Balkerne
Asset Management

Market Review as at 30 June 2022

Overview

It has been another difficult quarter for markets after what had already been a tough start to the year. This is now the worst first half of the year for developed market equities in over 50 years. To make matters worse, government bonds have also been hit so far this year, failing to provide the protection that investors usually look to them for.

Government bonds markedly underperformed as markets moved to price in significant further increases in interest rates on top of what has already been announced. Markets now expect interest rates to rise to 3.8%, 3.0% and 1.6% in the US, UK and Europe, respectively, by the end of 2022. That increase in expectations for the path of interest rates has also contributed to a decline in equity valuations, along with concerns about the growth outlook. Recession fears have risen, due to the squeeze on consumers from higher prices and higher borrowing costs as the central banks seek to fight inflation.

Market & Index	01 April to 30 June 2022	01 January to 30 June 2022
UK - FTSE-100	-4.6%	-2.9%
UK - FTSE-250	-11.8%	-20.5%
UK - AIM-100	-17.7%	-30.8%
US - S&P-500	-16.4%	-20.6%
US – NASDAQ	-22.5%	-29.5%
UK – GILTS	-7.9%	-14.9%
UK – REAL ESTATE	12.0%	-14.4%

The good news is that asset valuations are now well below their average since 1990 in every major region other than the US. In the US, the cheaper parts of the market now trade at relatively low valuations compared with history, with the Russell 1000 Value Index trading on a price-to-earnings (P/E) multiple of 13, whereas the Russell 1000 Growth Index still trades on a P/E of 21. That's despite growth stocks having already significantly underperformed value stocks so far this year. The Russell 1000 Growth Index is down -28% year to date, whereas the Russell 1000 value index is -14% lower.

Despite recession fears building, consensus analyst forecasts still, perhaps surprisingly, expect positive growth in company profits for both this year and next. So, the key risks from here, with P/E ratios already looking cheap for most markets, are if company earnings disappoint relative to expectations, or if the still relatively expensive US growth stocks continue to see further declines in their valuations.

Market Review

UK - Unemployment remains low in the UK, but consumer confidence has hit a record low. Consumers are clearly feeling the squeeze from negative real wage growth. While the help from the chancellor to cope with higher prices will ease some of the pain, question marks remain as to whether it will be enough to prevent a recession.

Some households are also having to deal with rising mortgage costs at the same time as the squeeze from higher food and energy prices, as the Bank of England tries to bring inflation down by raising rates. About 17% of households are on tracker mortgages, while about a third of fixed rate mortgages are only fixed for two years, in sharp contrast to the US. So as interest rates rise and some fixed rate mortgage deals expire, mortgage costs are increasing.

UK equities fell over the quarter FTSE-100 -4.6%, FTSE-250 -11.8%, AIM-100 -17.7%.

US - While unemployment remains low and wage growth strong, consumer sentiment has fallen sharply. The University of Michigan Consumer Sentiment Index has plunged this year. The Conference Board's consumer confidence survey has held up better, given the higher importance it attaches to questions about the labour market, but has also weakened.

The other concern for the US economy has been the Federal Reserve's (the Fed's) indication that it is determined to get inflation under control, with the median Fed member now expecting to have to raise interest rates to 3.8% by next year to combat inflation. The Fed forecasts that unemployment will need to rise to just above 4% to get inflation down. However, the market is clearly worried that getting inflation under control could require unemployment to rise much higher, as has historically been the case.

There are already some signs that expectations for higher interest rates are starting to weigh on economic activity. With house prices almost 40% higher than at the start of 2020, and 30-year fixed mortgage rates having risen from below 3% to nearly 6%, housing has become much less affordable. That development is starting to be seen in the economic data, with the number of home sales declining.

On the plus side, while the number of housing transactions, and the associated economic activity, could continue to slow, it appears unlikely that we will see a repeat of the 2008 housing-led financial crisis. That's because 95% of Americans today are on long-term fixed rate mortgages, compared with only 80% in 2007. So, there should be far fewer forced sellers. There has also been much less sub-prime lending, and the banks are now better capitalised, which means they are more able to withstand any loan losses that might be seen in a recession. On top of this, there has been much less home building than in the run up to 2008, so there are far fewer homes available for sale today than was the case in 2007.

US equities declined over the quarter S&P-500 -16.4%, Nasdaq -22.5%.

Europe - In Europe, consumer confidence has also fallen dramatically. The biggest risk to the European economy is the reduction in gas supplies coming from Russia, which has driven prices up significantly, and is raising fears of outright shortages and rationing if it continues. Gas shortages could have grave consequences for the European economy. Even without gas rationing, the business surveys have started to weaken.

Somewhat surprisingly, the market is pricing in significant rate rises from the European Central Bank (ECB). At the same time, the difference between the rate at which the Italian and German governments can borrow has widened materially, as it did in the run up to the eurozone sovereign debt crisis about a decade ago. In reaction, the ECB has said that it will come up with an antifragmentation tool to limit the rise in Italian borrowing costs, allow for an even transmission of its desired monetary policy across the eurozone, and hence help keep the eurozone together. The market, though, wants more detail on the tool and any conditions attached.

European equities fell -10% over the quarter.

China - A recent study from the Chinese Centre for Disease Control and Prevention showed that of more than 33,000 patients who have been sent to hospital after catching Omicron, only 22 developed severe illness, all of whom were over 60 and had pre-existing medical conditions. The study raises hopes that China may be able to move beyond the heavy restrictions that have severely affected economic activity this year. After a tough start to the year, Chinese equities rose marginally over the quarter.

Conclusion - While risks remain, we should remember that markets have already fallen a long way. So, even if we do end up in a recession, selling stocks now and buying them back cheaper at a later date would require an ability to time the bottom of the market in a way that very few investors have historically been able to do. Therefore, we currently think that maintaining a neutral allocation to risk assets while bringing bond positioning closer to average weightings probably makes sense.

Market Outlook

Markets do not like uncertainty and we are currently experiencing several once in a generation events at the same time, Covid-19, the war in Ukraine, high inflation and the cost of living crisis, and a dearth of strong political leadership.

The outcome of the war in Ukraine remains highly uncertain. The conflict continues to put upward pressure on energy and commodity prices, exacerbating inflation and supply chain constraints that already emerged post pandemic and putting global growth at risk of recession. Central banks remain focused on fighting inflation and interest rates will rise further in 2022. In the UK the cost of living crisis will continue for quite some time, with inflation likely to stay above 10% for at least 12 months.

With markets now pricing in higher inflation for the longer term we see rising interest rates in the UK and the US in 2022 and throughout most of 2023, although the ‘peak’ will be much lower than previous cycles, maybe as low as 2.5% to 3.5% (previous cycles have averaged 5%). As a result we have seen a resurgence in value stocks and a repricing lower of growth stocks, although this is now showing signs of starting to reverse, as markets start to fear recessions in the UK, Europe, and the US.

Investment Strategy

During this difficult time we have a broadly neutral, balanced portfolio of UK & International equities, corporate bonds, and defensive alternatives, with a core focus on income. We continue to believe that when investing for the longer term we should keep an overweight to long-term growth themes and we are complementing this with a broad range of value stocks, undervalued cyclical equities and an increased allocation to alternative income assets, as a hedge against inflation.

We remain at our minimum exposure to fixed-interest and corporate bonds, although we are now seeing good long term value and will be slowly increasing weightings.

Globally we continue to favour US and Asian equities, with a clear underweight to European stocks. Technology disruption, Healthcare and electrification remain our favoured long-term themes. We have increased our UK equity allocation, as valuations are undemanding and offer good upside. We are reducing our exposure to smaller companies to control portfolio risk.

Our allocation to alternative income producing assets, with linkages to inflation protection, continues to grow. Tactical cash holdings are circa 4-6% and we continue to be patient for stocks and funds to meet our target entry prices, to ensure that we obtain the best risk / reward metrics.

Please note: We are changing our Asset Allocation guidelines for our Income and Balanced portfolios to allow a higher allocation to alternative assets as follows:

THE INCOME PORTFOLIO - Lower than Medium Risk Profile

Asset Allocation Guideline:

Asset	Allocation
UK Equities	20-50%
International	0-25%
Fixed Interest	30-50%
Property	0-15%
Cash	3-50%
Alternative	0-25% (from 0-15%)

THE BALANCED PORTFOLIO - Medium Risk Profile

Asset Allocation Guideline:

Asset	Allocation
UK Equities	40-78%
International	5-30%
Fixed Interest	15-30%
Property	0-20%
Cash	2-40%
Alternative	0-20% (from 0-15%)

Sources – J P Morgan, The Financial Times, Ionic Information, Bloomberg

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