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Market Pulse

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MARKETS RALLY ON POLICY PIVOT EXPECTATIONS

Lenny McLoughlin

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

Both equities and bonds rallied strongly in November as speculation grew that the pace of US Federal Reserve (Fed) interest rate rises would soon begin to slow and that central banks might reach the end of the current tightening cycle in the first quarter to the second quarter of 2023. Weaker-than-expected inflation readings in both the US and the Eurozone contributed to the belief that an upcoming policy pivot from central banks was now more likely. Signs that China was beginning to relax its zero-tolerance Covid-19 policy and slowly moving towards a reopening of the economy led to an improvement in sentiment around Chinese growth, as did renewed efforts to support the Chinese property market. More resilience in hard economic data, and sentiment surveys across developed markets, also increased hopes that a soft economic landing was achievable and that a global recession could be avoided. The dollar weakened significantly as investors discounted a slower pace of Fed rate rises and a lower peak in the federal funds rate.

The Fed

The Fed raised interest rates as expected by 75 basis points (bps) for the fourth consecutive meeting, with the tone of the press conference being more hawkish than anticipated. While Fed Chair Powell suggested the pace of rate rises could soon slow, he attempted to downplay this and noted that the more important issues were the level of the terminal federal funds rate and how long policy remained restrictive. The October inflation reading was below forecasts, with year-on-year headline inflation falling to 7.7% from a recent peak of 9.1%. Post the inflation release, markets discounted only a 50bps rise in interest rates at the December policy meeting and a peak in rates just below 5%. Fed Chair Powell appeared to confirm these expectations at a conference on 30 November when he said a slowdown in the pace of rate rises could come as soon as the December meeting.

The ECB

Commentary from the European Central Bank (ECB) was quite mixed but, overall, there was a modest easing in expectations in relation to the scale of additional tightening. The minutes for the October policy meeting were more hawkish than expected. Concerns over upside risks to inflation and a possible un-anchoring of inflation expectations appeared to outweigh fears over a possible recession. It was suggested that a shallow recession was unlikely to keep inflation in check and that further rate rises would be required in such a backdrop. By month end, expectations for rate rises were slightly lower as Eurozone inflation surprised to the downside for the first time since mid-2021; headline inflation fell to 10.0% year-on-year, from the recent peak of 10.6%, as energy prices eased. More dovish sentiment around the US rate outlook also spread across to European markets with a slight fall in the expected peak in the ECB deposit rate to 2.75%.

China policy

Sentiment around the direction of Chinese policy was relatively cautious after the 20th Party Congress in October, where the rhetoric had been insular and apparently less supportive of growth. However, with ongoing disruptions due to the zero-tolerance Covid-19 policy having an increasingly negative impact on the economy, the authorities began to loosen restrictions; hope grew that a full reopening of the economy could occur in the first half of 2023, which could lead to a significant recovery in growth. Some of the loosening measures included a reduction in quarantine times, the introduction of less onerous testing requirements and the easing of restrictions on airline travel. Despite Covid-19 case numbers rising to new record highs as the more flexible rules were applied, hopes remained that China would continue on the slow path towards a full reopening of the economy by late in the first quarter or early in the second quarter, which would lead to a sharp recovery in growth, as occurred in developed markets as they moved to 'living with Covid-19' through 2021. The authorities also announced new measures to support the property market, including the extension of loans and bond repayment schedules, the temporary extension of bank lending to developers, the provision of state guarantees for developer funding and the extension of mortgage repayment periods. These helped stabilise the property market and boost sentiment in the overall economy.

MARKET ROUND-UP

Equities

The MSCI AC World equity index rose 6.3% (3.5% in euros) over November. Emerging market (EM) equities outperformed, rising 11.7% (10.2% in euros), benefiting from improving sentiment around the Chinese growth outlook. A weak US dollar also benefited EM regions. Pacific Basin ex Japan equities rose 10.7% (10.1% in euros), similarly benefiting from improved China sentiment, with Hong Kong being strong, up 23.1%. The US lagged, rising 5.4% (1.2% in euros) as some large cap technology companies suffered from a poor earnings season, while other regions benefited from relatively better news flow. Japan also lagged, rising 3.0% (5.3% in euros) as economic data related to trade, capital goods orders and the services sector disappointed.

Currencies and commodities

The euro rose 5.3% against the dollar to 1.0315. Expectations that the Fed will soon slow the pace of interest rate rises, and a lowering of expectations for the peak in the federal funds rate, contributed to the fall in the US dollar, as did the more 'risk-on' investment environment.

Commodities fell -1.7% (-5.6% in euros). Brent oil fell -9.9% on suggestions that OPEC+ could respond to US pressure and was considering a surprise increase in production at its December meeting. Lowered short-term demand forecasts, partly due to the currently weaker Chinese growth backdrop, also contributed to the weakness. Having fallen through late summer, European gas prices rose in November due to the onset of cold weather and the recognition that Russian gas supplies still need to be replaced in 2023 as gas storage levels are drawn down during the winter.

Gold rose 7.1%, supported by a weaker US dollar and falling US real yields. Metals were higher on improving sentiment towards Chinese growth in 2023, with copper rising 10.5% and aluminium 11.5%.

Bonds

The Eurozone >5-year bond index rose 3.8%, and German 10-year yields fell to 1.93%, as Eurozone inflation surprised to the downside, appearing to have peaked. Global bonds benefited from the belief that the pace of global rate rises will soon slow, and expectations for the peak in the ECB deposit rate were slightly reduced.

As a result, peripheral spreads narrowed. Additional contributing factors to this were proposals to revise European fiscal rules with less onerous conditions and the more moderate stance of the new Italian government. Italian 10-year spreads against Germany fell to 194bps, while Spanish 10-year spreads declined to 102bps.

European investment-grade corporate bonds rose 2.8% as yields fell 40bps to 3.81%, while spreads narrowed 37bps to 177bps. High yield corporate bonds rose 2.4% as yields fell 42bps to 7.67%, while spreads declined 15bps to 412bps.

EM local debt rose 3.4% as yields fell 65bps to 6.90%. EM currencies were weaker against the euro, which was a slight drag on performance. EM hard currency debt rose 7.0% as yields fell 105bps to 7.77%, while spreads narrowed 74bps as sentiment towards EMs improved.

CHARTS OF THE MONTH

Global Equities

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

Bonds – German 10-year yield

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

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	MTD Return (%)	YTD Return (%)	2021 Return (%)
MSCI Ireland	4.0	-18.9	17.1
MSCI United Kingdom	6.3	5.5	27.5
MSCI Europe ex UK	7.1	-8.8	25.4
MSCI North America	1.2	-5.2	36.6
MSCI Japan	5.3	-7.8	9.8
MSCI EM (Emerging Markets)	10.2	-10.1	5.2
MSCI AC World	3.5	-5.7	28.1
10-Year Yields	**Yield Last Month (%)**	**2021 Yield (%)**	**2020 Yield (%)**
US	3.61	1.51	0.91
Germany	1.93	-0.18	-0.57
UK	3.16	0.97	0.20
Japan	0.25	0.07	0.02
Ireland	2.38	0.24	-0.30
Italy	3.87	1.17	0.54
Greece	4.15	1.34	0.63
Portugal	2.88	0.47	0.03
Spain	2.95	0.57	0.05
FX Rates	**End last month**	**2021 Rates**	**2020 Rates**
U.S. Dollar per Euro	1.03	1.14	1.22
British Pounds per Euro	0.86	0.84	0.90
U.S. Dollar per British Pounds	1.19	1.35	1.37
Commodities (USD)	**MTD Return (%)**	**YTD Return (%)**	**2021 Return (%)**
Oil (Brent)	-9.9	7.1	55.0
Gold (Oz)	7.2	-4.2	-3.4
S&P Goldman Sachs Commodity Index	-1.7	27.7	40.4

Source: ILIM, Bloomberg. Data is accurate as at 1 December 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 over the year to date as central banks have tightened policy, bond yields have risen and growth forecasts have fallen.

Post the falls, equities now look attractive on an absolute valuation basis, trading on a 12-month forward price-to-earnings (P/E) multiple of 15.2x 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.

Risks to growth remain, with fears of a possible recession in 2023. Due to inflation remaining well above target, central banks are likely to maintain a restrictive policy stance for some time. Central bank balance sheets are expected to continue to shrink, removing a support for equity markets in recent years. Given the significant rise in bond yields, equities are no longer cheap on a relative valuation basis and are now expensive versus bonds. Earnings are at risk of being downgraded due to slower top-line growth in a slowing growth environment and margin pressures from higher input and labour costs.

For equities to continue their recent rally, investors need to believe that interest rate settings will be sufficient to lower inflation back towards targets of 2% while avoiding a recession and achieving a soft landing. Given the continued uncertainty around inflation and the length of time that central banks will need to maintain restrictive policy settings, 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 prospects remain positive over the medium to long term, with upside of approximately 5% per year expected on a 5-10 year view.

THE MONTH AHEAD

DECEMBER

12	13	14	15
GB GDP MoM (October)	US Inflation Rate YoY (November)	GB Inflation Rate YoY (November)	ECB Interest Rate Decision BoE Interest Rate Decision

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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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