IMPERIUM CAPITAL

momentum

Finding your anchor

Global Matters Weekly

25 July 2022

– **Stephen Nguyen, CFA**

What a difference a few months make. After a relatively calm year in 2021, we have witnessed several asset classes posting significant losses in the first half of 2022, including equities, credit, and sovereign bonds. We have seen an increase in volatility and traditional diversifiers like government bonds have failed to provide protection, as their correlation with risky assets has risen. The increase in correlation between bonds and equities has caused major headaches for the traditional multi asset investors. It is worth remembering that asset prices habitually swing from week to week and at times even intraday. Stock markets are volatile creatures and while historically they have reliably delivered strong returns when held for the long run, it is anybody's guess what will happen in the short term. You cannot control the market, but you can control how you react to it, by finding your anchor.

Markets have been very choppy amid mounting concerns about the economic and corporate earnings outlook. Investor sentiment has deteriorated over the course of the year due to many factors, not least the ongoing conflict in Eastern Europe, supply chain disruptions and soaring food and energy prices (pushing inflation to levels not seen for decades). Consequently, corporate margins are under pressures from surging producer input prices and rising labour costs. Central banks' 'transitory' view on inflation has, in hindsight, proven to be incorrect and they are now being forced to act much more aggressively than initially anticipated by both themselves and investors. The probability of a 'soft landing' is diminishing as the cumulative effects of these front-loaded rate hikes could potentially push the economy into a recession.

We believe market volatility is likely to persist in the coming months, but we are hoping to see some of the biggest drags on markets ease in the second half of the year: more visibility on the corporate earnings outlook; inflation peaking; and the Fed's tightening coming closer to its end.

Losses in sovereign bonds are somewhat to be expected as the rate re-pricing began from an unsustainably low level. However, the pace of the rise in bonds yields has caught investors by surprise. The market is struggling with the (low) growth vs (high) inflation dilemma, and this has led to continued elevated volatility in bonds. Corporate spreads have also widened meaningfully, albeit from extremely low levels at the end of last year. At the same time, the decline in equities so far this year, particularly in the US, has been predominantly driven by a contraction in multiples.

The pace of the rise in bonds yields has caught investors by surprise

We are conscious of the risks but can also identify longer-term opportunities. Equity valuations are now more attractive having seen multiple de-ratings across all regions. Meanwhile government bonds in the US are now offering higher yields across the curve, making them more appealing. Spread products (i.e. high yield) are already pricing in economic weakness and a pick-up in defaults which present opportunities for active investors. We continue to see promising opportunities presenting themselves in Japanese and non-US equities, and we are paying closer attention to US equities as valuations there become more attractive.

During times of turmoil, it pays to find your anchor and stay true to what works best and reliably over the long run. We let our bottom-up valuation discipline steer us towards the most attractive opportunities, whilst being mindful of the risks. Portfolio construction resiliency is important at the best of times, but it becomes vital when the seas are turbulent.

Investors should stay broadly diversified and remain patient when allocating to risky assets. One of our tenets is "diversify your diversifiers", and this has become increasingly important in recent months. While traditional diversifiers in the form of US Treasuries and gold have come under pressure this year, our allocation to Chinese government bonds and liquid alternatives have held up much better. Stocks are not outright cheap by historical standards; however, they are no longer expensive.

The biggest risk for investors is not price volatility, but rather the probability of not achieving their longer-term investment objectives. However, we are cognisant that short-term price swings could lead investors to act irrationally. Stay invested, be prepared for a bumpy ride, but avoid the temptation to try and time the next recession.

The **Marketplace**

- Global equities rose 3.2% last week
- Russia announced that gas flows into Europe would resume after Nord Stream maintenance, but that supply could be tightly curbed if a dispute over sanctioned parts is not resolved
- Brent crude rose 2.0% over the week to $103.2 a barrel
- Gold rose 1.1% to $1727.6 per ounce

Market **Focus**

US

- US equities rose 2.6% last week
- Sentiment among US housebuilders fell to a two year low as The National Association of Home Builders (NAHB) housing market index fell to 55 in July (vs. 65 expected)
- US weekly jobless claims came in at an eight month high of 251k for the week ending 16 July pointing to a softening labour market
- US housing starts fell to an annualised rate of 1.559m in June (vs. 1.580m expected), their lowest level in nine months, and building permits similarly fell to a nine month low, with an annualised rate of 1.685m (vs. 1.650m expected).

UK

- UK equities returned +1.6% last week
- Consumer Price Inflation (CPI) data showed that inflation rose to a 40-year high of 9.4% in June (vs. 9.3% expected)
- Data from the Office for National Statistics (ONS) recorded that property values rose 12.8% year-on-year in May, up from the prior month's reading of 11.9%
- The unemployment rate for the three months to May stood at 3.8%, unchanged from the prior three months
- The number of payrolled employees in the UK rose by 31k in June (vs. 68k expected)
- Retail sales dipped again in June by -0.1%.

Europe

- European equities returned +3.1% last week
- The European Central Bank (ECB) began their hiking cycle with a 50bp hike for all three of their main interest rates, which leaves the deposit facility rate at 0%, and the main refinancing rate at 0.5%
- A draft EU document warned that a potential Russian gas cut-off could cut EU Gross Domestic Product (GDP) by 1.5% in a worst-case scenario
- In Italy, Prime Minister Draghi delivered his resignation to President Mattarella with the latter subsequently dissolving parliament.

Asia/Rest of The World

- Global emerging market equities rose 3.0% over the week
- Chinese equities grew 1.2% over the week
- Japanese equities rose 3.4% over the week
- China maintained status quo on its benchmark rates for corporate and household loans, leaving the one-year Loan Prime Rate (LPR) at 3.70%, and the five-year LPR at 4.45%
- The Bank of Japan chose to maintain its ultra-loose monetary policy. They decided to maintain their -0.1% policy rate, as well as the 0.25% yield cap on 10-year Japanese Government Bonds
- China also reported 699 Covid cases on Monday, which is the highest daily number since May 2022.

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Asset Class/Region	Currency	Currency returns			
		Week ending 22 July 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	2.6%	4.7%	-16.4%	-8.4%
United Kingdom	GBP	1.6%	1.5%	3.1%	11.7%
Continental Europe	EUR	3.1%	5.1%	-13.3%	-7.3%
Japan	JPY	3.4%	4.6%	-0.4%	5.2%
Asia Pacific (ex Japan)	USD	2.8%	-0.2%	-15.8%	-21.3%
Australia	AUD	2.8%	3.4%	-6.9%	-4.3%
Global	USD	3.2%	4.2%	-17.2%	-11.7%
Emerging markets equities					
Emerging Europe	USD	6.8%	-0.6%	-77.2%	-76.9%
Emerging Asia	USD	2.6%	-1.0%	-18.0%	-23.9%
Emerging Latin America	USD	1.9%	-2.6%	-3.1%	-15.7%
BRICs	USD	2.0%	-3.0%	-19.5%	-29.2%
China	USD	1.2%	-6.0%	-16.6%	-32.0%
MENA countries	USD	6.5%	3.7%	2.4%	11.1%
South Africa	USD	5.8%	0.3%	-7.1%	-10.6%
India	USD	4.2%	4.9%	-9.3%	-0.1%
Global emerging markets	USD	3.0%	-0.6%	-18.2%	-23.3%
Bonds					
US Treasuries	USD	0.9%	1.4%	-7.7%	-8.5%
US Treasuries (inflation protected)	USD	1.2%	2.4%	-7.5%	-4.9%
US Corporate (investment grade)	USD	1.6%	2.7%	-12.1%	-12.9%
US High Yield	USD	2.5%	4.3%	-10.5%	-9.3%
UK Gilts	GBP	1.7%	2.0%	-12.9%	-14.6%
UK Corporate (investment grade)	GBP	1.7%	2.3%	-12.2%	-13.9%
Euro Government Bonds	EUR	0.5%	2.2%	-10.3%	-12.2%
Euro Corporate (investment grade)	EUR	1.2%	3.4%	-8.9%	-10.2%
Euro High Yield	EUR	2.4%	3.8%	-11.2%	-11.0%
Japanese Government	JPY	0.1%	0.3%	-2.8%	-3.3%
Australian Government	AUD	-0.3%	1.2%	-9.1%	-11.8%
Global Government Bonds	USD	1.5%	0.9%	-13.4%	-16.0%
Global Bonds	USD	1.6%	1.1%	-13.4%	-15.9%
Global Convertible Bonds	USD	2.5%	2.1%	-19.2%	-22.7%
Emerging Market Bonds	USD	3.2%	1.3%	-25.7%	-27.3%

Source: Bloomberg. Past performance is not indicative of future returns

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Asset Class/Region	Currency	Currency returns			
		Week ending 22 July 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	3.3%	3.8%	-17.7%	-7.2%
Australian Property Securities	AUD	2.4%	7.7%	-19.3%	-8.3%
Asia Property Securities	USD	1.5%	-3.1%	-7.5%	-15.3%
Global Property Securities	USD	3.7%	2.9%	-17.0%	-12.5%
Currencies					
Euro	USD	1.5%	-2.4%	-10.1%	-13.0%
UK Pound Sterling	USD	1.4%	-1.3%	-11.2%	-12.7%
Japanese Yen	USD	1.9%	-0.2%	-15.4%	-19.0%
Australian Dollar	USD	2.3%	0.5%	-4.5%	-5.8%
South African Rand	USD	1.8%	-3.2%	-5.1%	-12.4%
Swiss Franc	USD	1.8%	-0.7%	-5.1%	-4.3%
Chinese Yuan	USD	0.1%	-0.8%	-5.8%	-4.1%
Commodities & Alternatives					
Commodities	USD	1.6%	-3.5%	18.8%	29.9%
Agricultural Commodities	USD	-1.5%	-7.4%	0.9%	13.3%
Oil	USD	2.0%	-10.1%	32.7%	39.9%
Gold	USD	1.1%	-4.5%	-5.6%	-4.3%
Hedge funds	USD	0.5%	0.0%	-5.0%	-4.8%

Source: Bloomberg. Past performance is not indicative of future returns

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