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# June 2023
# Quarter in Review

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# MARKETS RALLY ON US STRENGTH AND AI OPTIMISM

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Economic data in Q2 continued to suggest that inflation remains sticky amid a divergence between a resilient US economy and elsewhere. The eurozone entered a technical recession in Q1, and China's economic data has been lacklustre since the country's reopening from Covid restrictions in December 2022. Despite this, global asset markets continued to rally as signs of a recession were yet to show up in US economic data, while positive sentiment around artificial intelligence (AI) and its potential to boost corporate profit margins supported some technology stocks. Global equities, as represented by the MSCI All Country World Index (ACWI), rose by 6.7% (5.9% in euro terms) in Q2, while the ICE BofA 5+ Year Euro Government bond index was up by 0.4% over the period.

## US economy

US inflation fell but remains sticky. May consumer prices decelerated on the headline and core levels to 4.0% year-on-year (y/y) and 5.3%, respectively. However, this remains uncomfortably above the Federal Reserve's (Fed's) 2% target.

The quarter began with concerns that the US banking crises could lead to a recession. As expected, lending standards tightened, but also significant was falling loan demand; despite this, US economic data has been resilient. Meanwhile, at the end of May, the US avoided a default associated with the debt ceiling issue as the houses of Congress passed the compromised deal which suspends the debt ceiling until January 2025. This improved sentiment on the economy and consumer confidence indicators rose over the quarter.

May retail sales rose more than expected, by 0.3% month-on-month, amid robust demand for vehicles and building materials. In addition, the third estimate of Q1 GDP was upwardly revised in June by 0.7% to an annualised 2.0% quarter-on-quarter amid higher net exports and consumption. Labour market data was also strong in terms of both earnings and job creation. US average hourly earnings growth was 4.3% y/y in May, and 339,000 non-farm jobs were added against a consensus estimate of 195,000. However, the unemployment rate rose from 3.5% in April to 3.7%, the highest level since October.

## Fed policy

At its June meeting, the US central bank left the federal funds rate unchanged at a range of 5.00-5.25%, but the monetary policy committee's projections suggested two more rate hikes in 2023 amid an improved growth outlook. Chair Powell struck a hawkish tone, suggesting that bringing inflation down further was still the Fed's priority, stating that the central bank "will do whatever it takes to get it down to 2% over time."

## Europe

In Europe, economic activity showed signs of slowing. The eurozone entered a technical recession in Q1 following a second consecutive fall in GDP. Retail sales were flat month-on-month in April after a 1.2% decline in March. The composite PMI index for June fell close to 50.3, a five-month low, and there was a sharp slowdown in the services sector, leaving uncertainty around the economic recovery in the region.

At the same time, inflation has not fallen to satisfactory levels for the European Central Bank (ECB). Headline consumer-price inflation fell to 5.5% y/y, down from 6.1% in May and the lowest since January 2022. However, core prices accelerated marginally from 5.3% y/y to 5.4%. This was indicative of sticky price pressures, and the core measure is something that the central bank remains focused on reducing via tighter policy. At the ECB's June meeting, the deposit rate was raised by 25bps to 3.50%, the highest level since 2001. ECB President Lagarde reiterated that inflation remains "too high", indicating that further hikes were to come.

## UK

The Bank of England surprised markets at its June meeting with a 50bp increase in its key rate to 5.0% compared to a projected rise of 25bps. This followed May consumer price data which showed headline inflation flat at 8.7% y/y and an acceleration in core prices to 7.1%, both above consensus expectations. Forecasts of higher rates caused UK gilt yields to soar, with the 10-year yield reaching 4.39%, close to the highs in September/October at the height of the LDI crisis.

# MARKET ROUND-UP

## Equities

Global equities, as represented by the MSCI All Country World Index (ACWI) rose by 6.7% (5.9% in euro terms) in Q2.

The theme of artificial intelligence (AI) received a boost from chipmaker Nvidia in May as it reported better-than-expected Q1 results. The firm projected $11 billion in sales for the three months to end-July – 50% above market expectations – amid strong demand for its chips that are able to handle AI and its applications. As a result, the company's share price rose by 52.3% in Q2 – bringing the year-to-date gain to 189.5% – and its market cap rose above $1 trillion during the quarter. The announcements were viewed as indicative of AI gaining traction, and stocks related to this theme, (particularly technology stocks) benefited, with the NASDAQ index up by 12.8% over the period.

Large caps outperformed amid the ongoing market leadership of the US megacap stocks, as concerns around the impact of the banking crisis on growth and credit creation weighed on small caps.

Emerging market equities rose by 1.8% (0.6% in euros), well below the performance of developed markets (which rose 7.3% in local currency terms and 6.6% in euros). The asset class was weighed down by lacklustre economic data from China as the reopening boost at the start of the year faded and authorities appeared unwilling to support activity via significant policy easing. The MSCI China fell by 8.9%.

## Bonds

The global backdrop of broadly steady economic data led bond yields to rise over the quarter as concerns over the banking crisis faded and central banks guided for further rate hikes in the second half of 2023. This pushed up short-term bond yields at end-June to close to levels prior to the banking crisis. Fixed income markets traded in a narrow range during Q2, which was reflected in lower bond volatility: at end-June, the ICE BofA MOVE index was at its lowest level since February.

Expectations of higher rates in the UK pushed gilt yields higher, with the ICE BofA UK Gilt Index down by 6.0% in Q2. Meanwhile, the ICE BofA 5+ Year Euro Government bond index was up by 0.4% over the period.

Peripheral eurozone bond spreads narrowed. Italian 10-year spreads over the equivalent German bunds fell by 12bps to 168bps, while spreads for Spanish government bonds were unchanged at 100bps. The moves were likely supported by falling headline and core inflation in both Italy and Spain over the period, with headline CPI at 1.9% y/y in June for the latter.

European investment grade (IG) corporate bonds rose by 0.4% in Q2, supported by interest rate carry and by investors favouring higher rated corporate debt amid a slower growth backdrop in the region. IG yields rose by 24bps to 4.41% and spreads narrowed by 5bps to 160bps over the period. Global high yield bonds rallied by 1.4% in Q2, also supported by interest rate carry, with yields up by 18bps to 7.79%, and spreads narrowed by 37bps to 358bps.

Emerging market local debt rose by 2.6% in Q2. Yields fell by 29bps to 6.33%. Emerging market hard debt yields also fell, by 10bps to 7.61%, likely aided by expected policy easing in countries like Brazil.

# CHARTS OF THE QUARTER

## Global Equities


Source: ILIM, Bloomberg. Data is accurate as at 30 June 2023.

## Bonds – German 10-year yield


Source: ILIM, Bloomberg. Data is accurate as at 30 June 2023.

# MARKET SNAPSHOT

## Market returns (EUR)

| Equity Markets (EUR) | QTD Return (%) | YTD Return (%) | 2022 Return (%) |
|---|---|---|---|
| MSCI Ireland | 4.0 | 24.3 | -21.1 |
| MSCI United Kingdom | 1.8 | 6.1 | 1.4 |
| MSCI Europe ex UK | 3.0 | 13.5 | -11.9 |
| MSCI North America | 8.0 | 14.2 | -13.8 |
| MSCI Japan | 6.0 | 10.8 | -10.8 |
| MSCI EM (Emerging Markets) | 0.6 | 2.8 | -14.5 |
| MSCI AC World | 5.9 | 11.8 | -12.6 |

| 10-Year Yields | Yield Last Month (%) | 2022 Yield (%) | 2021 Yield (%) |
|---|---|---|---|
| US | 3.84 | 3.87 | 1.51 |
| Germany | 2.39 | 2.57 | -0.18 |
| UK | 4.39 | 3.67 | 0.97 |
| Japan | 0.40 | 0.42 | 0.07 |
| Ireland | 2.81 | 3.13 | 0.24 |
| Italy | 4.07 | 4.70 | 1.17 |
| Greece | 3.67 | 4.62 | 1.34 |
| Portugal | 3.13 | 3.59 | 0.47 |
| Spain | 3.39 | 3.66 | 0.57 |

| FX Rates | End last month | 2022 Rates | 2021 Rates |
|---|---|---|---|
| US dollar per euro | 1.09 | 1.07 | 1.14 |
| British pound per euro | 0.86 | 0.89 | 0.84 |
| US dollar per British pound | 1.27 | 1.21 | 1.35 |

| Commodities (USD) | QTD Return (%) | YTD Return (%) | 2022 Return (%) |
|---|---|---|---|
| Oil (Brent) | -6.1 | -12.8 | 10.5 |
| Gold (Oz) | -2.5 | 5.2 | -0.3 |
| S&P Goldman Sachs Commodity Index | -2.7 | -7.5 | 26.0 |

Source: ILIM, Bloomberg. Data is accurate as at 30 June 2023.

# THE ILIM VIEW – LOOKING AHEAD

Global equities have proved resilient in the face of mounting headwinds, from lacklustre earnings to continued monetary tightening and banking crises. However, in our view, equities could be vulnerable to some short-term downside. Headwinds from slower growth in the second half of the year with lingering risks of a recession, monetary policy remaining restrictive for longer, reduced liquidity levels and a potential new round of downward revisions to earnings forecasts all could cause equities to retrace some of their recent gains.

Following the gains year to date, global equities appear slightly expensive, trading on a 12-month forward P/E multiple of 16.4x against a long-term average of 16.0x. The 12-month forward P/E for the MSCI USA is 19.7x against a long-term average of 17.1x. Equities outside the US offer better value. Europe ex-UK equities trade at a multiple of 12.8x against a long-term average of 13.1x, while emerging markets are trading at 12.1x versus a long-term average of 11.6x. Equities remain expensive against both bonds and cash given the high yields currently available. On balance, we believe there could be a better entry point for equities later this year.

Potential offsets to any short-term downside in equities would be: growth remaining positive and a soft landing for the economy, inflation falling faster allowing central banks to loosen policy earlier, the benefits from the application of AI accruing more quickly, and long-only institutional investors closing underweight equity positions.

The outlook for equities on a 12-month view remains positive. Once the question around slower growth or recession is resolved, central banks are likely to pivot towards looser policy in 2024 as inflation continues to fall. An anticipated rebound in earnings as growth recovers should also provide a tailwind while, over the medium term, the rollout of AI should boost efficiencies and earnings across the whole market. The ongoing green-related capex cycle could also boost earnings over the medium term.

# THE MONTH AHEAD

## JULY

| MONDAY | TUESDAY | WEDNESDAY | THURSDAY | FRIDAY |
|---|---|---|---|---|
| | | | | |
| | | 12<br>US Inflation Rate YoY | 13<br>GB GDP MoM<br>US PPI MoM | 14<br>US Michigan Consumer Sentiment Prel |
| 17<br>CN GDP Growth Rate YoY<br>CN Industrial Production YoY | 18<br>US Retail Sales (MoM) | 19<br>GB Inflation Rate YoY | | 21<br>JP Inflation Rate YoY |
| | | 26<br>US Fed Interest Rate Decision | 27<br>EA ECB Interest Rate Decision | 28<br>JP BoJ Interest Rate Decision |
| 31<br>EA Inflation Rate YoY Flash<br>EA GDP Growth Rate YoY Flash | | | | |

Source: tradingeconomics.com

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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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