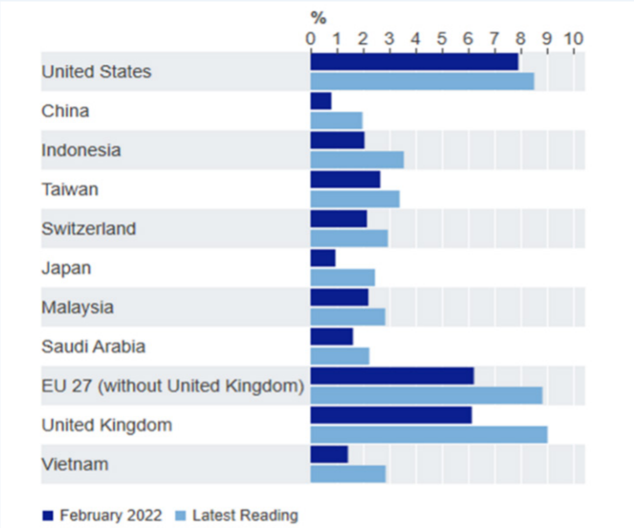
Source: Refinitiv Datastream

Where is the Asian inflation?

Although inflation has been a more persistent problem in the West than had been perhaps expected, Asian countries have generally been far less affected. There are several reasons for this divide. The first has to do with oil. Many countries are oil producers themselves where subsidised energy is the norm, while those that aren't have generally kept normal relations with Russia (think India and China) and so are purchasing discounted oil and gas. The other main reason is that many of these countries are exporters of manufactured goods to the West. While bottlenecks are preventing these goods reaching western markets, forcing up prices, these are not such a problem for domestic consumers. As a result rapid rate hikes from central banks, such as the Bank of Japan, are unlikely to be required.

Inflation is mostly a DM phenomenon

CPI inflation % YoY



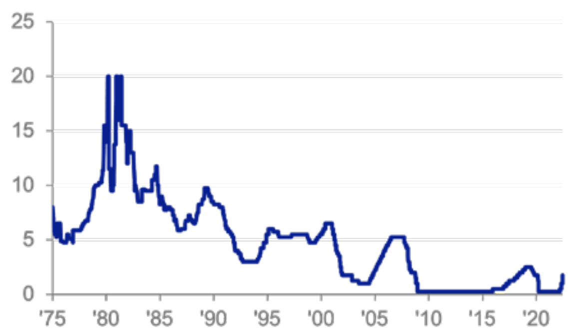
Source: Macrobond

Fed in hiking mode

What was perhaps surprising about the fact the federal Reserve raised interest rates by 75bps, the most aggressive rate hike since 1994, was that in the end nobody was really surprised. A couple of years ago this would have been inconceivable, however in the run up to the meeting in June markets started to price in the likelihood as inflation data from the US continued to surprise to the upside. The 'Dot Plot' reveals that Fed members now expect the year end interest rate to be 3.4%, up from 1.9% in March. With this figure in mind another 75bps rate hike at the next meeting is considered more likely than not.

Despite a 75bps rate hike, US interest rates remain near historic lows

US interest rates



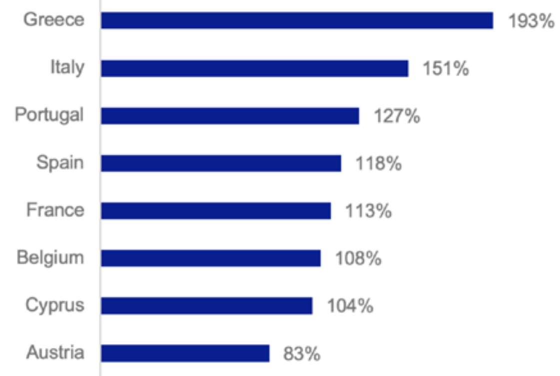
Source: Federal Reserve, Mazars Calculations

Is another eurozone crisis looming?

During the 2008 Global Financial Crisis, asset managers warned that as the world became increasingly fractious, one of the first structures to be imperilled would be the European Union. The prediction came true two years later, when the sovereign debt of countries that had increased their borrowing in prior years, such as Greece, Italy, Ireland, Portugal, and Spain, came under immense pressure in bond markets. The Euro was nearly dissolved, saved at the last minute by an impromptu promise from Mario Draghi, the Chairman of the European Central Bank (ECB), to print as much money as was required to protect the common currency. That promise staved off further attacks and remained central to the resilience of the eurozone.

EU periphery countries are still heavily indebted

Debt as a percentage of GDP, end of 2021



Source: Mazars Calculations

A decade later, steps have been taken to shore up the eurozone's defences. A few mechanisms have been created as 'lenders of the last resort', to keep countries from succumbing to a liquidity crisis. Greece has passed significant reforms and ensured that its financing is secured for the next few years. Italy and Spain have also seen major reform. However, the structural flaws of the eurozone remain. The Banking Union (in essence, a European Federal guarantee of deposits) remains far from complete. Additionally, while bond purchases by the ECB may have unified a portion of the debt, it's still primarily down to individual countries to source the money with which they can use to pay down these debts.

Many European banks are heavily exposed to non-performing loans and unemployment continues to persist in the European periphery. For a common currency to succeed over the long term, transfer payments between strong and weak member states, as well as a banking union, are essential. Until now, structural weaknesses present in the European monetary experiment have remained well-hidden behind the ECB's pledge to buy national bonds through quantitative easing.

Periphery spreads with Germany rising

10y bond spreads with Germany

Source: IMF, Mazars Calculations

However, rising inflation is now threatening the potency of this pledge; one that continues to underpin the cohesion of the eurozone. European countries, a lot of which are, by-and-large, dependent on Russian gas, are seeing prices rise at a rapid pace. This leaves the ECB with a conundrum. On the one hand, it can raise rates and drastically reduce monetary accommodation, in a bid to control inflation. If it does so, Italy and Greece, in the first instance, are left exposed. A new cycle of market attacks on the eurozone could begin. In contrast, the central bank may opt to keep rates low. In this case, the Euro will weaken versus the US Dollar (the currency in which most commodities trade), and it will be effectively importing additional inflation through currency depreciation.

As with the previous crisis, the major pressure points are expected to make themselves known over the following months. When considering where these pressures are likely to materialise, the eurozone is certainly at the top of the list.

Sustainable global equity income – In focus

We are making a change

In order to position our sustainable portfolios in stocks that tend to pay higher, more consistent dividends, we are replacing one of our global equity funds with the Sarasin Global Higher Dividend fund.

Why the change?

Sustainable or ESG funds tend to favour more growth focused parts of the market and invest in sectors such as technology due to their low environmental impact. However, as the economic outlook becomes increasingly uncertain and downside risks increase, we believe that it is appropriate to adopt a more defensive position in our sustainable portfolios. Global equity income funds target financially robust, quality companies that can afford to pay dividends on a consistent basis and provide strong dividend growth.

The Sarasin Global Higher Dividend fund is run by Neil Denman and deputy fund manager Alex Hunter. They are supported by a wider team of both core investment and ESG analysts at Sarasin. The fund adopts a multi thematic framework to identify long term sustainable growth trends, while looking for high-quality companies that the team believe will deliver on this growth potential. In particular, those that can deliver sustainable growth of revenue and margins over the long term. ESG factors are fully integrated in their investment analysis, and they seek companies with positive or improving ESG credentials.

What is the impact?

The Sarasin Global Higher Dividend fund will replace the WHEB Sustainability fund in our Sustainable Balanced, Sustainable Capital Growth and Sustainable Adventurous models.

Sarasin Global Higher Dividend has been resilient over the past year

Total returns, Sterling