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Market Pulse

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BONDHOLDERS BITTEN AT BOTH ENDS: RISING YIELDS AND INFLATION

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The market sell-off, which commenced in the first quarter, intensified through April; global equities and bonds are both down mid-single digits since the end of March. Expectations of aggressive central bank policy to fight inflation, global growth concerns and the ongoing war in Ukraine all weighed on investor sentiment in the markets. Inflation readings hit consecutive new highs, interest rate expectations rose and bond yields rocketed. Bondholders have been bitten at both ends so far this year with capital losses added to the negative real yields on their holdings. Expectations for the path of monetary policy have seen a significant shift; markets are now pricing in interest rates of well over 2% in both the US and the UK by year-end. Meanwhile, eurozone rates are expected to move into positive territory as early as the autumn.

Rising interest rates

In March, the US Federal Reserve (Fed) announced the first interest rate rise of the cycle and has since turned increasingly aggressive on fighting inflation. US headline inflation hit 8.5% in April, while the unemployment rate fell to 3.6%, spurring markets to price a front-loaded removal of accommodative monetary policy as the Fed looks to take rates back to neutral as quickly as possible. Markets see the Fed raising rates to well over 2% by the end of the year with suggestions that rates could rise in multiple 50 basis point (bps) intervals. Controlling inflation is gaining traction among European Central Bank (ECB) council members as well. Eurozone headline inflation rose to 7.5% in April while growth slowed to 0.2% in the first quarter, increasing fears of stagflation in Europe through the second half of the year. The Bank of England made its third consecutive interest rate hike at its March policy meeting, raising rates by 25bps to 0.75%.

Ukraine war: economic impact

The war in Ukraine moved to a new stage in April. Russia intensified its efforts in the southern region after making less progress than expected in its initial assault. The impact of this on global energy markets remains high as Europe struggles to find substitutes for its Russian energy supplies. Gas prices in Europe eased through the month but remain more than 40% higher year-to-date and susceptible to threats of supply cuts. We saw Russia cut off supplies to Poland and Bulgaria due to their refusal to make payment in rubles, sparking concerns over a broader cessation of gas flows. The European Commission looks set to announce its sixth raft of sanctions on Russia in early May, with a phased embargo on Russian oil imports expected to feature. The impact of the conflict in Ukraine is beginning to come through in economic data: while labour markets remain robust and unemployment rates fell across the eurozone, consumer sentiment measures have continued to weaken. Consumer confidence has fallen to levels consistent with recession as rising inflation squeezes household purchasing power.

China growth concerns

With Chinese authorities struggling to contain a major outbreak of Covid-19, Shanghai has spent all of April in a full lockdown with reports emerging of new containment measures in Beijing. Rolling lockdowns in China since the beginning of the year reveal the fundamental weakness in China's zero-Covid-19 strategy, as more virulent strains of the virus are more difficult to control by restrictive mobility measures. China's response presents headwinds to Chinese and global growth at a time when growth is already under pressure. China's 5.5% growth target for 2022 is now looking unlikely.

CHART OF THE MONTH

Global Equities

Source: ILIM, Bloomberg. Data is accurate as at 30 April 2022.

MARKET ROUND-UP

Equities

The MSCI AC World equity index fell -6.5% (-2.9% in euros) as markets priced in more aggressive monetary policy tightening from global central banks. European equities outperformed, falling -1.1%, as encouraging quarterly earnings partially offset concerns on slowing growth, high inflation and tightening monetary policy. UK equities posted positive returns, rising 1.0% (1.6% in euros), benefitting from their relatively large weight in materials and commodity stocks. Emerging markets fell -3.5% (-0.4% in euros), as markets priced in continued uncertainty from the Russia-Ukraine war, an increasingly hawkish Fed, intensifying lockdowns in China, and further dollar strength. The US fell -9.1% (-4.1% in euros) as growth stocks were hit hard on the back of rising Treasury yields, growth fears and some disappointing earnings reports. Japan fell -2.7% (-3.8% in euros), despite the Bank of Japan remaining extremely dovish.

Bonds

The Eurozone >5-year bond index returned -5.4% in April as bond markets continued their sell-off from the first quarter, leaving their year-to-date returns deeply negative at -12.2%. An ongoing deterioration in the inflation outlook has led to a significant change among investors on their outlook for interest rates and central bank policy over the short to medium term. The German 10-year yield rose 39bps to 0.94%, its highest level since 2015. Meanwhile, Italian, and Spanish 10-year spreads against Germany widened to 184bps and 104bps respectively, as markets priced the impact of increasingly aggressive ECB rate hike expectations amid slowing European growth. The poor outlook for economic growth will leave peripheral bonds exposed if there are any political or economic shocks. Investment grade corporate bonds fell -2.8% as spreads widened 21bps to 149bps. High yield corporate bonds fell -3.3% as yields rose 84bps to 6.20% and spreads widened 46bps to 364bps.

Both emerging market (EM) local and hard currency debt returns were negative for the month as a sell-off in US Treasuries on the back of a more hawkish Fed weighed on fixed income returns. EM local debt fell -1.3% in euro terms during the month as yields rose to 6.8%. EM hard currency debt fell -5.9% (-0.8% in euros) as yields rose to 7.4%, while spreads widened to over 438bps. Sovereign credit spreads widened in the hard currency universe on the back of increased risks to global growth, and expectations of increasingly aggressive central bank policy tightening. The euro return on local currency debt benefitted from a weaker euro relative to EM currencies.

Currencies and commodities

The euro fell -4.7% against the dollar to 1.0545 as growth headwinds in Europe and prospects of a rapid pace of Fed rate hikes fuelled dollar strength versus the euro. Commodities rose +5.1% (+10.9% in euros), bringing their year-to-date return to 39.9% (50.9% in euros) as the war in Ukraine dealt a major shock to commodity markets, altering global patterns of trade, production, and consumption. Crude oil was up +4.4% while European gas fell -22.1%. The Russia-Ukraine conflict continues to drive volatility in energy markets, but slowing global growth and rolling lockdowns in China as a result of a Covid-19 outbreak provided some relief on the demand side. Gold fell -2.4% as real yields moved higher on bets of aggressive monetary policy tightening by global central banks.

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	MTD Return (%)	YTD Return (%)	2021 Return (%)
MSCI Ireland	1.2	-17.2	17.1
MSCI United Kingdom	1.6	5.7	27.5
MSCI Europe ex UK	-1.1	-8.8	25.4
MSCI North America	-4.0	-6.5	36.6
MSCI Japan	-3.8	-8.0	9.8
MSCI EM (Emerging Markets)	-0.4	-5.2	5.2
MSCI AC World	-2.9	-6.0	28.1
10-Year Yields	**Yield Last Month (%)**	**2021 Yield (%)**	**2020 Yield (%)**
US	2.93	1.51	0.91
Germany	0.94	-0.18	-0.57
UK	1.91	0.97	0.20
Japan	0.23	0.07	0.02
Ireland	1.61	0.24	-0.30
Italy	2.77	1.17	0.54
Greece	3.34	1.34	0.63
Portugal	2.02	0.47	0.03
Spain	1.97	0.57	0.05
FX Rates	**End last month**	**2021 Rates**	**2020 Rates**
U.S. Dollar per Euro	1.05	1.14	1.22
British Pounds per Euro	0.84	0.84	0.90
U.S. Dollar per British Pounds	1.26	1.35	1.37
Commodities (USD)	**MTD Return (%)**	**YTD Return (%)**	**2021 Return (%)**
Oil (WTI)	4.4	39.2	55.0
Gold (Oz)	-2.4	3.7	-3.4
S&P Goldman Sachs Commodity Index	5.1	39.9	40.4

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

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.

While equity markets have fallen year-to-date and, as a result, absolute valuation levels have declined, using more realistic earnings forecasts, price-to-earnings (P/E) multiples are at their long-term average.

Global growth forecasts for 2022 have been revised down to 3.3% but remain well above trend growth of 2.7% and the level of growth generated during most of the recovery from the Global Financial Crisis. Looking into 2023, a further slowdown is expected, particularly when taking account of the war in Ukraine, lockdowns in China and a squeeze on household purchasing power due to continued above-trend inflation.

In recent years, equities have consistently remained attractive on a relative valuation basis against bonds given the historically low level of bond yields. With the recent sharp rise in bond yields, this relative valuation support for equities has been removed and equities are now beginning to look expensive against bonds.

Given the removal of the undervaluation of equities against bonds, the potential for higher bond yields in an environment of high inflation and tighter monetary policy and the possible risks to economic growth looking into 2023, equities appear fair value at current levels with limited upside. If anything, the balance of risks is probably skewed to the downside in an environment of heightened uncertainty and volatility.

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

THE MONTH AHEAD

Economic data to watch

11 May	US Inflation Rate YoY (April)
12 May	GB GDP Growth Rate YoY (Q1)
17 May	GB Unemployment Rate (March) US Retail Sales MoM (April)
18 May	GB Inflation Rate YoY (April)

Source: ILIM, Trading Economics. Data is accurate as at 30 April 2022.

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