June 2022

INVESTMENT OUTLOOK

Monthly round-up of global markets and trends.

TILNEY

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Welcome to Investment Outlook. This publication, which replaces our monthly Market & Economic Outlook, covers events during May 2022 as well as providing a look forward. Please read the important information section.

Stock markets have not been jubilant, but there are still reasons to be optimistic

Amid the celebrations for the Queen's Platinum Jubilee this year, there remains a cautious undertone in global markets. Equity and bonds were dragged down by rapidly accelerating inflation and rising interest rates. Some of the biggest losers so far this year have been the interest-rate sensitive US mega cap stocks. Bonds have not escaped unscathed either – the 30-year US Treasury total return has fallen a staggering 34% since reaching a peak on 9 March 2020![1]

This market uncertainty, driven by the war in Ukraine and China's disruptive battle with Covid, has been reflected in sector rotation, lower equity valuations and higher bond yields. Asset managers, according to May's Bank of America's Fund Managers' Survey, have lifted their average cash level in portfolios to their highest level for 21 years.[2] The MSCI Global Equity index is now trading on a price-to-earnings ratio of 15.5 times earnings, essentially erasing the valuation boost from the post-Covid recovery and accommodative policy over the past two years.[3] Bond yields have risen, but there are potentially further rises to come as the fixed income market prices-in a higher inflationary environment, which would be detrimental to existing bond investors.

As markets adjust to a new macro environment, there is a risk equities overshoot on the downside especially if the Fed cannot engineer a soft landing of lower inflation without causing a recession. The odds don't look great. Gavekal, a research house, showed that since 1954 the Fed achieved such a soft landing on only three occasions (1965, 1984 and 1994) out of the last 12 major tightening cycles.[4] Fast forward to today and the Fed needs to bring down annual 8%+ CPI inflation before it becomes entrenched in the economy. In the Wall Street Journal on 16 May, Fed Chair Powell stated that monetary policy will continue to be tightened until there is "clear and convincing" evidence that inflation is decelerating towards the central bank's 2% target.[5] Assuming the consensus of economists is correct, inflation will trend down to below 6% by the end of this year and to 2.6% by the third quarter of 2023.[6] So, it may take time to convince the Fed that inflation is under control.

On the demand side, the Fed can currently count on solid labour demand to support the economy when interest rates are rising. Moreover, companies are, on-the-whole, reporting record profit margins and have relatively healthy balance sheets. Once supply constraints ease, companies are well placed to invest in their businesses. This should help reduce the risk of a US recession.

Longer term, more business investment should boost worker productivity and constrain unit labour costs and inflation. A US productivity boom is just what the Fed needs to effectively balance inflation and growth. Over the near term, investors will be looking for evidence of moderating inflation. Only then would the Fed have leeway to take its foot off the monetary brake, which would give some well needed support for equities.

UK consumers face an annus horribilis

Out of the G7 economies, the UK economy is, arguably, the most vulnerable to a downturn. In April, the IMF forecast the UK would expand by 1.2% in 2023, half that of the other advanced economies. UK growth expectations have since deteriorated. Consumers now must endure higher National Insurance contributions, rising interest rates and inflation (CPI) at a 40-year high. In April we saw a 54% rise in the energy cap for 22 million customers and this is likely to rise again in October.[7] It's no wonder that May consumer confidence fell to its lowest level since records began in 1974. Given this backdrop, the Bank of England has

become more pessimistic and projects no growth in 2023 on the back of forecasts that households' real income will fall by the second largest amount since records began in 1964.

However, the UK economy is not the stock market. Many of the largest companies in the UK stock market have a global focus; around two-thirds of UK large-cap index earnings are from abroad. This means that many companies have relatively low exposure to the domestic economy. The UK stock market still looks cheap relative to many of its peers and a weak sterling exchange rate has boosted the value of US dollar earnings when repatriated back to the UK.

Still, given the downside risk seen in consumer demand, it is probably prudent to steer away from consumer discretionary parts of the UK equity market and tilt towards opportunities in large cap UK stocks linked to global growth, rather than owning domestic-focused stocks. For example, the MSCI UK energy index appears attractively priced and trades on a record low price-to-earnings ratio of 5.8 times earnings.8 This shows that even during the current market turmoil there are opportunities. Though the Government's "one off" windfall tax on oil and gas companies could be a drag on the energy sector's relative performance.

When the outlook is uncertain it is worth remembering that trying to time the market is difficult and risky. Often the best days in the UK market follow some of the worst days. Indeed, our analysis shows that missing the 10 and 30 best days in the UK stock market over the last 35 years reduced returns by 50% and 80%, respectively.9It remains to be seen what impact the permanent economic changes caused by the pandemic will have on the growth and inflationary outlook.

[1,3,8,9] Refinitv, Tilney Smith & Williamson

[2] BoFA Global Fund Managers Survey, If they can't rally now, 17 May 2022

[4] The Fed's Soft Landing Play, Gavekal, 10 May 2022

[5] https://www.ft.com/content/f4610109-f1fa-4584-aa44-f65246365f2e

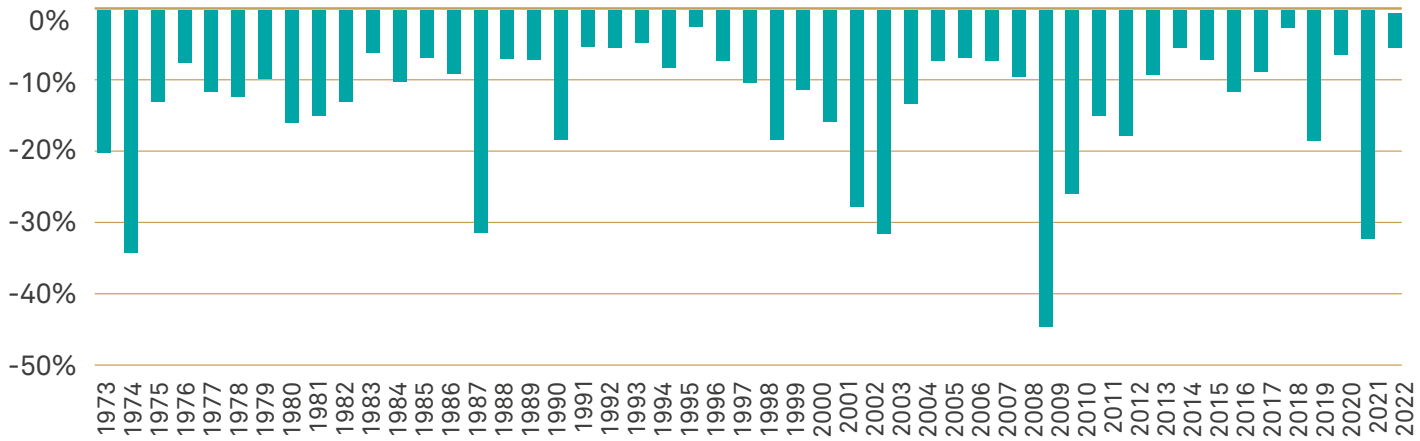
[6] Bloomberg

[7] https://www.ofgem.gov.uk/publications/price-cap-increase-ps693-april

EQUITIES

At the time of writing, the MSCI USA large-cap equity index, is perilously close to entering bear market territory, which is defined as a peak-to-trough fall of 20% or more. At times like this, it is tempting for investors to be overly concerned with day-to-day changes in equity portfolios. However, it's important to zoom out and take a longer-term view. We've been here before. As the chart shows, over the last 50 years we've seen 13 drawdowns (peak to trough falls) of a comparable size, or greater, in the US equity market. So, roughly speaking, we can expect to see one every 4 years. The scale of the current downturn is not uncommon. Despite these setbacks, the MSCI USA is over 3000% higher than at the start of 1973, and if we include the dividends that companies have paid out across this period as well, invested capital has grown over 5000%.

Maximum annual drawdown for the S&P 500, 1973-2022

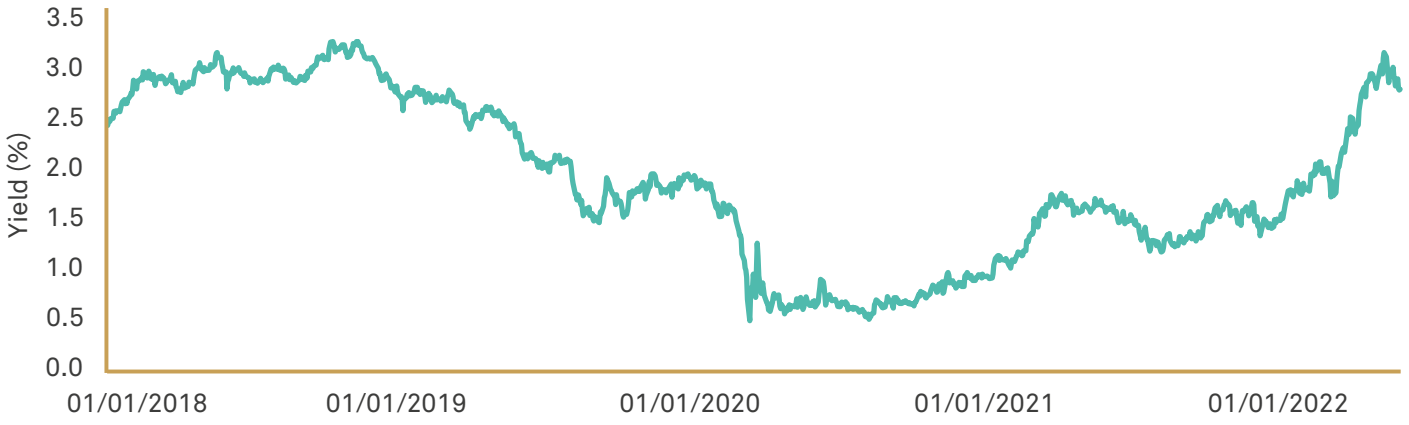


Source: Bloomberg/Tilney, data as at 30 May 2022

FIXED INCOME

As investors sold bonds this year in the face of higher inflation, the yield on the 10 year US Treasury bond, a key market interest rate, moved above 3% for the first time since 2018 (yields increase as prices fall). However, in recent weeks the yield has fallen as investors returned to the asset class, breaking the strong upward trend. This was motivated by two key drivers. First, investors are concerned that we may be entering into a period of lower economic growth, which historically tends to favour bonds. Second, and linked to the first point, investors are now pricing in lower inflation over the medium term. The 10 year bond compensates investors for taking on inflation risk, and the compensation that investors require has fallen over the last month, indicating that the market might be pricing in a peak in medium term inflation expectations.

Yield on 10 year US Treasury, nominal



Source: Refinitiv Datastream, Tilney, data as at 30 May 20221

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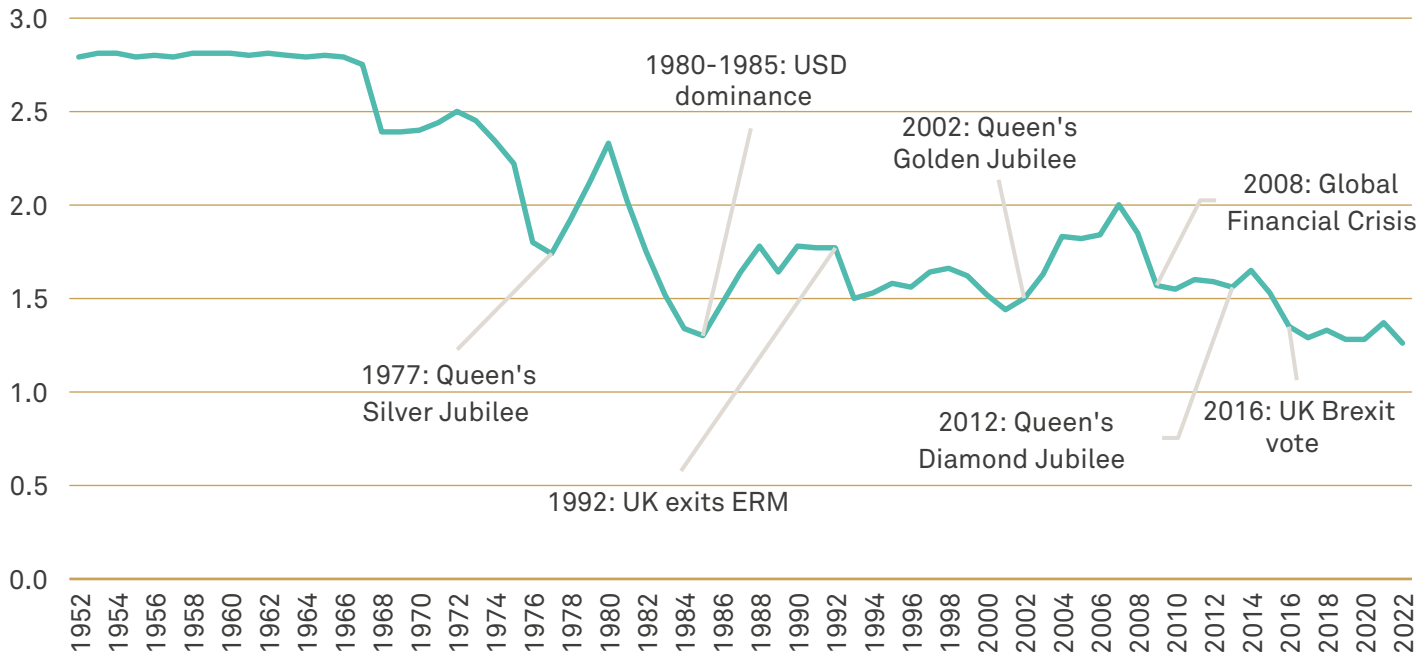
FX AND COMMODITIES

Citizens and currency markets alike are anticipating the Queen's platinum Jubilee. In 1952, when the Queen ascended the throne 1 pound sterling was worth $2.80. Over the last 70 years, while sterling has rallied for the Queen's Silver, Golden and Diamond Jubilees, its value has declined over the whole period with many major devaluation events occurring. For example, between 1980 to 1985, a strong US economy and increasing interest rates led GBP to a larger than 50% decline, and when the UK exited the European Exchange Rate Mechanism in 1992 there was a 20% decline in GBP. In more recent history the UK was not immune to the effects of the Global Financial Crisis which saw a 30% GBP decline, and in 2016 a major devaluation came with the Brexit vote which brought sterling down to $1.20. Today, the increasing cost of living is a major headwind for the UK economy with sterling currently around $1.25.

GBPUSD exchange rate



Source: Refinitiv Datastream, Tilney, data as at 30 May 2022

Market returns (Total return (%), sterling)	1 month	3 months	1 year	5 year
Equities				
MSCI All-Country World	-0.2	0.4	5.6	61.6
MSCI UK	1.3	4.4	15.7	23.1
MSCI UK Broad	0.9	3.0	10.0	20.9
S&P 500	-0.6	0.0	10.2	91.2
MSCI Europe ex UK	0.3	0.5	-1.2	31.2
MSCI Japan	1.3	-1.6	-1.9	24.9
MSCI Pacific ex Japan	-0.8	6.7	3.2	34.3
MSCI Emerging Markets	0.1	-1.2	-9.3	25.7
Bonds				
iBoxx GBP Gilts	-3.3	-8.1	-11.9	-3.8
iBoxx USD Treasuries	-0.3	-0.1	4.2	7.1
iBoxx GBP Corporate	-1.3	-5.3	-10.6	2.9
Commodities and trade-weighted FX				
Oil Brent Crude ($/barrel)	14.1	21.5	76.4	145.9
Gold ($/ounce)	-3.3	-3.1	-3.2	45.5
GBP/USD	0.4	-6.1	-11.3	-2.4
GBP/EUR	-1.1	-1.5	1.2	2.5
EUR/USD	1.5	-4.6	-12.4	-4.7
USD/JPY	-0.7	11.7	17.6	16.3

Market commentary

Inflation and monetary policy continue to be key drivers of markets, which experienced big daily swings in sentiment over the month. The US equity market fell to levels not seen since March 2021 with high growth stocks falling the most before a relief rally took hold on 23 May. The US market ended the month 0.6% lower in GBP total return terms, underperforming its geographical peers. The UK ended the month on another cheerful note returning 1.3% for the month. While Europe ex UK also rallied to end the month returning positive 0.3%. Government bonds ended the month with little change despite also exhibiting volatility. The UK 10 year yield crept up 10bps to nearly 2%, while US 10 year fell slightly to 2.7%. While markets remained challenging for much of the month, the end of month rally is a sign that some optimism has returned.

Key macro data	Latest	2021 Consensus forecast	Spot rates	31-May	Yields (%)	31-
UK GDP (YoY%)	8.70	3.80	GBP/USD	1.26	MSCI UK	3.77
UK CPI Inflation (YoY%)	9.00	7.65	GBP/EUR	1.18	MSCI UK broad	3.56
Bank of England Base	1.00	1.60	EUR/USD	1.07	10 Year Gilt	2.07

The market commentary, values and charts as at 31 May 2022. Total returns in sterling.

Returns are shown on a total return (TR) basis i.e. including dividends reinvested (unless otherwise stated). Net return (NR) is total return including dividends reinvested after the deduction of withholding tax.

Source: Refinitiv Datastream/Bloomberg

IMPORTANT INFORMATION

Please remember the value of investments and the income from them can fall as well as rise and investors may not receive back the original amount invested. Past performance is not a guide to future performance.

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