

Executive Summary

The global economy has continued to face multiple headwinds in the second quarter, creating a challenging environment for equity and fixed income investors. These economic and geopolitical developments have **increased the probability of recession in developed economies**, and markets have reset to lower valuations as a result.

The inflationary environment is globally pervasive, and has led to a sharp adjustment in monetary policy. Interest rates are being increased across the developed world in a bid to restore price stability.

The signs suggest that many **pandemic-related factors** that have driven high inflation, such as elevated demand for goods and supply chain disruption, are much improved.

The risk of a shallow recession in the next 12 months is undeniably higher than normal. But the chance of a severe recession remains small. It is our view that we are witnessing a normalisation of the US economy with core inflation already moderating. This will allow the Federal Reserve space to reiterate their rate hiking timetable, rather than expedite once more. Investment markets should interpret this favourably.

The global outlook remains clouded by geopolitical developments. The risk of a material escalation of events in Ukraine poses a significant threat to global growth, particularly if energy supply suffers further blockages and prices leap higher. This risk is particularly acute for Europe, where a technical recession seems unavoidable at this stage

Drivers of inflation are similar across developed economies, however the European Central Bank has fewer policy options to combat it. Competing priorities across member states mean that confidence and stability in the Euro-area will remain fragile.

Our analysis finds that market valuations have reset to reflect all but the worst case scenarios. In the US, equity markets now trade on price-to-earnings multiples in-line or slightly below 10 year average levels, consistent with the outlook we describe.

Portfolio changes this year have had the effect of raising cash, emphasising resilience, and rotating capital away from areas with weakened prospects. We expect to make further tactical adjustments in the coming weeks and months.

The higher inflation environment we are experiencing presents the choice between corrosion of wealth in real terms, or investment in risk-assets. The latter stands a good chance of delivering real returns over the long term, but requires a tolerance for elevated volatility and market weakness.

Our approach remains wedded to core investment principles, seeking out long term growth, value and diversifying sources of return.



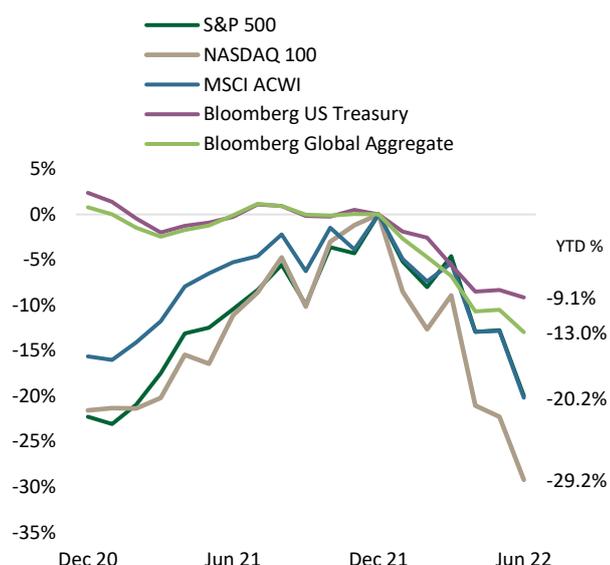
Introduction

The global economy has continued to face three primary headwinds in the second quarter, creating a challenging environment for equity and fixed income investors. US financial conditions have tightened sharply, commodity prices have remained elevated, and China’s zero-covid policy has delayed the Asian recovery. Russia’s ongoing military aggression in Ukraine adds further complexity to an already highly uncertain backdrop.

These economic and geopolitical developments have increased the probability of recession in developed economies, and markets have reset to lower valuations as a result.

The market’s reaction has been orderly and rational, but painful nonetheless. Following virtually uninterrupted gains since the depths of the pandemic in early 2020, most equity markets have fallen by 15–20% since the start of the year. Sectors which typically carry the strongest growth expectations (and highest valuations) such as US technology, are down by c. 27%. With bond yields moving higher (on higher interest rate expectations) and credit spreads widening (consistent with slowing economic growth), there have been few shelters from the storm for investors this year (chart 1).

Chart 1¹: Bond and equity markets under pressure

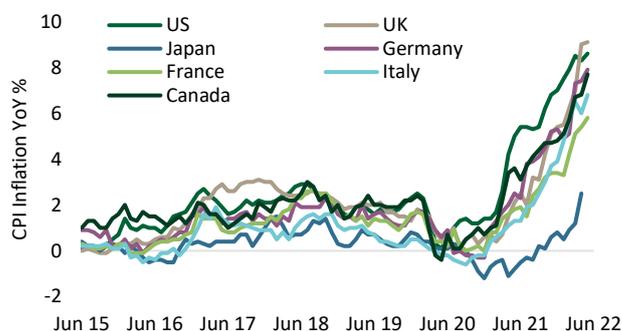


¹ Source: Bloomberg, total returns in USD, June 2022

It’s the economy, stupid

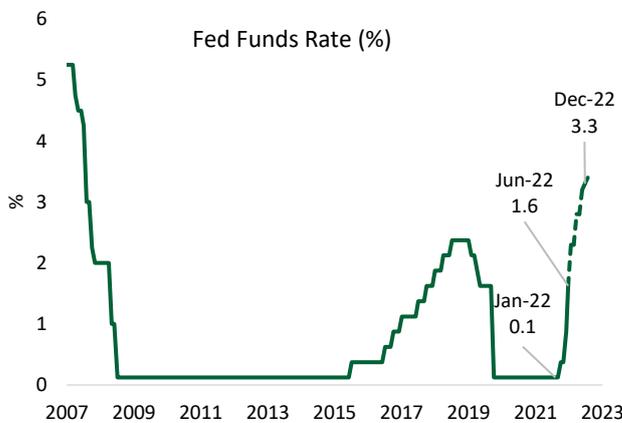
Much like 30 years ago when this political slogan captured American concerns, the state of the economy is top of the agenda for investors and voters alike. For most of the 2010’s monthly inflation readings came and went with barely a mention. Recently they have been the focus of mainstream media headlines. Multi-decade highs in year-over-year inflation rates are widespread in the developed world (chart 2).

Chart 2¹: Inflation is a global issue



This inflationary environment is globally pervasive, and has led to a sharp adjustment in monetary policy. Interest rates are being increased across the developed world in a bid to restore price stability. Having raised interest rates by 0.75% in recent weeks (and 1.5% this year so far), the market now expects the US interest rate to be 3.3% by the end of the year. This compares to near zero at the start of the year (chart 3).

Chart 3¹: Interest rate expectations have caught up



Dotted line reflects market priced path of future rate



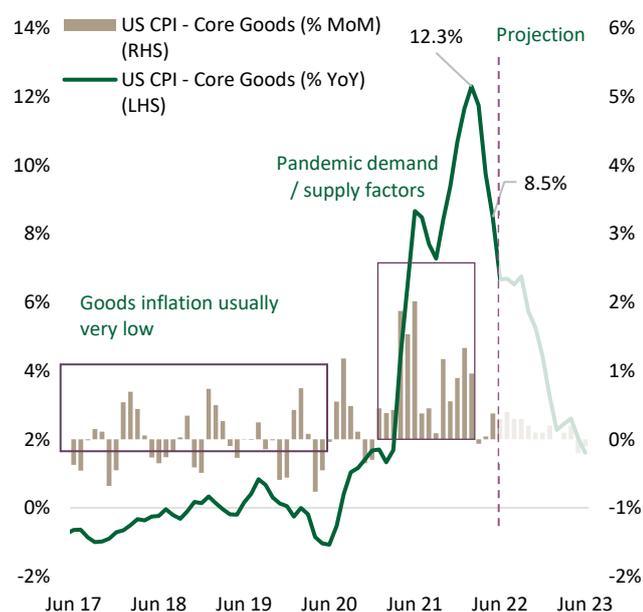
The question that follows is whether ‘core’ inflation (i.e. excluding energy and food prices) will continue to trend higher, or retreat to more comfortable levels. If it does start to decline then the threat of near term recession is likely to diminish, and interest rate hikes are unlikely to exceed those planned.

Core inflation is broadly split between goods, like household furnishings and cars, and services, largely rent, as well as medical and transport costs.

The signs suggest that many pandemic-related factors that have driven high inflation, such as elevated demand for goods and supply chain disruption, are much improved.

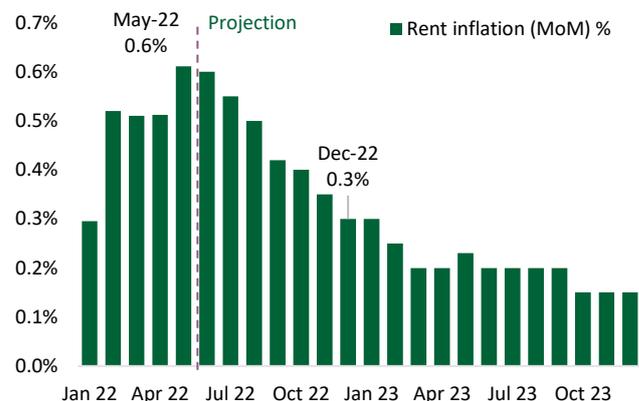
Consumers now prefer to spend on services, in contrast to their habits of the past two years, and supply chain stresses have moderated, reducing goods inflation (chart 4).

Chart 4²: Goods inflation already subsiding



Inflation in the service sector has been driven higher by a mini-boom in the housing market, on the back of record low borrowing costs. Rent inflation in the US has been extremely high, however the sharp increase in mortgage rates this year has already slowed housing activity and, in time, house price growth and rent inflation will soften (chart 5).

Chart 5²: Rent inflation is expected to cool



Recession fears – local and global issues

It is our view that we are witnessing a normalisation of the US economy with core inflation already moderating. This will allow the Federal Reserve space to reiterate their rate hiking timetable, rather than expedite once more. Investment markets should interpret this favourably.

However, this outlook carries considerable uncertainty. In particular, the question remains whether the tightening in financial conditions is already ‘too much’ for the US consumer. As consumer spending declines, a period of economic contraction and declining corporate revenues would likely spell further market weakness.

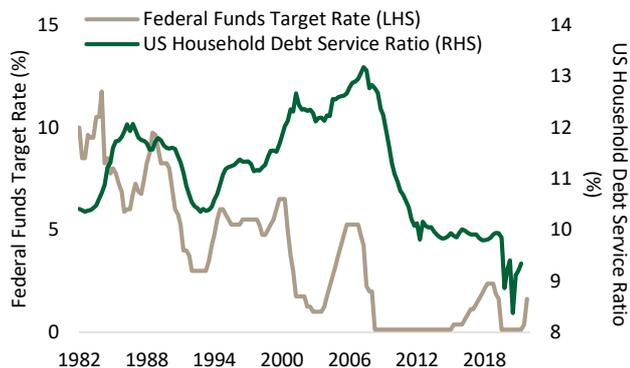
The risk of a shallow recession in the next 12 months is undeniably higher than normal. But the chance of a severe recession remains small.

The good news is that households and businesses have unusually strong balance sheets for a period of rising interest rates. Consumers retain a financial cushion from pandemic-related savings, and US corporates have low leverage ratios in aggregate – a very different picture from the years that preceded the Global Financial Crisis.

² Source: Oxford Economics, June 2022



Chart 6³: US household leverage cost historically low



The global outlook remains clouded by geopolitical developments. The risk of a material escalation of events in Ukraine poses a significant threat to global growth, particularly if energy supply suffers further blockages and prices leap higher.

This risk is particularly acute for Europe, where a technical recession seems unavoidable at this stage. The European post-pandemic recovery was already lacklustre compared to the US, and the Russia-Ukraine war has squeezed consumers and businesses more. A reliance on Russian oil and gas is a burden the US does not suffer.

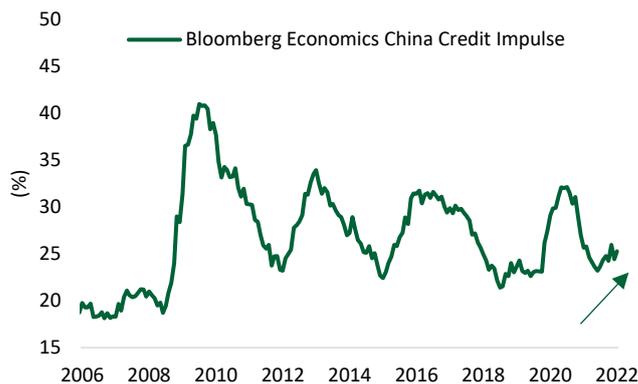
Drivers of inflation are similar across developed economies, however the European Central Bank has fewer policy options to combat it. Competing priorities across member states mean that confidence and stability in the Euro-area will remain fragile.

The Bank of England also face a delicate balancing act between recession and higher inflation. In this case, the regulatory ‘Ofgem price cap’ mechanism will delay further energy cost inflation to later this year, at which point it will jump again. Headline inflation is unlikely to fall meaningfully until 2023, while consumers face additional cost pressures in the form of higher taxes.

In Asia, the reimposition of severe lockdowns in major Chinese cities has stifled growth for the region. Indicators of Chinese economic activity have plummeted back to 2020 pandemic lows in some cases.

The Chinese slowdown is not in its infancy. Economic growth trends have been deteriorating since early 2021, reflecting the authorities de-leveraging and regulatory reform programme. The good news here is the worst of the Chinese downturn is likely to be behind us, with evidence of easing lockdowns and policy becoming more expansionary.

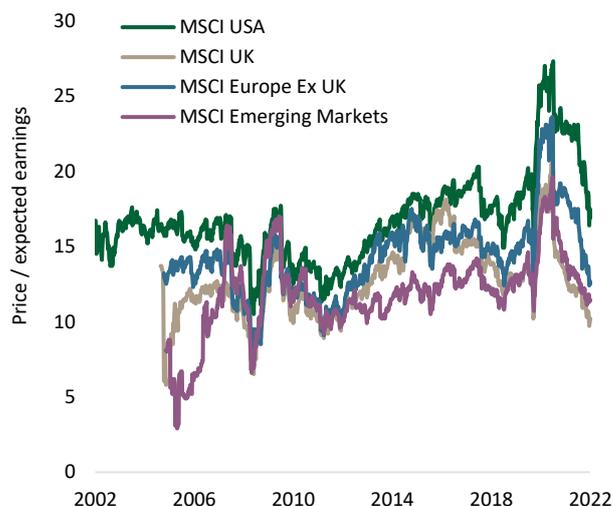
Chart 7³: China will need to stimulate the economy



Investment strategy – opportunities emerge

Our analysis finds that market valuations have reset to reflect all but the worst case scenarios. In the US, equity markets now trade on price-to-earnings multiples in-line or slightly below 10 year average levels, consistent with the outlook we describe. In Europe, UK, Asia and broad emerging markets, areas of value can be found, reflecting heightened economic and geopolitical risks.

Chart 8³: Valuations reflect the fundamentals



³ Source: Bloomberg, June 2022



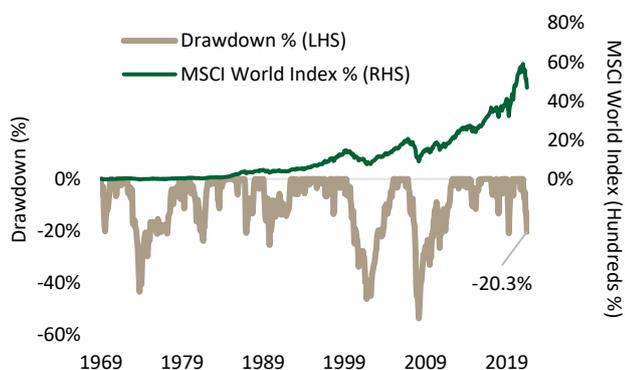
As valuations have fallen several of our managers are seeing attractive opportunities emerge and have rotated capital accordingly. For example, we have seen managers in UK value, US thematic and US small cap adding to energy companies, whilst US and global quality growth strategies have reduced consumer-facing technology stocks.

At the asset allocation level, we have also made changes to portfolios this year, exiting local currency emerging market debt (including China sovereign bonds), reducing European equity in favour of US equity, and reducing mid-cap UK equity in favour of large cap UK equity. These changes have had the effect of raising cash, emphasising resilience, and rotating capital away from areas with weakened prospects. We expect to make further tactical adjustments in the coming weeks and months.

Looking forward, a long term discipline remains critical. Enduring a period of negative returns is unnerving, but not uncommon. As the below chart shows, corrections of c. 20% have occurred at least once each decade, before a durable period of market gains has taken hold. On only three occasions in the past half-century have these corrections extended much further – the Global Financial Crisis, the bursting of the ‘dot-com bubble’ in early 2000s, and the mid-1970s inflationary bust.

It is our view that economic and market conditions today are far healthier than such historical comparisons, and valuations are looking increasingly attractive for those with the stomach for volatility.

Chart 9⁴: The peaks and troughs of long term returns



⁴ Source: Bloomberg, Total Returns in USD, June 2022

Concluding remarks

The first half of 2022 has been painful for all, with real returns deeply negative. Of course, a strategy that shifted materially into cash at the end of 2021 would have been favourable. But the long term prognosis for such a strategy is very poor. Two timing decisions need to be precisely judged, both exiting and re-engaging with the market, which is rarely witnessed.

The higher inflation environment we are experiencing presents the choice between corrosion of wealth in real terms, or investment in risk-assets. The latter stands a good chance of delivering real returns over the long term, but requires a tolerance for elevated volatility and market weakness.

Our approach remains wedded to core investment principles, seeking out long term growth, value and diversifying sources of return. We continue to apply continual scrutiny to all underlying allocations.

Stonehage Fleming Investment Management
July 2022



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