REYL OVERSEAS

STRATEGY OUTLOOK

August 2022

July saw a bounce in markets as historically weak levels of sentiment saw buyers slowly return across assets. Year to date returns remain poor. Indeed, the only stock market up for the year are Brazilian stocks posting a +4.2% return versus, for example, a laggard – in German equities, down 28.8% in USD terms. The only asset classes that are still positive are Oil and the US dollar with the majority firmly in the red e.g., UK stocks and EM sovereign bonds have returned to date -7.4% and -20.8% respectively.

Nothing has dramatically changed across economics, society, or the political and geopolitical landscape since our last review. For the time being the bounce in markets is probably mostly to do with assets having sold off too much and a far too bearish extreme in sentiment becoming prevalent. However, despite the summer 'lull' and bounce we would note a few points of interest especially on the growth front, which supports our view, as we continue to look forward.

"the outlook has darkened significantly since April. The world may soon be teetering on the edge of a global recession"

IMF Chief Economist
July 26 2022.

Four days after the above comment, on 30 July, US Q2 GDP was released at -0.9% which satisfies the definition of two consecutive quarters of negative GDP. The US is therefore officially in a **technical recession** at least from a statistical viewpoint but, as of yet, its not really a 'real' recession. A real recession is more qualitative, a trauma that's economy wide which sees consumers and businesses retrench, cut costs, shed jobs with pain clearly visible on main street. Its worth noting that both GDP is a lagging indicator and that the **Federal Reserve's forecast at the beginning of the year was for +4% growth in 2022**.

However dark clouds aren't going away, and **the consumer is under increasing pressure**. Walmart (a reasonable bell weather for the US consumer) have issued their second profit warning as higher prices, especially in non-discretionary food and fuel, are affecting their customers ability to afford other goods. Meta (the new Facebook) announced their first revenue decline since going public as advertising slowed and Amazon have substantially reduced their hiring plans for next year. However, the economic data, although weakening, remains reasonably robust.

The Fed have raised rates 2.25% in less than five months which outright and via other tightening financial conditions is still feeding irregularly into the system. The graph overleaf highlights housing sales as an example.

"we are watching for a slow down in economic activity" Fed Chairman Powell
July 27, 2022.

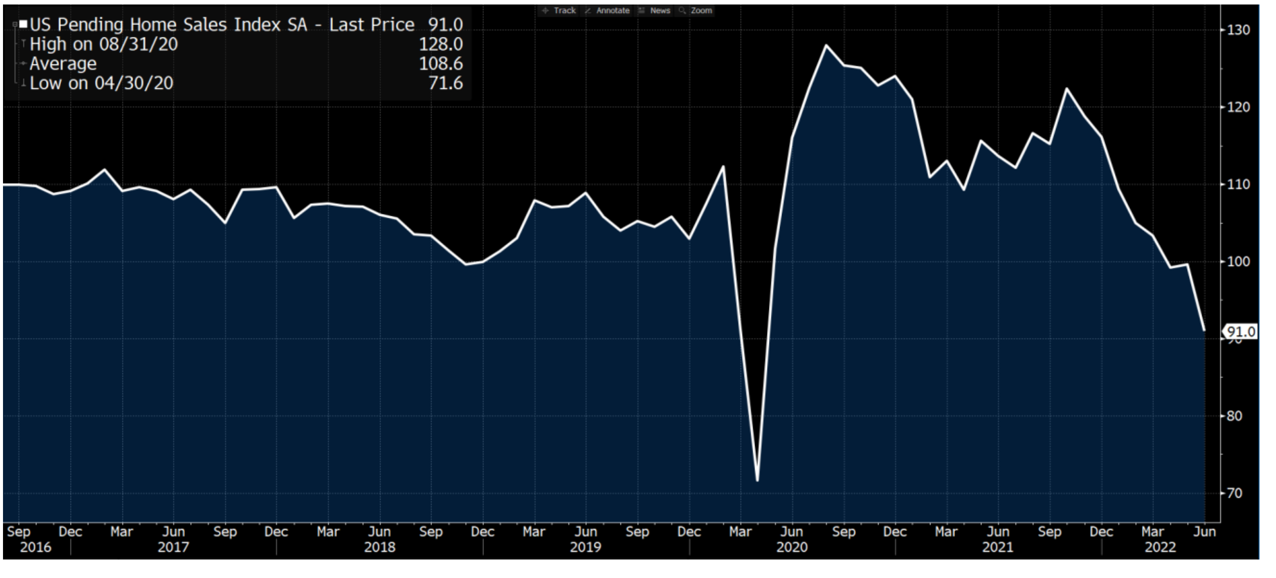
"I am not seeing evidence of a US recession now" US Treasury Secretary Yellen
July 24, 2022.

Our view remains that the data will continue to worsen given the scale of the tightening witnessed to date. **Two negative quarters can easily double but how long and deep this recession ends up being is now the question**. At the end of August, the Federal Reserve gather for their off-site at Jackson Hole where their issue remains defeating inflation. With this and the US mid terms in November the political pressure alone will be enormous. Biden and the Democrats face a huge uphill struggle.

Every central bank failed to predict the inflation prints we are seeing today. The Fed called higher inflation 'transitory' at the time. We think they may well be proved correct on a medium-term view, but that time scale is at odds to a politician's re-election. Given the Fed's miss on inflation their reaction function to future events will likely be less proactive than before too. Clearly bringing down inflation is their goal and hence we can likely expect further volatility in the second half of the year**.** **Inflation falls in a recession** but its a lagging indicator that's tricky to model.

In Germany retail sales are now back to levels last seen since German reunification (-9.8% yoy to June). **German electricity prices are 10x higher than their 2010-2020 average and exports are literally nose diving.** As one of the worlds leading exporters this can't happen in isolation. German inflation hit 8.5% yoy in July with producer prices over 30%. With all nations having raised interest rates the ECB finally, almost hesitantly, joined the club with a 50bps hike in July.

In Italy we saw the Government fail with President Draghi resigning. **Italy has now had 69 governments since 1945 i.e. one every 1.11 years**. In the UK Boris was ousted as Prime Minister (PM) with his replacement still to be decided. At his last PM's Questions his last words were **"hasta la vista baby "**. For a man who won a UK General Election with a historic majority his shoes are going to be tough to fill. **Maybe Boris and Trump will be back?**



Social change and hence eventually a changing political climate continue to be underreported by the mainstream media. From emerging markets like Sri Lanka or South Africa to Holland and Italy citizens are rising up and protesting. Food and electricity hikes are crippling people on the bread line and in 'Western' nations new regulations are killing livelihoods e.g., the farming sector via reduced emissions. Holland is the second largest agriculture exporter in the World, but the Dutch Government seek to cut farm emissions by 30%. Similar is happening in Canada. **Protests then political change are only going to increase.**

One impact from our current environment is the fall in births so far this year compared to a year ago. Germany is down 13%, UK -7.7%, Taiwan -23.2%, Sweden -6.6% and Holland -6.3%. Demographics were already an issue. China this year has moved from an ageing country to an aged country where more people die than are being born. South Korea is tipped to next follow China and Japan with a fertility of just 0.9 children per couple. These are **long term themes which are difficult to invest in but supportive of our bullish view on India.**

Time will tell whether July was the start of a bounce or low in markets. We expect the economic data to weaken further and put pressure on the Fed. However, the Fed are going to need clear evidence that inflation is under control and their reliance on their internal models has probably weakened this year. So, we expect markets to price in and out the chance of a Fed pivot in, with a pause to their hiking cycle.

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

The Fed's Jackson Hole summit will be the next event for clues as to Fed thinking. In the meantime, its about watching the data. Russia/Ukraine and Taiwan/China remain ongoing and unresolved issues that could come back to the fore. Valuations need to see earnings downgrades, and this prevents us getting super bullish on risk assets for the medium term especially as central bank liquidity is missing. Portfolios remain small underweight to stocks with an overweight to Government bonds and unchanged positioning to alternatives, gold and cash.

Zurich portfolio management team.

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