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Market Pulse

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PUTIN'S STRANGLEHOLD ON EUROPE

Lenny McLoughlin

Chief Investment Strategist, Irish Life Investment Managers Limited (ILIM)

Despite the July equity rally continuing through the first half of the month, equities and bonds fell in August. Equities initially benefited from speculation over a possible policy pivot by the US Federal Reserve (Fed). A better-than-expected earnings reporting season and signs of a more resilient US economy also supported stocks in the early part of the month. The rally, however, faded, following the July Fed policy meeting minutes and Chair Jerome Powell's comments at the Jackson Hole Economic Symposium. It was suggested that the Fed will continue to aggressively raise interest rates until it is convinced inflation has been tamed and is moving back towards its 2% target. In Europe, the ongoing surge in gas prices and new record highs in inflation led several European Central Bank (ECB) council members to suggest that further tightening of monetary policy is warranted; this caused German 10-year yields to register their largest monthly rise since 1990. The euro weakened further and temporarily fell below parity against the US dollar on expectations of tighter US monetary policy and increasing concerns over the European growth outlook.

Inflation

US inflation surprised to the downside for the first time in many months with the headline reading flat month-on-month (m/m) while falling to 8.5% year-on-year (y/y) from 9.1%. This lower inflation reading contributed to the more dovish sentiment around Fed policy earlier in August.

Eurozone inflation surprised to the upside and reached a new all-time high at 9.1% y/y, spurred by higher gas, electricity and food prices. Given the recent increase in gas prices, which surged to four times their mid-June levels during the month, eurozone inflation is expected to rise to double digits in the coming months. The EU announced that it is considering capping electricity prices across the region and will try to break the link between gas and electricity prices; it will reveal details of its proposals on 9 September. These measures could reduce upward pressure on headline inflation towards year-end.

In the UK, inflation also came in higher than expected at 10.1% y/y, with some forecasters suggesting it will reach 18% in early 2023 as utility prices are set to rise further in response to the most recent rise in energy prices.

Central bank policy

The Fed minutes for the July policy meeting pushed back against investors' expectations of a possible policy pivot. The minutes highlighted that it was essential to adopt an ongoing restrictive monetary policy stance to contain inflation. At Jackson Hole, Chair Powell doubled down on the more hawkish guidance, noting that the longer inflation remains high, the greater the risk is of it becoming more entrenched. He also noted that some economic pain among consumers and businesses was likely from the tighter monetary policy, with below-trend growth expected.

The ECB's July policy meeting minutes highlighted the upside risks to inflation and suggested these might not necessarily diminish in the event of a recession. ECB members suggested a 75 basis point (bps) interest rate rise might be appropriate at the upcoming September policy meeting, with further large increases still warranted before year-end.

The Bank of England (BoE) raised interest rates by 50bps to 1.75%, the largest increase since 1995. Despite forecasting five consecutive quarters of negative GDP growth, the Bank still guided to additional rate hikes and said it will continue to act forcefully if required. This seems likely as some forecasters predicted UK inflation would rise to 18% in early 2023. The BoE also suggested that it would consider selling gilts from its balance sheet from September onwards.

Macroeconomic data

The US stood out among the major regions as the labour market remained robust, with stronger-than-expected non-farm payrolls rising 528,000 while core retail sales, durable goods orders and ISM sentiment surveys improved during the month. Consumer confidence also rose from recent lows as inflation showed signs of peaking, with consumer sentiment also rising slightly across the eurozone.

However, the flash composite PMI for developed markets fell further into contractionary territory, with services being particularly weak, especially in the US. Other European business sentiment surveys such as ZEW and IFO readings continued to weaken.

Chinese lending data, industrial production and retail sales all disappointed as the Chinese economy faced headwinds from new restrictions as Covid-19 cases rose, while there were power outages across several regions given severe drought conditions. Asian industrial production and trade releases were soft.

MARKET ROUND-UP

Equities

The MSCI AC World equity index fell -2.9% (-2.3% in euros). Emerging market (EM) equities outperformed, rising 1.2% (1.9% in euros) as the Chinese market was supported by increased stimulus from the authorities. Japan also outperformed, rising 1.1% (-1.2% in euros), benefiting from the weaker yen and improving economic data as the economy reopened after recent Covid-19 restrictions. European equities underperformed, falling -4.7% (-5.1% in euros) as concerns increased over the economic outlook given the continued deterioration in economic data and the ongoing surge in gas prices. The US also lagged, falling -3.9% (-2.6% in euros) on the back of more hawkish Fed commentary and increased expectations regarding the level of upcoming rate rises.

Bonds

The Eurozone >5-year bond index fell -7.0% as yields, which move inversely to price, rose with ECB commentary suggesting a faster and larger scale of rate rises was necessary to combat high inflation. The monthly rise in the German 10-year yield of 72bps to 1.54% was the largest since 1990. Italian and Spanish 10-year spreads against Germany widened on expectations of more aggressive policy tightening by the ECB and uncertainty ahead of the Italian general election on 25 September. By month-end, Italian spreads had risen to 234bps while Spanish spreads rose to 120bps. European investment grade corporate bonds fell -4.3% as yields rose 94bps to 3.28%, while spreads increased 14bps to 196bps. High yield corporate bonds fell -2.3% as yields rose 60bps to 7.42%, while spreads were almost unchanged at 444bps. EM local debt rose 1.1% as strength in EM currencies against the euro offset a modest rise in yields. EM hard currency debt fell -1.4% as yields rose, pulled higher by the rise in global and US bond yields on the back of more hawkish central bank commentary.

Currencies and commodities

The euro fell -1.6% against the dollar to 1.0053 as risks to the Eurozone economy were heightened by a surge in gas prices and ongoing weakness in economic data. More aggressive rhetoric from the Fed and changing expectations regarding US rate hikes also supported the US dollar. Commodities fell -2.7% (-1.3% in euros). Brent oil fell -12.3% on increasing concerns around the global growth backdrop. Improving prospects for a US/Iran nuclear deal, which would allow Iranian oil back on to the global market, also contributed to the fall in oil. European gas rose 21.4%, though it had been up as much as 76%. This was due to Russian supplies to Europe remaining well below normal and Russia announcing that supplies via the Nord Stream 1 pipeline would be stopped for three days due to maintenance, raising fears over future supply levels. Gazprom also announced that it was suspending gas supplies to the French utility, Engie, due to alleged non-payment. Gold fell -2.8% due to the stronger US dollar and higher US real yields.

CHART OF THE MONTH

Global Equities

Source: ILIM, Bloomberg. Data is accurate as at 1 September 2022.

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	MTD Return (%)	YTD Return (%)	2021 Return (%)
MSCI Ireland	3.3	-20.4	17.1
MSCI United Kingdom	-4.3	0.9	27.5
MSCI Europe ex UK	-5.1	-14.8	25.4
MSCI North America	-2.6	-6.0	36.6
MSCI Japan	-1.2	-6.9	9.8
MSCI EM (Emerging Markets)	1.9	-6.4	5.2
MSCI AC World	-2.3	-6.7	28.1
10-Year Yields	**Yield Last Month (%)**	**2021 Yield (%)**	**2020 Yield (%)**
US	3.19	1.51	0.91
Germany	1.54	-0.18	-0.57
UK	2.80	0.97	0.20
Japan	0.23	0.07	0.02
Ireland	2.19	0.24	-0.30
Italy	3.88	1.17	0.54
Greece	4.11	1.34	0.63
Portugal	2.63	0.47	0.03
Spain	2.74	0.57	0.05
FX Rates	**End last month**	**2021 Rates**	**2020 Rates**
U.S. Dollar per Euro	1.01	1.14	1.22
British Pounds per Euro	0.86	0.84	0.90
U.S. Dollar per British Pounds	1.16	1.35	1.37
Commodities (USD)	**MTD Return (%)**	**YTD Return (%)**	**2021 Return (%)**
Oil (WTI)	-9.2	19.1	55.0
Gold (Oz)	-2.8	-6.2	-3.4
S&P Goldman Sachs Commodity Index	-2.7	32.1	40.4

Source: ILIM, Bloomberg. Data is accurate as at 1 September 2022.

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THE ILIM VIEW – LOOKING AHEAD

The outlook for equity markets over the next 12 months is dependent on several factors including central bank policy, growth, inflation (both expected and realised) and the evolution of the Russia/Ukraine crisis.

Equities have declined year-to-date (YTD) as central banks have tightened policy, bond yields have risen and growth forecasts have fallen.

After these falls, equities now look attractive on an absolute valuation basis trading on a 12-month forward price-to-earnings (P/E) multiple of 14.4x against a long-term average of 16.0x.

If consensus economic and earnings forecasts prove to be correct and we are just in a mid-cycle slowdown, there is double digit upside in equity markets on a one-year view. A moderation in inflation, with no additional policy tightening beyond what is currently discounted in markets, would also be supportive.

However, equities continue to face several headwinds. Due to the persistence of high inflation, central banks continue to tighten policy and withdraw policy accommodation, which has been supportive of equity markets in recent years. Given the significant rise in bond yields, equities are no longer cheap on a relative valuation basis and are expensive on some measures versus bonds. Earnings are at risk of being downgraded due to margin pressures from input and labour costs, with risks to top line growth in a slowing growth environment.

For equities to recover from their YTD falls, investors need to believe that we are at the peak of policy tightening and that growth risks are fading. Given the risks around inflation and central banks' policy responses, potential downside in growth and earnings forecasts, the failure to find resolutions to geopolitical issues and the removal of the undervaluation of equities versus bonds in the higher yield environment, we see risks in equities as still being skewed to the downside.

Navigating equity markets is difficult even in a benign environment, but it has become more arduous in the current backdrop, with heightened uncertainty on many issues. As a result, the increased volatility evident this year is likely to continue.

While our outlook for equity markets suggests limited upside in the short term, the outlook remains positive over the medium to long term, with upside of approximately 5% per annum expected on a 5-10 year view.

THE MONTH AHEAD

SEPTEMBER

- 7 – US Balance of Trade
- 8 – ECB Interest Rate Decision
- 12 – GB GDP MoM (July)
- 13 – US Inflation Rate YoY (August)
- 15 – BoE Interest Rate Decision
- 21 – Fed Interest Rate Decision
- 22 – Japan Interest Rate Decision
- 30 – EA Inflation Rate YoY Flash (September)

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Contact us

Phone (01) 704 1200
Fax 01 704 1918
Website www.ilim.com
Write to Irish Life Investment Managers, Beresford Court, Beresford Place, Dublin 1

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