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Q2 2022: Quarterly Review

07 July 2022

At the end of the second quarter of the year, Guy Foster, our Chief Strategist, looks back at the events that have shaped the markets over the past three months.

2022 has so far proven to be a particularly challenging year for investors. The most common threat to equity values is a recession. As the risk increases, investors anticipate falling profits, but they can usually balance that with the comforting expectation of a cut in interest rates by central banks.

Lower interest rates aim to get consumers spending, which helps companies generate higher profits in the future. Lower interest rates also make these profits more valuable to investors. This is because the interest an investor would receive on their funds is what they give up when they choose to buy an equity investment. The lower that rate is, the less they are forfeiting and so the more valuable the investment is to them.

So far in 2022, central banks have not been defending against a recession but have instead been fighting against inflation. This involves raising interest rates, meaning central banks are no longer the ally of investors.

Inflation targeting

At the beginning of this year, economists forecast that US interest rates would rise to 1.5% in 2023. Interest rates have already surpassed that level and are now expected to rise to 3.5%. The Federal Reserve, in its eagerness to tame the beast of inflation, raised rates by three quarters of a percentage point in a single month for the first time since 1994 and it is expected to do so again.

This steep reappraisal of interest rate expectations was bad news for virtually all long-term investments. It caused the prices of both equities and bonds to fall at the beginning of 2022 and resulted in many equity markets around the world entering bear market territory during June (defined as a 20% decline from the market peak).

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The sharp change in the interest rate trajectory reflects the rapid increase in inflation. For the last 12 months it has felt as if circumstances have conspired to drive prices higher. Poor weather depleted renewable energy production and China cut its coal production to address pollution before the winter Olympics. However, a fundamental policy misstep taken in synchrony by central banks around the world was the main driver of rising prices.

What they diagnosed as a deflationary impact from the Covid-containing lockdowns turned out to be quite inflationary as consumers spent on new goods that locked down companies were unable to supply. That made the record breaking fiscal and monetary stimulus painfully inappropriate.

War: what is it good for?

Piling fuel onto the inflationary fire was Russia’s invasion of Ukraine, which threatened shortages of a wide range of commodities – most notably, oil, gas and wheat.

When Russia invaded Ukraine, the oil price initially soared to a level which could not be maintained. Over the second quarter of 2022, though, it continued to rise and was quickly passed through into higher prices, most notably for petrol and diesel but a wide range of other products as well. Sanctions have limited the revenue that Russia makes from oil, with Russian crude trading at a $30 discount to more universally acceptable oil. However, the general rise in energy prices has meant that even at this discount oil remains a lucrative business for Russia. The country has exploited its position as the monopoly supplier of pipeline gas to Eastern Europe to boost gas revenues and threaten shortages of supply in order to undermine the coordinated Western sanction response.

Negative energy

In the UK, the quarter began with a scheduled change to the domestic fuel price cap. This saw energy prices increase by £700 for the typical household, but during the quarter forecasters began speculating about what kind of further increase could be expected in October, when the cap is next revised. This caused the Bank of England to begin forecasting double-digit inflation, and the government to mobilise a package of measures to soften the impact.

Where's my stuff?

High oil prices contributed to sharp increases in airfares, which are very sensitive to fuel costs. Inflation in this category was particularly high because last year Covid was still keeping airfares very low. Hotel rooms also saw steep increases in prices as opportunities to travel re-emerged. Vehicle prices saw particularly sharp rises due to shortages of semiconductors that form an integral part of modern cars.

Many of these challenges reflect the abruptness with which demand and supply shifted in the wake of the pandemic. Much of the spending that would normally have been directed at services was redirected towards goods, creating a surge in demand that caught both manufacturers and shippers by surprise.

Bad medicine

As 2022 continues, shortages of some goods remain acute, while others are showing signs of excess. It will take some time for the patterns of consumption to return to normal. Running a business under such wildly fluctuating conditions proved challenging. Running an economy proved more so.

While central banks cut interest rates and printed money to support demand, finance ministers spent heavily on measures to fight Covid, protect furloughed or laid-off workers and keep consumers spending. Some of this spending provided vital support, but a lot of it stoked the inflationary fire. At the time, it would have been hard to imagine a labour shortage in 2022, but an acute one exists and provides another compelling rationale for central bankers to slow the economy with higher interest rates.

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There was a great focus on China as the country attempted to take a different approach to the management of economic and health challenges.

The Chinese domestic market had been severely wounded by president Xi Jinping's focus on how companies can fulfil the goals of the Chinese Communist Party, dubbed "common prosperity", rather than the profits they can generate for their shareholders. That culminated in a series of regulatory interventions to the detriment of shareholders.

The authorities were also keen to keep the property sector in check. Property has been an important driver of growth for many years but has built up leverage and questionable assets in doing so. Xi, as a self-styled economic conservative, was keen to rein in the sector, a process that led to some losses. But these concerns were beginning to ebb and the biggest anxiety related instead to China's latest wave of coronavirus.

In accordance with the Chinese policy of not tolerating any Covid cases, harsh lockdowns were enforced which slowed economic activity to a crawl. These harsh but effective measures were being relaxed towards the end of the quarter, providing Chinese stocks with an opportunity to escape from multiple restrictive measures.

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Is inflation peaking?

The second quarter of 2022 ends with the global economy potentially at another inflexion point. More interest rate increases are expected, but the debate has begun about whether those that have been announced so far may already be dousing the inflationary flames. If that were true, then it would reduce the headwind posed by central bank interest rate policy, turning a headwind into a tailwind for investments.

Generally, economic activity was slowing as the quarter ended. The red-hot US housing market looked to be cooling as high prices and mortgage rates deterred new buyers. Manufacturers saw their new orders reduce as supply chain pressures began to ease. Few will be under any illusions that inflation is going to quickly return to target, and the greatest unknown relates to factors affected by the machinations of Russia's president Vladimir Putin.

Many of these issues are what Donald Rumsfeld, the former US secretary of defence, described as "known unknowns", in contrast with threats that cannot yet be foreseen. Higher interest rates have already depressed the values of bonds, but their returns are fixed and so a lower return to date simply means a higher return in the future. Equities don't offer the same rigid returns as bonds, but lower prices generally offer a better future return potential than higher prices do. These longer-term investments are already reflecting interest rate moves, which have not yet occurred and may never happen.

Interest rates will continue to rise as this new quarter begins and the market currently expects them to keep rising all year, most likely peaking in early 2023. There is considerable uncertainty in the interest rate trajectory, but the outlook for the market is far brighter when it is already anticipating bad news.

> "Successful investing is anticipating the anticipations of others."
>
> British economist John Maynard Keynes

Since writing this review, prime minister Boris Johnson has announced he will stand down as leader of the Conservative Party. Although this Westminster event may seem momentous, it has very little impact in the financial markets.

The prime minister's departure was very much anticipated. Furthermore, it is not obviously going to lead to a dramatic change in policy. The most one could say is that a new Conservative prime minister would potentially have a more fiscally conservative approach than the outgoing one, but we don't know to what extent.

First, there needs to be a Conservative leadership contest which will take several weeks. Once a new prime minister is appointed, they would usually want to seek a new mandate through a snap election, but it is far from a foregone conclusion that they will do so. The Conservatives have suffered in the polls recently and would want to give themselves the best chance of winning before calling an election.

Globally operating companies will be largely completely immune to this news. For more domestically focused companies, it's not clear whether there will be any material impact. Movements in the pound have been marginal and UK government bonds are outperforming those in other European states, but gas supplies and the war in Ukraine remain the most critical determinants of relative European bond performance.

Guy Foster, Chief Strategist

Guy leads Brewin Dolphin's Investment Solutions team working to align our investment capabilities with the needs of clients. He also provides recommendations on tactical investment strategy to our investment managers and strategic recommendations to the group's Asset Allocation Committee. Guy has a Masters in Finance from London Business School. He is also a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. He frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.

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