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Market Pulse

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INFLATION BITES: ANOTHER VOLATILE MONTH FOR MARKETS

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May was a volatile month and equities fell to new lows for the year; the S&P 500 fell more than 20% from its all-time high in early January. Markets, however, rallied in the last week of May to end only slightly down for the month. Early weakness was due to the continued aggressive inflation-fighting rhetoric from central banks and further rises in bond yields in response to persistent high inflation. Increasing concerns over the growth outlook and rising fears over the possibility of recession also contributed to the initial falls. The late month respite was due to perceptions among some investors that US inflation and, therefore, the Federal Reserve's (Fed) aggressive policy guidance, may have peaked. The reopening of the Chinese economy also helped ease growth fears.

Inflationary pressures

Inflation readings remained high. US headline inflation moderated to 8.3% year-on-year but was slightly higher than expected due to food and service inflation. The Fed's preferred measure of inflation, core PCE, declined to 4.9% and was in line with expectations; this provided some hope that inflation was peaking. Eurozone inflation surprised to the upside and rose to a new high of 8.1%, with core inflation up to 3.8% as food prices rose 7.5%. Eurozone inflation is expected to peak during the summer as utility price increases are implemented. In the UK, inflation rose to 9.0%, with the peak expected in the winter as energy price increases are implemented with a lag. Food price inflation has become an increasing concern as exports from Ukraine have been disrupted by the war, while fertiliser costs have also increased sharply due to the conflict. Poor harvests due to weather conditions have added to food price pressures, which the Bank of England Governor described as 'apocalyptic'.

Growth concerns

Economic data was generally weak in May. There were increasing concerns over the possibility of a recession in 2023. Activity and sentiment data in China were particularly weak, following the lockdowns associated with the 'zero tolerance' Covid-19 policy. Elsewhere, the global manufacturing Purchasing Managers Index continued to drift lower to levels consistent with global growth of just 1.7%. Industrial production and factory orders in Europe were weak. Meanwhile, consumer confidence across most regions continued to ease and fell to the lowest level in the UK since 1974. Labour markets, however, generally remained firm with unemployment continuing to fall. This contributed to wage inflation rising to 2.8% across the Eurozone and 7.0% in the UK.

Central bank policy

As expected, the Fed raised interest rates by 50 basis points (bps) and indicated similar rises at the next two policy meetings. The Fed also announced that it would begin to reduce its balance sheet at a rate of $47.5bn per month in June and that this would be raised to $95bn in September. While Fed Chair Powell appeared to rule out a 75bps rise, he suggested that rate rises would continue until there is clear and convincing evidence that inflation is retreating.

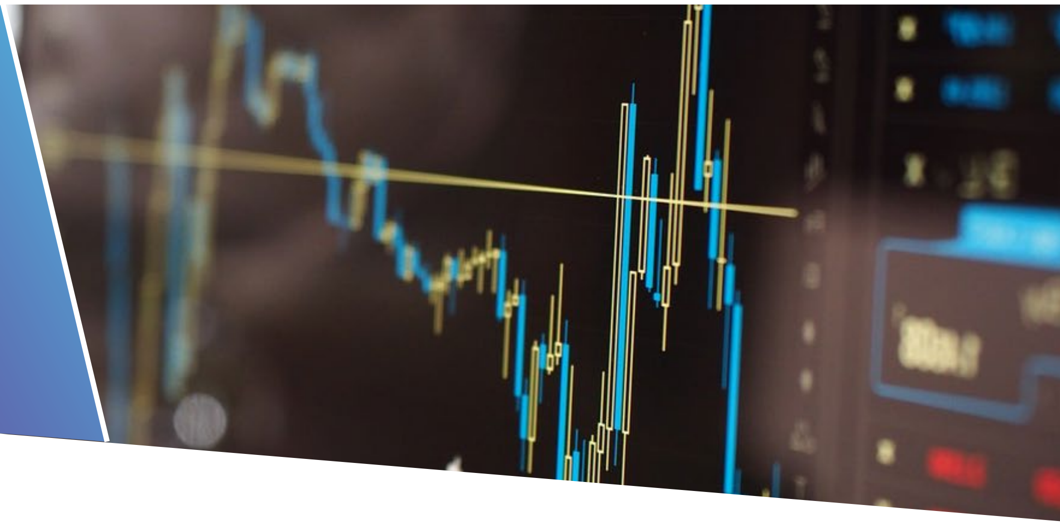
Minutes from the European Central Bank's (ECB) last meeting suggested increased worries over the broadening and persistence of inflation. ECB President Lagarde indicated that the deposit rate would be raised from the negative level of -0.5% to zero by September.

The Bank of England raised interest rates by 0.25% in a six-to-three vote, with those who dissented looking for a 0.50% rise. The Bank indicated a further modest tightening was likely and forecast inflation to peak at 10.2% year-on-year in 2022.

War in Ukraine

The war in Ukraine has become focused in the Donbas region and appears to be developing into a stalemate with fighting likely to continue for some time and no resolution in sight. Sanctions are likely to remain in place and will continue to have implications for inflation and growth, particularly in Europe. Events in Ukraine have led Sweden and Finland to apply for NATO membership. Putin appears to have accepted that both will join on the condition that no NATO military bases are located in either country. This has eased concerns over a possible escalation of tensions. The EU announced an embargo on Russian oil and plans to reduce imports by 90% before year end, with an exemption for Hungary. This contributed to a rise in the price of oil during May. Most European importers of Russian gas have arranged for payment in roubles, which has maintained gas flows to the region. Russia has, however, cut gas supplies to certain countries such as Finland, the Netherlands and Denmark, while keeping supplies open to the key markets of Germany and Italy.

MARKET ROUND-UP



Equities

The MSCI AC World equity index fell -0.2% (-1.3% in euros). The UK outperformed, rising 1.3% (0.2% in euros) and continued to benefit from its high weight in energy and commodity stocks. Japan rose 0.9% (0.1% in euros) as, in contrast to most other global central banks, the Bank of Japan has committed to maintain a loose monetary policy stance. The Pacific Basin fell -1.1% (-1.9% in euros) as concerns over Chinese growth weighed on the region. European equities underperformed, falling -0.6% (-0.8% in euros), as the ECB has become increasingly focused on tackling inflation, guiding to an earlier and faster pace of interest rate rises, while economic data was generally soft.

Bonds

The Eurozone >5-year bond index fell -2.7% as yields rose on higher-than-expected inflation and more aggressive policy guidance from the ECB; the bank suggested that the deposit rate will be raised to zero by September. The German 10-year yield rose to its highest level since 2014, ending the month up 18 bps at 1.12%. Italian and Spanish 10-year spreads continued to widen against Germany to 200bps and 111bps respectively, as markets priced in the impact of increasingly aggressive ECB rate hike expectations amid slowing European growth. Investment grade corporate bonds fell -1.3% as spreads widened 10bps to 159bps, while yields rose 27bps to 2.39%. High yield corporate bonds fell -1.3% as yields rose 5bps to 6.25% and spreads widened 15bps to 379bps.

Both emerging market (EM) local and hard currency debt returns were slightly positive on the month, benefiting from a better performance from US bonds in May; investors began to speculate that US inflation was close to peaking and that the Fed was close to its peak level of hawkishness. EM local debt rose 0.3% with strong EM foreign exchange (FX) rates supporting local markets as yields remained largely unchanged at 6.7%. EM hard currency debt rose 0.3% (-1.3% in euros), with spreads relatively stable while yields remained close to 7.0%.

Currencies and commodities

The euro rose 1.8% against the dollar to 1.0731 as the ECB became more hawkish, guiding to an increase of 50bps in the deposit rate by September. Speculation that the Fed could be close to its peak level of hawkishness, combined with investors being relatively long the dollar, also contributed to the move. Commodities rose 5.1% (3.5% in euros), bringing their year-to-date return to 47.0% (56.1% in euros). Crude oil was up 9.5% as the EU announced an embargo on Russian oil imports. Meanwhile, hopes for a US/Iran nuclear deal, which would release Iranian oil onto the global market, began to fade. European gas fell -7.4% as importers set up facilities to pay in roubles, which maintained the flow of gas to the majority of European countries. Food prices rose due to dislocations caused by the war in Ukraine, poor growing conditions and a wheat export ban announced in India, which caused wheat prices to rise 11.8%. Gold fell -2.7% as US real yields moved back into positive territory with inflation expectations easing.

CHART OF THE MONTH

German 10 Year Yield

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

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	MTD Return (%)	YTD Return (%)	2021 Return (%)
MSCI Ireland	-0.9	-17.9	17.1
MSCI United Kingdom	0.2	5.9	27.5
MSCI Europe ex UK	-0.8	-9.6	25.4
MSCI North America	-1.7	-8.1	36.6
MSCI Japan	0.1	-7.9	9.8
MSCI EM (Emerging Markets)	-1.1	-6.2	5.2
MSCI AC World	-1.3	-7.3	28.1

10-Year Yields	Yield Last Month (%)	2021 Yield (%)	2020 Yield (%)
US	2.84	1.51	0.91
Germany	1.12	-0.18	-0.57
UK	2.10	0.97	0.20
Japan	0.24	0.07	0.02
Ireland	1.70	0.24	-0.30
Italy	3.12	1.17	0.54
Greece	3.58	1.34	0.63
Portugal	2.26	0.47	0.03
Spain	2.23	0.57	0.05

FX Rates	End last month	2021 Rates	2020 Rates
U.S. Dollar per Euro	1.07	1.14	1.22
British Pounds per Euro	0.85	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)	9.5	52.5	55.0
Gold (Oz)	-2.7	0.9	-3.4
S&P Goldman Sachs Commodity Index	5.1	47.0	40.4

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

THE ILIM VIEW – LOOKING AHEAD

The outlook for equity markets over the next twelve 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 close to their long-term average.

Global growth forecasts for 2022 have been revised down to 3.1% but remain above trend growth of 2.7%. Looking into 2023, some further slowdown is expected, particularly when taking account of the war in Ukraine, lockdowns in China and a squeeze on household purchasing power because of 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 close to fair value 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 subsequent 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 upside of approximately 5% per year expected on a 5 to 10-year view.

THE MONTH AHEAD

Economic data to watch

9 June	EU – ECB Interest Rate Decision
10 June	US – Inflation Rate YoY (May)
13 June	UK – GDP MoM (April)
15 June	US – Fed Interest Rate Decision US – Retail Sales MoM (May) China – Industrial Production YoY (May)
16 June	UK – BoE Interest Rate Decision Japan – Balance of Trade (May)
17 June	Japan – BoJ Interest Rate Decision UK – Retail Sales MoM (May)

Source: ILIM, Trading Economics. Data is accurate as at 1 June 2022.

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Figures referenced herein have been sourced from ILIM and Bloomberg. Forecast figures have been prepared by ILIM based on reasonable assumptions, internal data and data sourced from Bloomberg.

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