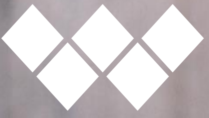

INVESTMENT OUTLOOK Q3-2022

NOWHERE TO HIDE: SOARING INFLATION, FALLING RETURNS

2022 had a first half to forget, as a rapid effort to contain inflation with rising rates has driven record-low returns from both bonds and equities. Our thoughts remain with those affected by the war in Ukraine

The first six months of 2022 has seen bonds produce their worst first half performance in over a hundred years and stocks having their worst performance since the 1970's both ending the second quarter down in the high teens. The only places that have provided any meaningful respite so far this year have been commodities and energy.

As a result, portfolios built using a mix of stocks and bonds delivered unusual performance across the board. For the last 20 years investors have enjoyed a level of positive correlation between bond yields and stock prices, meaning that in periods of distress, bonds could be relied upon to offer positive returns, offset stock losses, and cushion the overall blow. Year-to-date, bonds have not delivered capital preservation nor diversification from equity, and this has caused additional market angst.

Our monthly updates touch on the reasons why it has been such a challenging year for investors - specifically rising inflation – now at levels not seen in over forty years. The reason for this is inflation being driven all at once in a somewhat an unprecedent manner by both internal (demand) and external (supply) economic pressures. On the demand side, pent up savings and over stimulus has seen growing consumerism, while on the supply side, the horrifying war in Ukraine and rolling lockdowns in China have continued to disrupt commodity markets and already fragile supply chains. Consequently, major central banks have rapidly raised interest rates in 2022 in an effort to contain an inflationary price spiral that has put strain on many households. In the UK and the US, rates have risen from 0.25% in January to 1.75% in June and are fully expected to be in excess of 3% by the end of the year. For markets the ongoing concern remains that, given the inflation outlook, major central banks may need to raise interest rates to such a degree that the economy falls into a recessionary state. Such a backdrop is very conducive to further stock market volatility. While there are several reasons to lean towards pessimism, we are equally aware that there are still many positive indicators, such as the robust labour markets that continue to support a healthy economic environment.

FINDING A BALANCE

At times like this it is important consider looking at the whole picture and focus on taking a long-term approach. The normalisation of the ultra-low levels of interest rates that supported asset prices and economies during the pandemic was inevitable, however, the pace at which it has occurred has roiled markets. Our view is that the diversification potential from a from a blended portfolio of stocks and bonds has been restored to a degree and could provide benefits for investors in what looks like an uncertain period ahead. We still think stocks will outperform over the long-term but have selectively reduced exposure to high-risk regions such as the UK and Europe. As a result, we are broadly neutral, with selective underweights on stocks reflecting our view that corporate earnings may come under short-term pressure in a recessionary environment. Our balanced allocation to bonds, which is tilted to short duration, will mitigate against losses in this scenario, while providing decent income returns given the upward adjustment in yields in 2022.

This document has been prepared by Wealthify's Investment team and the opinions expressed here are theirs.

TOP RISKS

Inflation and Policy Uncertainty
High levels of inflation increase the risk of unanchored inflation expectations. Major central banks have revised up their interest rates forecasts to combat this. Whether they can fulfil all that is expected is unclear.

Global Recession
Tightening monetary and fiscal conditions, with ever increasing price pressures for consumers, increase the concern of a global economic contraction.

Russia Ukraine Crisis
With no end in sight, the threat of escalations remains as the war squeezes commodity and energy markets.

New covid-19 variants are vaccine resistant.
Stock markets remain highly sensitive to rates of infection. A continued successful and evidently efficient vaccine roll out is key to support further gains

China Risks
Regulatory crackdowns on the private sector, property market troubles, widespread strict covid-zero lockdowns as well relations with the US remain an ongoing threat to global economy.

Post-Brexit UK
The UK's evolving trade relationships still weigh on investor sentiment.

INVESTMENT TYPE	OUTLOOK	RATIONALE
SHARES		
UK	+	International investor sentiment towards the UK has improved, spurred on by a successful vaccine roll out and economic reopening. But UK shares face a gloomy economic outlook and lingering negativity driven by Brexit, which has seen UK investors seek offshore investments. This is surprising given UK shares have a heavy weighting to overseas earnings, at around 70% for FTSE-100 and around 50% for FTSE-250. While the outlook has deteriorated, UK shares remain both comparatively and historically cheap.
US	+	US policy makers delivered a comparatively stronger fiscal and monetary response than expected, supporting the economic recovery from covid-19. This led to surging demand which combined with disruptions in supply chains and commodity markets has led to soaring inflation. The US Fed has moved aggressively to contain and anchor inflation which has raised recession risks, and in turn, near-term downside risks to corporate earnings. US stock valuations have moderated drastically and given the greater economic resilience we are positive on the long-term outlook for US shares relative to other markets.
Europe ex UK	-	The fallout from Russia restricting energy supplies to the region is live – The EU depends on Russia for a quarter of all its energy needs – and will likely have a negative impact on the regions GDP. Soaring inflation, driven largely by energy commodity inflation, has stirred the European Central Bank (ECB) with the bank poised to bring the Eurozone out of negative rates - a monetary position it has held since 2014. This is also likely to affect economic growth longer-term, as the region is a major exporter to China, it remains at risk to further US-China trade tensions, and a possible China slowdown in the short-term.
Japan	=	The Bank of Japan (BOJ) is one of the few central banks still following easy monetary policy. Imported inflation on the energy and commodity front as well as covid-19 lockdowns have seen pedestrian demand. Easy monetary policy to support the economy has led to significant yen weakness in recent times. The yen has weakened against the US dollar to levels not seen since 1998 as US interest rates have increased rapidly. A loosening of strict covid border restrictions would bring a much-needed boost to the economy. With valuations currently low and the yen at these levels, Japanese equities offer an interesting diversification option across developed markets.
Emerging Markets	+	Emerging markets (EM) monetary tightening cycle is advanced, so higher U.S. rates are less of a constraint than has been the case in the past. EM valuations are at depressed levels, and there is significant valuation gap between developed markets. China, a key component of this grouping, continues to have scope to focus policy on supporting growth. It's worth watching for a revival in China's credit cycle, increases in infrastructure spending, and a rebound in the housing sector where peak stress is passing as China moves away from stringent zero-Covid mobility restrictions. We remain vigilant to risks in China, but overall are constructive on the long-term outlook for EM.
Asia Pacific ex Japan	+	The region is geographically and economically removed from the conflict in Europe, whilst inflation is less of an issue. It's likely to be a benefactor from an improving China story. Risks related to China, which include domestic (property market troubles and regulatory crackdowns) and foreign (US-China relations) remain noteworthy near-term risks, but we remain constructive on the region's long-term prospects.
FIXED INCOME		
Government Bonds		
UK	=	UK government bonds (gilts) have come under increasing pressure after a long period of supportive monetary conditions. The cycle appears to have taken a sharp turn in 2022 with soaring inflation taking hold. There remains considerable uncertainty, and market volatility, of how far the Bank of England will go in terms of rate rises to combat inflation given the negative economic outlook. As a result, we have maintained our balanced exposure to the interest rate sensitive assets with a longer-term bias toward short duration assets.
US	=	Investors have become increasingly concerned about rampant inflation and how the Fed will engineer anchored inflation while avoiding a recession. Fed officials have made it clear that inflation is their core focus, with aggressive rate hikes planned and delivered upon. This has led to sharply rising yields and volatility, reflecting the uncertainty of a soft landing. Despite near-term uncertainty, we took the opportunity to increase our allocation to duration at significantly higher yields to provide greater portfolio diversification capital protection.
Europe ex UK	-	Eurozone government bonds remain at risk due to a long period of overvaluation and continued distortion by Quantitative Easing. Soaring inflation is increasingly forcing the hand of the ECB to consider rate hikes which will negatively impact the asset class. Concern still surrounds the long-term debt sustainability of the periphery compared to the core.
Japan	-	Japanese bonds offer little income and remain severely distorted due to the BoJ's "Yield Curve Control" program. While the BoJ might alter this program, there's little expectation for significant medium-term change.
Emerging Markets	=	EM government bonds offer a strong yield premium compared to Developed Markets, coming at the cost of higher volatility. Similarly, their currencies appear undervalued, offering an additional supportive factor. Comparisons of the current situation with the 1998 EM crash are overdone, with external debt, Foreign Exchange reserves, and overall fiscal prudence significantly firmer.
Corporate Credit		
UK	=	The planned gradual unwinding of the BoE's expanded bond buying program announced in May will see declining support for corporate credit. This combined with near-term economic headwinds have seen spreads widen. We are reluctant to increase our position at this stage, given the uncertainty of the economic outlook.
US	=	Quantitative tightening and rising rates have seen spreads expand as the economic outlook impacts expectations for corporate earnings driving investors to seek higher yields to take on corporate risk. As with other regions, we prefer Investment Grade over High Yield, which we think will remain mostly insulated.
Europe ex UK	-	The ECB's planned quantitative tightening and interest rate hikes against a worsening economic backdrop make these bonds uncompelling, particularly compared to shares.
Japan	-	Like Japanese government bonds, Japanese corporate bond prices have been distorted by QE. We prefer share exposure, especially while Abenomics continues.
Alternatives & Thematics		
Environmental	+	Companies focused on reducing their environmental impact often have a competitive advantage due to greater resource efficiency, leading to lower costs. They may also experience lower downside risks due to more robust corporate governance, and this can support greater diversification benefits.
Global Real Estate	=	Covid-19 placed real estate under pressure, we now see this strain easing. The retail sector's woes are well documented, but a sectorally and regionally diverse portfolio remains fundamentally appealing given constrained supply and still low-interest real rates which also provide a buffer.