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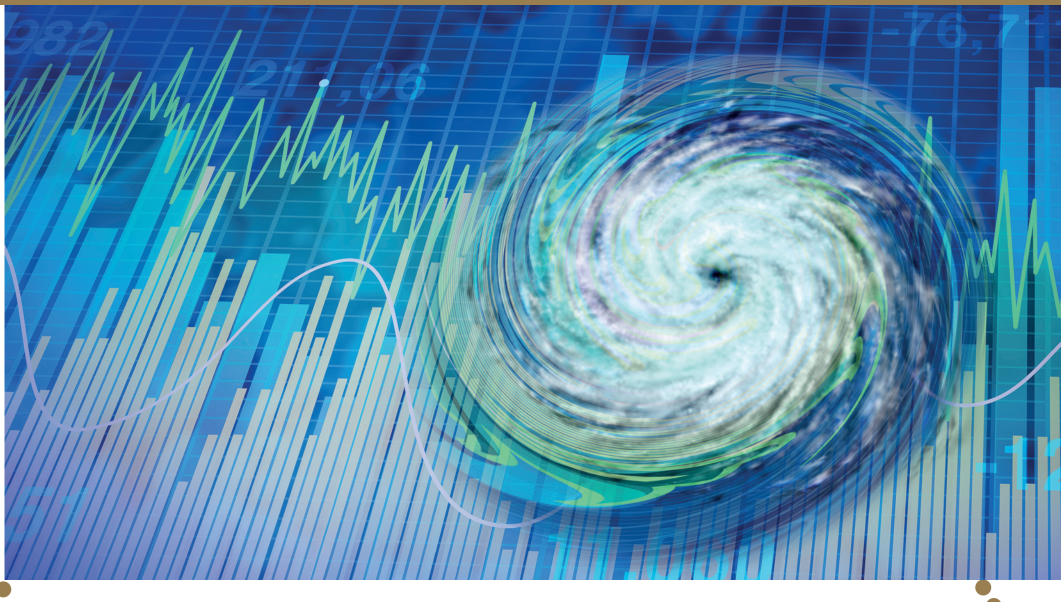
Market Environment

Q2 2022



Market Environment

The second quarter of 2022 has been one to endure rather than enjoy for many investors. High inflation, the Russia-Ukraine war and rising interest rates pushed global equities into negative territory. Technology proved a bellwether in terms of equity performance. In April the tech-heavy Nasdaq 100 Index experienced its biggest monthly fall since 2008. Information technology stocks were among the biggest losers of the quarter.

Equity market performance continued to disappoint in May and June as jittery investors worried that monetary tightening could push major economies into recession. Better-than-expected US inflation news briefly saw stocks rebound later in the month, only to fall back sharply again in June as inflation worries re-emerged. The Ukraine situation weighed heavily on sentiment in the UK and Europe. If there was a bright spot it was China, where stocks rose after a loosening of Covid-19 lockdown restrictions. Asia Pacific (excluding Japan) outperformed the global average, although still posted a negative return.

Stubbornly high inflation was the story of the quarter, and the response from central banks left investors with few places to hide. The Bank of England raised rates twice over the period to reach 1.25%. The US Federal Reserve (Fed) also increased rates twice, by 50 basis points (bps) in May and 75bps in June, the largest hike since 1994 (it has since hiked them by the same amount again). The European Central Bank (ECB) kept rates unchanged in the second quarter but imposed a larger than expected 50bps rise in July.

Annual inflation in the US fell to 8.3% in April, but then rose by 8.6% in May and 9.1% in June. The global bond market dropped 8.3% in the three months to 30th June, its worst quarter on record. The bond market was another victim of rising interest rates.

Performance

Predictably (given the above) equity markets delivered negative returns over the quarter. Equities in the UK, US and Europe suffered most, testing the nerve of investors.

Markets faced another challenge during the quarter, with bonds and equities both in the doldrums. That meant many diversification strategies proved less effective as a hedge against inflation. Or to put it another way, safe havens were hard to find. Defensive assets also suffered. Sterling and Global Credit have been negative to performance, for example, particularly in lower risk portfolios.

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The silver lining here is that the funds we expect to do well in this type of environment have done so. Invesco European and JO Hambro UK Dynamic in particular have performed well relative to their indexes, thanks to their more value biassed style.

On the other hand, the most challenged funds - in terms of performance versus their own market index - have been Abrdn's Global mid cap, UK and Emerging Markets Smaller Companies Funds, and Blackrock European Dynamic.

The Abrdn Global mid cap and UK smallcap funds take five factors into account: Price Momentum, Value, Growth, Earnings Momentum and Quality. Earnings Momentum is double weighted, but there is also strong consideration of Quality. This has prevented these funds from buying into sectors with the most recent earnings momentum – and energy in particular. That has naturally harmed returns.

Smallcap suffered in the UK in particular, where energy is a much bigger part of the large cap index. The EM smallcap fund was impacted by a long held (and high conviction) overweight to technology. Tech stocks suffered as investors sold 'growth' assets.

For the Blackrock European Dynamic fund, Giles Rothbarth aims to have a flexible investment style but will generally lean towards a Growth bias. Quality growth has been particularly painful in the current market – names like ASML and LVMH are big positions in the fund and have fallen dramatically. But negative returns from the fund over this short period have been largely offset by the more value-style Invesco European Fund.

Market Outlook

The Russia-Ukraine conflict is likely to dominate the news in the short term, with the conflict adding to the challenging macroeconomic backdrop for global equities. It also adds to pressure on energy and commodity prices. Markets will remain volatile, with Covid-19 variants, rising inflation, higher rates and the slowdown in China weighing on sentiment. That said, many of the risk factors prevalent throughout 2021 are reducing, with global vaccination rates rising and the direction of Chinese policy becoming clearer.

Within fixed income, investor attention will likely focus on the effectiveness of central bank measures to control inflation, especially with the Russia-Ukraine conflict exacerbating rising consumer prices in the short term. Hawkish comments from the US Federal Reserve have led to expectations of further substantial rate hikes in 2022. Meanwhile, the European Central Bank has recently raised rates for the first time since 2011, amid sustained high inflation in the Eurozone.

Important information

Past performance is not a guide to future results. The value of investments, and the income from them, can go down as well as up and you may get back less than the amount invested.

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