July 4th, 2022

As Bad as It Felt

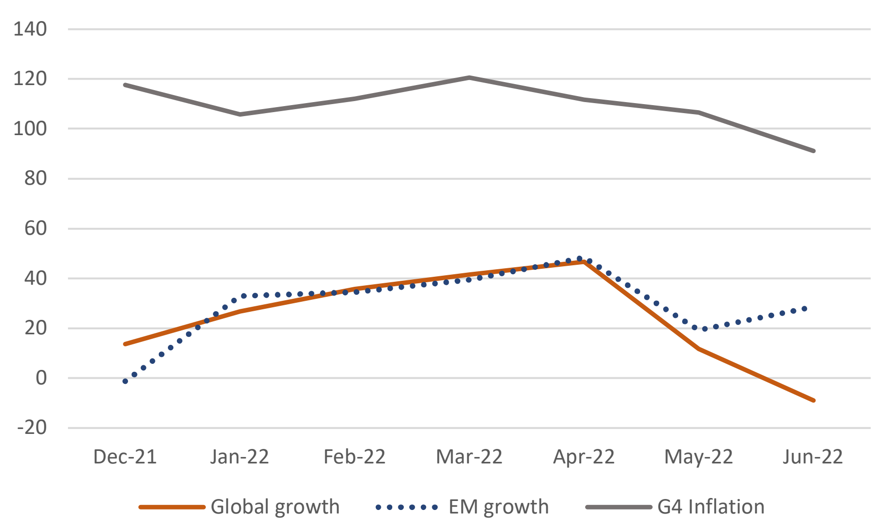
- **Asset markets have a poor quarter**
- **Equity losses focussed on tech and economic sensitive sectors**
- **Investment grade bonds maintain the momentum of losses seen in Q1**
- **High yield and Emerging market debt performs likely equity with heavy losses**
- **Investors move into the third quarter fearing recession and hoping that central bankers will go easy.**

The end of last week drew curtains on what was a tumultuous quarter of negative returns for most asset classes. We continue to believe that the world is facing a structural shift in risks. It is no longer that case that a well-behaved inflation will allow central banks to provide virtually fee liquidity to pump up asset prices. The market, despite the recent poor returns, is pricing in a cyclical dip with a recovery in 2023. The jury is out.

First Half Economic Backdrop

In the first half the key change in sentiment amongst economists and central bankers has been the marked deterioration in their outlook for inflation. As Chart 1 shows, inflation has continued to significantly surprise to the upside through the first half of 2022. Interestingly though forecasters have been late in pressing the warning button about their outlook for growth. In fact, growth surprises have only just recently started turning negative. Nevertheless, as the quarter ended, markets heaved a sigh of relief as authorities in China, encouraged by the recent spate of upbeat economic data, considered more widespread support for the economy. The stringent lockdowns in major cities such as Beijing and Shanghai that appear to be abating, boosting sentiment, and helping set the stage for a much-anticipated growth revival.

Chart 1: Economic surprise indices for inflation and growth

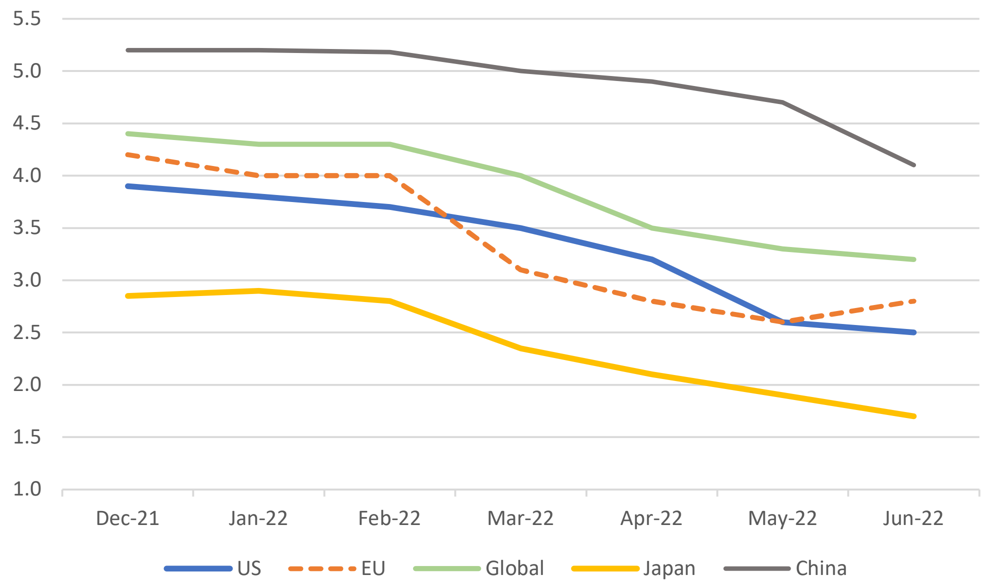


Source: Bloomberg

Note: Economic surprise indices show the degree to which economic data comes in above or below expectations.

The second quarter saw a steady pattern of downgrades to global growth forecasts by most of the major forecast groups including the IMF and World Bank.

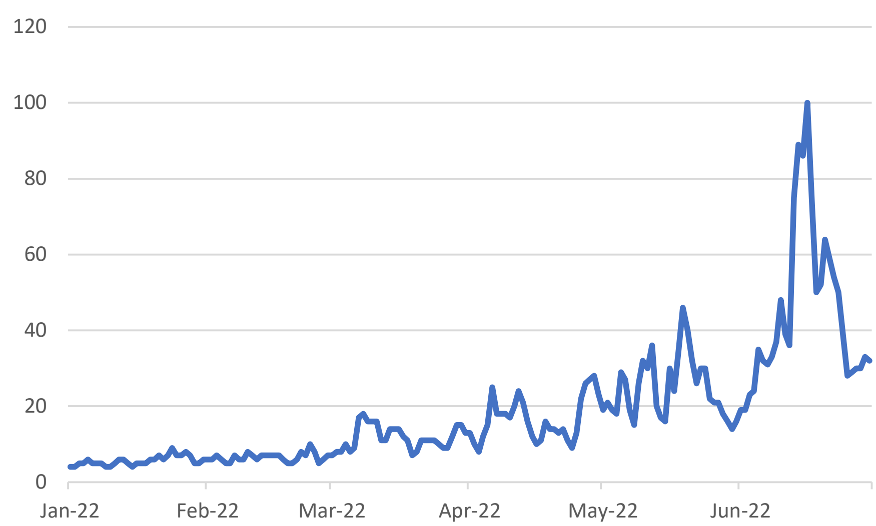
Chart 2: Consensus growth forecasts for 2022 have only recently been cut back markedly
Year on year %



Source: Bloomberg

The marked difference between the second and the first quarter was the substantial increase in the number of people concerned about the risk of a recession. Indeed, Google searches for the term recession increased to a fever pitch in the second half of June (Chart 3). And the ‘R’ word has figured more prominently in central banks’ statements recently.

Chart 3: Google searches for the term recession



Source: Google

With central bankers increasingly turning hawkish in their monetary policy stance to rein in inflation, the fears of a potential US or global recession have grown recently. Virtually every major central bank has increased interest rates or signalled that they may markedly increase policy rates in the coming months. **The futures market has gone from implying a year-end Fed funds rate of 0.8% at the start of the year to building in a US policy rate of 3.3% currently**.

Bonds – Beaten up but hoping for the best

Unlike equities, bonds witnessed a fairly consistent sell-off throughout the two first quarters of the year. The Global Aggregate index saw sell-offs of almost equal size in both quarters. Global high yield that tends to have a high correlation with equities had outsize losses in the second quarter.

At 2.88%, the US 10-year government bond yield ended the quarter just below 3%, a long way below the 3.44% peak in yields seen in mid-June. Currently, the market is betting on central banks acting in moderation on interest policy lest a too high policy rate plunges their respective economies into recession.

Much will depend on the path that inflation takes. We saw good buying when the US 10-year bond yield approached 3.5%. Investors took the bet that long term inflation would be at worst around the long-term Fed target for inflation of 2.0%. Hence, 10-year government bond yields around 3.5% implying a 1.5% real yield became attractive.

Table 1: Global Bond returns for the first half of 2022

Total returns	1H	Q2
Global Aggregate	-9.1%	-4.3%
US Aggregate	-10.3%	-4.7%
Global High Yield	-15.2%	-10.6%
China Aggregate	-3.1%	-4.3%
	bps change	
US 10-year bond yield	150	68
US 2-year bond yield	144	62

Equities – a bad quarter

Fear has truly gripped the equity markets with losses accelerating significantly in the just-concluded quarter. Global equities returned -14.3% in the quarter, accounting for almost 80% of the total losses year-to-date. In USD terms losses have been quite similar across the world save for the UK where the heavy weighting of oil stocks saved the market from serious losses. The dollar's strength though has only exacerbated losses for dollar-based investors. The Japanese equity markets is a good case in point – in JPY terms, it was only down 5.9%, but the slump was more drastic – 20.3% – in USD terms. The UK was up 1.7% in local currency terms.

Emerging markets have performed well in the second quarter, only selling off by half the losses seen in the developed markets. However, the weakness of emerging market currencies meant that the relative performance in dollar terms was a little less convincing.

The recovery of the Chinese equity market is providing some help to the EM bloc. Asia ex Japan has performed well, helping a broad re-opening of economies and greater mobility post COVID restrictions. The key factor to look out for is currency weakness that prompts their respective central banks to tighten monetary policy more than local economic conditions would warrant. As the quarter ended, some of the smaller countries started to see a pick-up in currency volatility. This will have to be monitored.

The energy sector was the only major sector to record gains in the first half of the year, managing to shake off most of the losses seen in the broader markets. However, as the quarter ended investors got anxious that the risk of recession could lead to challenges for oil companies, irrespective of the fact that the market remains in marked short supply.

Table 2: Major Equity Markets—losses accelerated in the second quarter

Total Returns	**1H**		**Q2**	
	Local	USD	Local	USD
MSCI World	-20.5%	-18.3%	-16.2%	-14.3%
MSCI US	-21.3%	-21.3%	-16.9%	-16.9%
MSCI Europe ex UK	-11.9%	-20.8%	-8.1%	-14.5%
MSCI Japan	-5.9%	-20.3%	-4.4%	-14.6%
MSCI UK	**+1.7%**	-8.8%	-2.9%	-10.5%
MSCI Asia Ex Japan	-11.6%	-16.3%	-6.9%	-9.0%
Emerging Markets	-13.7%	-17.6%	-8.1%	-11.4%

Sectors	1H	Q2
Energy	**+24.0%**	-5.1%
Consumer Discretionary	-31.9%	-23.8%
Banks	-18.6%	-16.2%
Tech	-29.7%	-21.8%

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