STRATEGY OUTLOOK

July 2022

We’re halfway through the year and **there remain more questions than answers.** When will inflation peak? Is a recession looming? Does Europe have access to enough energy? When will the Russian invasion conclude?

June marked a continuation of the trend, so far this year, of weak and volatile markets. Most major equity indices were down over the month with year to date (ytd) data clearly highlighting we are in a bear market (definitionally a >20% decline). The S&P finished down over 20% ytd with Europe (-19%) in a similar position (-19%). The UK and Japan have, to date, outperformed with ytd returns of -2.9% and -9.9% respectively due, in the UK, to their exposure to energy/commodities. Bonds had an eventful month, at one point, selling off heavily to rally back into the close of the month as the economic data weakened. It was additionally another strong month for the Dollar with Gold, but more so commodities, having a very weak month (Nat Gas -29.5%, Nickel -18%, Wheat -14%).

The Federal Reserve increased interest rates on June 15th by a surprise 75bps hike to over 1.5%. Markets had fully priced in only a 50bps hike with Fed speakers ratifying that in the weeks leading up to the decision. However, on the 10th, US CPI was released at 8.6% yoy against expectations of 8.3% yoy. Following the 75bps hike there was some unease in markets. There were rumours of panic either internally at the Fed causing them to hike more than expected or more likely from the politicians.

The Wall Street Journal survey of economist’s currently prices the risk of a recession at over 40%. Jamie Dimon, the CEO of JP Morgan was quoted talking about an upcoming economic “hurricane.” He added “we don’t know if its a minor one of Superstorm Sandy. You better brace yourself “. The co-CEO of Lennar, the housebuilder, additionally spoke about his business. He describes an environment of buyer hesitancy, an uptick in cancelled orders and severe regional soft areas of the market. Indeed, when you look at the data, pending home sales in California, declined 30.6% in May -the biggest drop since the first month of the pandemic. Active listings of properties surged 46.7% as people looked to sell.

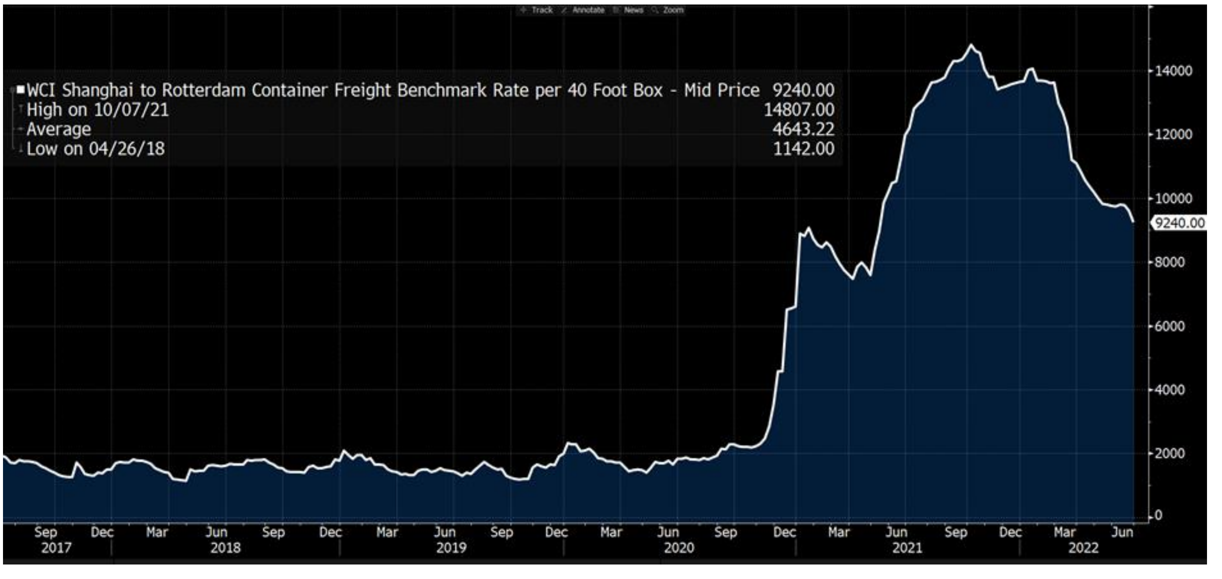
With mortgage rates screaming higher and consumer confidence hitting levels not seen since the pandemic these comments above fit. With CPI inflation at 8.6% (versus a 2% target) the Fed have an inflation problem. However, the tightening of financial conditions is also setting up severe headwinds to growth. **The risks of something breaking and a recession in the next 12 months we believe are above 40%.**

When will the Fed pivot from hiking interest rates to signalling a pause and potentially reversing course? We know inflation is a lagging indicator and so is likely to be somewhere near a peak. To what extent it falls to levels which make the Fed comfortable is clearly unknown. However, growth fears are the new kid on the block and that is far more relevant when we look forward, which is what monetary policy tries to do.

One area that is often overlooked is the fiscal side of the Government balance sheet. US debt to GDP is above 120%, the budget deficit is around 6% and all this debt, at a minimum, needs to be rolled, but additionally buyers found for the new issuance (an increasing problem after the sanctions imposed on Russia). Additionally, the current strength of the US dollar makes the return from owning US government debt meagre at best for overseas investors. In May US tax receipts fell 16% but Government spending continues apace, and no politician will move towards austerity. Indeed, gridlock from November will make matters worse. Someone will need to buy the debt and its likely, in our eyes, it will have to be the Fed via QE. **Developed markets are fast taking on the same macroeconomic characteristics that we once criticised emerging markets for having.**

This makes a Fed pivot more likely perhaps sometime this summer. We continue to use opportunities to add **tactically** to US government debt given our view of impending pivot and recession. We have a small underweight in stocks but are wary given what any pause would mean to risk assets. The counter to that is a recession needs to be priced into earnings so the outlook for assets remains volatile and highly uncertain.

Two other areas are worth mentioning – energy and China. China has bizarrely extended their zero covid policy to 2027 which has huge economic, social, and political ramifications, most of which probably aren't fully realised. China, out with their belt and road initiative, seems to have taken a step back from the world to an insular control of its population via digital currencies and social credit scores. Whether this occurs and on what time scale is almost impossible to predict however we have begun to **move exposure to India and other areas where the outlook, for us, is more positive.** It was interesting to read that the cost of sending a 40ft shipping container from Shanghai to Rotterdam has fallen 32% this year. This is however probably more a reflection of reduced demand from the European side than reduced supply from China.



The ramifications of the Russian invasion of the Ukraine continue to influence policy makers and markets. **The invasion has brought Europe closer** with the EU granting Ukraine candidacy status and Sweden/Finland set to join NATO. Everything and anything Russian from gas to gold to vodka is persona non grata. However, Putin's Russia has not seen a destruction of their currency and reserves, quite the opposite.

In the UK, the national grid is asking companies how much they would need to be paid to reduce their operations to prevent potential blackouts and winter rationing. Governments are urging consumers to take shorter showers and dry their clothes outside. Government bailouts are being discussed in Germany. **Energy has seen a dire drought of investment in the West for decades and these issues are now coming to the fore**. Mr Trump famously warned Germany in a speech at the UN about their reliance on Russian Oil & Gas and was laughed at – he was right Germany and Europe are now moving back to coal. Indeed, the G7 this month just dropped their earlier commitment that 50% of vehicles should be electric by 2030.

Markets have moved their concerns towards growth however inflation is not likely to simply fall in a straight line. Recessionary risks are rising and a Fed pivot or pause becoming more likely with each weaker economic data print.

- Narrative between ‘inflation’ and ‘disinflation’ will continue to hit markets via uncertainty but growth fears should only increase.
- Increasing evidence should materalise that the consumer is under pressure.

A Fed pivot or step back from its pronounced hiking cycle could be a positive for markets. So too would an end to Russian/Ukrainian hostilities albeit that feels a weak bet. Valuations are back to average or cheap however there remain several unanswered questions which will continue to baffle markets and keep uncertainty and volatility high as we move into the second half of the year.

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