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INDEPENDENT FINANCIAL PLANNING
& INVESTMENT MANAGEMENT

Asset Class Commentary
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Although economies are not yet in a state of stagnation, the news certainly is – inflation still rules the headlines, as it has done for much of the past year.

Last week the US entered a technical recession which is not yet officially a recession. What does this mean? US GDP growth was negative for two consecutive quarters, which is the formal indicator of a recession. In the US however, the National Bureau of Economic Research is required to confirm this before it is actually an "official" recession.

In other words, if we don't want a recession, we won't have one…yet.

The big problem for US officials is that markets have already priced in recession risk. The biggest risk for a further fall in markets now is how big a recession will be and how long it will last for.

Yields on US Government debt fell slightly as investors bet on the Fed slowing the magnitude of their rate increases and this also caused equities to rise.

Elsewhere in the world German consumers are quickly tightening their proverbial belts, with retail sales falling by 8.8%. Disparity among European countries is clear and investment returns are varied.

Global earnings are slowing and while valuations have dropped, some investors argue that they have not dropped far enough.

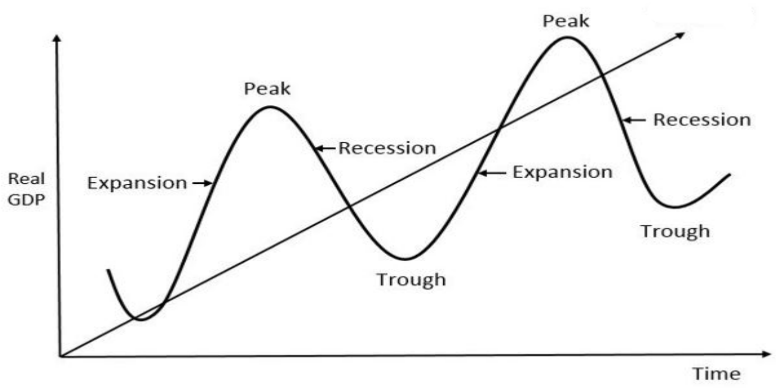
And finally, in an attempt to make this summary section more interesting, the new James Webb space telescope has produced images of the most distant galaxy ever seen, 35 billion light years away. We don't yet know what this means for equity markets, but if we find out we will let you know.

Areas of interest

- Indian equity has exhibited high levels of resilience and is one area to keep an eye on.
- Returns across emerging markets are highly varied and fund selection here is key.
- Chinese equities have given up recent gains as the country struggles to hit the economic growth targets.
- US equities have recovered somewhat as investors think the Fed will have to lower interest rates sooner than previously expected.
- UK equity has been supported by highly profitable energy firms but the outlook is bleak as the economy begins to slow down.

What is a recession?

The business cycle (see graph below) describes the expansion and contraction of the economy as Gross Domestic Product (GDP) shrinks and grows. Expansions and contractions recurrently happen and since the end of WW2 there have been seven recessions in the UK with the last occurring in early 2020 when the Covid pandemic hit.



A recession is a fall in a country's GDP, and is typically defined as when GDP has fallen for two consecutive quarters in a row.

A recession follows the peak of the business cycle as the economy is contracting in size. It is also characterised by higher unemployment, higher inflation, declining manufacturing, shrinking real income and increasing interest rates.

Another way of putting this is to define a recession as a simultaneous burst of business failings for one of the reasons listed below. A recession is essentially an economic indicator that something is not right in the economy.

It is usually not apparent a recession or expansion is happening until many months after. There are many indicators economists look at to determine when a recession may be approaching but it is far more of an art than a science. The length and magnitude of a recession is also a key variable that is unknown until after it has happened.

The exact causes of a recession vary, and it is difficult to attribute any one factor to a decline in GDP. The main causes in the past have been:

- A sudden economic shock
- Excessive inflation
- Excessive deflation
- Asset bubbles
- Excessive debt
- Technological change

For example, in the 2008 financial crisis vastly over-extended lines of credit on highly risky debt caused several large financial institutions to fail, sparking a global recession. Central banks had to reduce interest rates sharply in order to increase investment and productivity and bring economies out of recessions.

At the present time, supply chain shocks attributed from the war in Ukraine and general supply issues post-Covid (from a change in consumer spending habits) are causing prices to rise quickly. This is in turn causing consumers to cut back on their spending, decreasing consumption.

In order to try and bring the inflation rate down the BoE is raising interest rates. This has the effect of making it more attractive for consumers to save rather than to spend.

Higher interest rates also increase the cost of borrowing for businesses and consumers. Consumers will have less disposable income to spend and businesses will find it more expensive to obtain financing for investment and expansion. Businesses have to service their existing borrowings regardless of their revenue and this can cause them to reduce their labour force and/or reduce employees' salaries to save costs.

Overall the effect of increasing rates is to reduce demand which in turn reduces both inflation and GDP growth.

What does a recession mean for financial markets?

Whether an economy is in the expansion or recessionary phase of its business cycle matters for investment markets in the short and medium term. In the long-term most markets have grown regardless of the state of the economy at any one time.

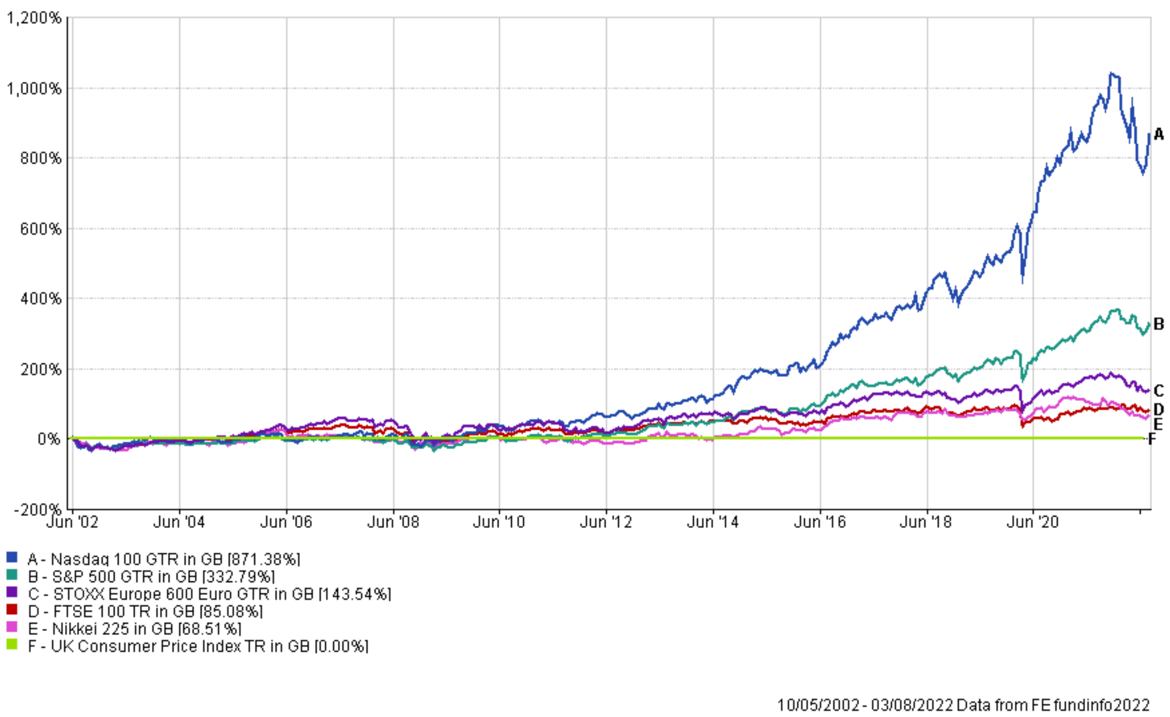


Chart showing performance of major indices since 2002 in real terms (using UK CPI as inflation proxy)

This is shown in the graph above. Despite several global recessions all of the above indices have grown in real terms.

As recessions approach, the perceived risk in equities is higher due to lower earnings and higher business failures, so investors tend to prefer safer assets such as government bonds. Property prices tend to drop as demand falls and infrastructure investment falls as government spending is cut back.

That said, different types of companies exhibit varying degrees of sensitivity to the health of the economy. The factors that affect this are: sensitivity of sales, proportion of variable costs to fixed costs (operating leverage), and the amount of borrowing (financial leverage).

Broadly, we can group companies into cyclical or defensive companies.

Cyclical company earnings tend to be sensitive to the health of the economy. An example of a cyclical industry would be the car industry. This is a discretionary good and for most people the purchase of a new car can be deferred until a time when their personal financial situation is in better shape i.e. when interest rates are lower on their borrowings and they have more disposable income.

For car manufacturers this means their earnings will not grow as much and will likely fall in a recession as they are selling less cars. The value investors place on them therefore falls.

Defensive companies are the opposite. Their earnings broadly stay the same regardless of the health of the economy. An example of a defensive company would be a supermarket. They provide consumer staples – people need to purchase food regardless of their financial situation. For this reason investors tend to move towards this type of company in a recession as their earnings are not expected to decrease and should stay the same or even grow.

On a larger scale we see investors choosing countries which have bigger industries which are expected to do well at any time. So far this year the UK's FTSE 100 has performed well, due in large part to its higher weighting of energy and commodity firms.

Countries which are big exporters of commodities have also benefitted from the high commodity prices and so have attracted investor attention. High commodity prices are typical at the height of an expansion.

The silver lining is that recessions do not last forever and markets do recover. Although economies will go through boom and bust cycles, it is important to remember that stock markets move independently of economies and tend to increase in value over the longer term.

UK

In the UK, social unrest over stagnating earnings growth is causing disruption in the public sector.

Consumer confidence continues to plummet and is at is lowest levels since records began. In October increases in the energy price cap are expected to pile more pressure on consumers as they look to start turning on their heating in the colder winter months.

Although the UK does not directly buy its energy from Russia, supply shortages have pushed global prices up impacting the UK nearly as much as mainland Europe. The increase in the price cap is only expected to add to already high inflation figures, currently at 9.4%.

At its last meeting the Bank of England increased interest rates by 0.50%, bringing the BoE base rate to 1.75%. This is not the 0.75% increase some investors had expected and the pound again dropped on this news.

GDP growth for the last quarter was 0.8%. The BoE has forecasted that the UK will enter a recession in the last quarter of the year and GDP will continue to shrink for 5 consecutive quarters. When the UK starts to grow again growth is expected to be slow relative to previous growth periods.

The debate over lower taxes and increasing economic growth is an important battleground in the contest between Rishi Sunak and Liz Truss to be the next Prime Minister. It is expected that if Liz Truss is elected the Pound will depreciate further in value. While this may benefit FTSE 100 companies, for the UK as a whole it is not ideal.

The key debate is whether cutting taxes at this time is a good idea, the aim being to spur economic growth. Sunak believes it is more important to control inflation first and then cut taxes. Truss believes in cutting taxes to promote economic growth and support consumers while prices are high.

The risk with Truss' approach is that it adds more fuel to the fire and pushes inflation up higher. It also increases the debt burden on the economy.

The risk with Sunak's approach is that by not helping consumers, his strategy risks pushing the economy into a deeper recession. Interest rates will only bring inflation down so much as much of the supply-side inflation is out of the BoEs control.

Year to date (YTD), UK stock markets are still the top performing major indices, although in the last month they have given up some of this ground as Asian and US equity markets recover some of their losses.

Europe

Second quarter Eurozone GDP was above the estimate, recording +0.7% on Friday 29th July 2022. This falls in line with the previous quarter's GDP growth.

Inflationary pressures continue to be a major problem not just in Europe but globally. To combat Eurozone inflation, which reached 8.6% in recent months, the ECB raised its interest rates by 0.5%. This rise has made indebted countries nervous as the cost of borrowing begins to rise.

As mentioned in the previous commentary, countries such as Italy are at a greater risk of yields spiking as interest rates are increased as they have a greater debt burden.

Europe increased its imports of Russian oil by over a fifth in July, highlighting the continent's reliance on Russian energy (which are supposed to reach zero in February 2023).

Following the pandemic, Europe's refining capacity has dropped yet oil prices have soared, until very recently as worries of recession have helped to reduce fuel prices. Energy and food prices soared when the Russia-Ukraine war broke out causing consumer spending power to deteriorate.

Furthermore, OPEC producers have agreed to slightly increase oil output by 100,000 barrels a day. Although this marginally helps, it does not provide the increased supply that is needed.

The Ukrainian infrastructure minister has claimed it will still take months to restore grain exportation to pre-war levels, despite Russia removing their blockade on Ukrainian ports. Some African nations rely heavily on Ukrainian grain, meaning acute food insecurities are not going to be resolved quickly.

Italy have encountered political issues over the last month deteriorating the investment case for the country further. After the Anti-Establishment 'Five Star Movement' boycotted a confidence vote on the 20th July, Italian Prime Minister Mario Draghi's resignation and the dissolution of parliament followed the next day.

Political instability usually negatively effects the macroeconomic conditions within a country as confidence falls and uncertainty increases. In the past, political instability has resulted in slower economic growth through decreased productivity and in some instances capital accumulation. The events in Italy have put pressure on the ECB to step up its anti-fragmentation programme, designed to protect countries that come under debt financing stress.

The German economy is continuing to struggle, as the country is experiencing serious natural gas shortages after supply from main Russian pipeline falls to a fifth of capacity.

Worries around the supply from Russia being cut completely have sparked estimates of the resulting damage. Commerzbank predicts German Economic activity would shrink by 2.7% in 2022 and 1.1% in 2023. The German government's response to the crisis is likely to be seen in gas rationing this coming winter. Shares in Commerzbank have fallen more than 20% over the past six months, the German DAX index has also fallen by 9.28% over this period.

Overall performance over the last year for the major European Indices is negative with the DAX index producing a performance of -14.42%. The Euronext France CAC 40 index appears to be the most resilient over the last year, only falling 2.72%. One likely reason for this resilience is France's inflation rate which has been regulated to just 5.84% compared with Germany's which has risen to over 7.9% (paired with its gas supply issues).

Chart showing the YTD performance of Major European stock market indices

US

The US Federal Reserve once again raised interest rates by 0.75%, bringing the target rate up to 2.25% to 2.50%. The hawkish tone of the Fed has slightly softened as they face the reality that an economic recession is more likely that not, even if they do not want to openly admit this. Inflation data also points towards a slight slowdown which will be scrutinised closely when the next set of data is released.

Further rate increases will be coming but the magnitude is likely to be lower and the turning point for when rates will need to be brought down has come forward.

As mentioned previously, although the US is technically in a recession, as the job market is still strong with unemployment low and consumer demand resilient, the US is officially not in a recession (in their opinion!).

US Government bonds have rallied as investors move to safer assets. At the same time US stocks have rallied as investors also price in the likelihood that peak interest rates will be reached sooner. In the last month the NASDAQ has gained 9.23% and the S&P 500 5.35%.

If the Fed does overstep the mark and damage the economy, which is most likely given recent economic data, in its bid to bring inflation down we will see bond yields drop further.

The number of jobs created is expected to have fallen from the previous month, indicating a further slowdown in the economy.

Emerging Markets

Early on in 2022 investor sentiment for returns from the Emerging Market sector were high as countries like South Africa and Latin America reaped the profits from high commodity demand and prices. We have recently started to see a reversal as investors look to trim their risk further amid rising US interest rates and increasing economic troubles in emerging countries.

If we look at the performance of the IA Global Emerging Markets sector, since the start of 2022 the sector has dropped over 12% with no signs of any recovery. The YTD performance and longer-term performance of the sector and individual countries are shown below. The outlook is extremely varied and far from certain.

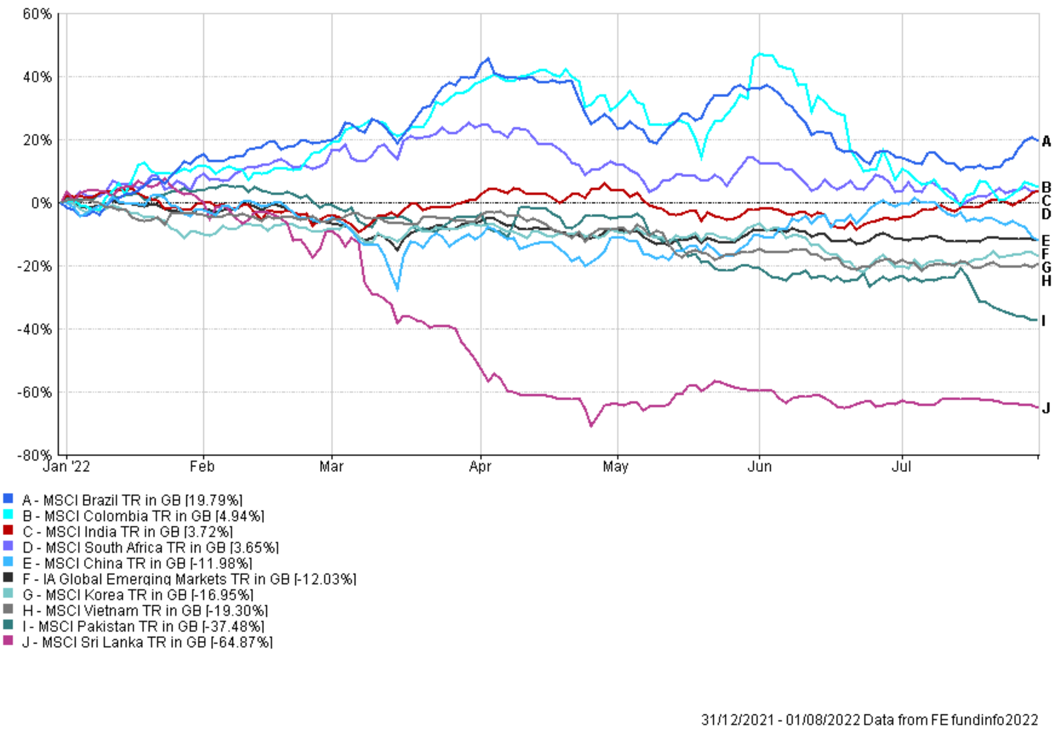


Chart showing YTD performance of MSCI Emerging Markets Indices

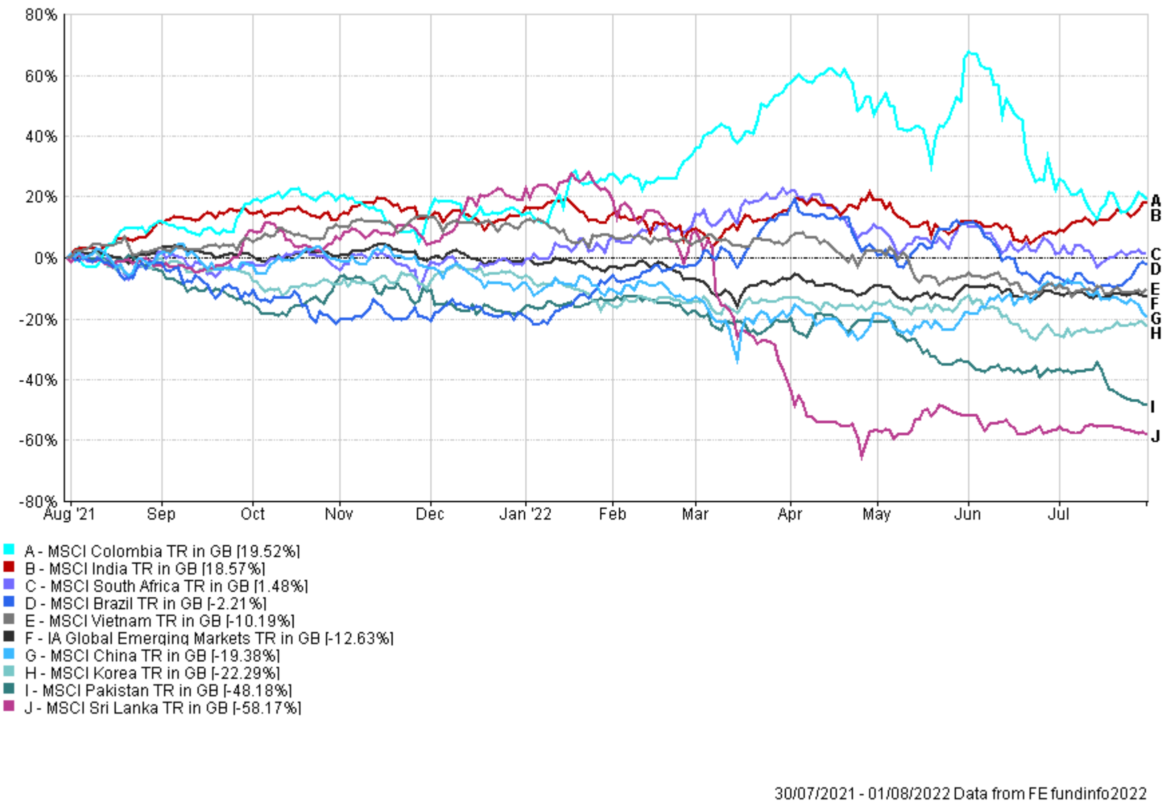


Chart showing 1 Year performance of MSCI Emerging Markets Indices

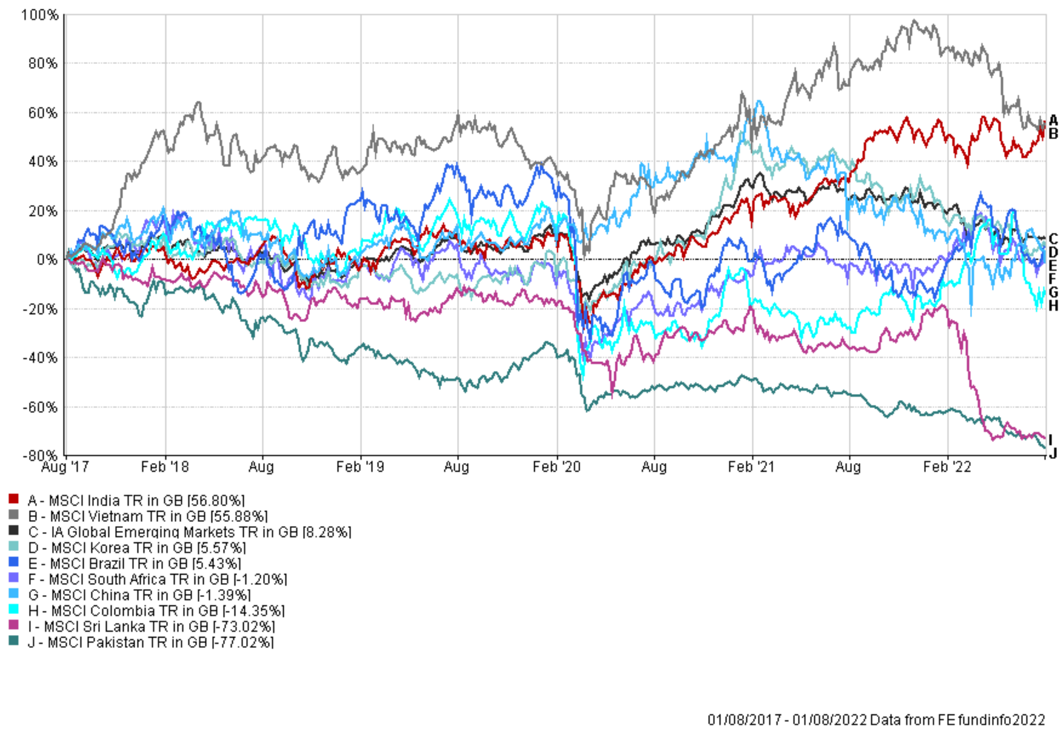


Chart showing 5 Year performance of MSCI Emerging Markets Indices

The charts above show that over the YTD performance of exporting countries such as South Africa and Brazil have performed well due to high commodity prices. Over the longer 5-year term these indices have produced meagre growth due to political instability and poorly managed economies.

As noted in the asset commentary in March, rising US interest rates makes it more expensive for emerging countries to service their debts as they are often denominated in US dollars. With a rising US dollar it becomes more expensive to buy the currency to pay interest payments on the debt. It also pulls investor demand away into a safer asset which is yielding an increased return relative to the risk and returns of emerging market equity.

An increasing problem for emerging countries and emerging funds is the slowdown in the Chinese economy. For emerging market funds China makes up a large proportion of the asset allocation – for example, in the MSCI Emerging Markets Index China makes up 35% of the index.

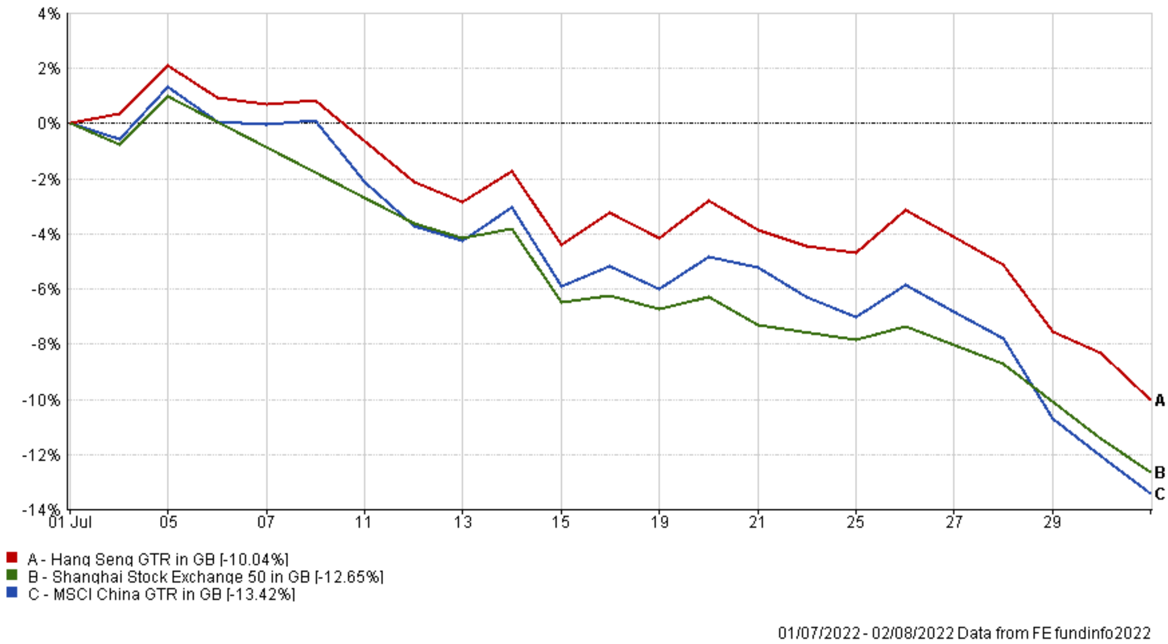


Chart showing 1 month performance of Chinese stock market indices

As we can see from the chart above, the slowdown in the Chinese economy has caused the equity markets to drop by over 10% in the last month alone. While Emerging Market funds may be agnostic from the Chinese indices, it still presents a bleak outlook for the sector as a whole due to their typically higher weighting.

Only a few months ago investors were reintroducing money back into Chinese equity as the government applied looser monetary policy while the rest of the world was tightening. We can see now that this optimism was short-lived.

This reiterates the point that a long-term investment strategy is more important than any short-term fluctuations in markets.

Many emerging countries rely on China for financing and with China's economic growth falling this financing is becoming harder to acquire.

China may also be more reluctant to invest in higher risk countries given the current state of its Belt & Road Initiative (its overseas lending program). Many of the borrowers are at risk of default and are trying to renegotiate the terms of the agreement with China and their other lenders.

The majority of borrowers in the initiative have high levels of economic and political risk and the risks of a debt crisis are increasing. The commercial return for Chinese banks is not materialising and this could prompt China to scale back any future overseas lending it has planned.

The level of risk in many emerging countries is high and at a time of already heightened volatility, many investors simply do not want this risk in their portfolio.

Take Sri Lanka for example. The country is in economic turmoil and has defaulted on loans including on those from China. The MSCI Sri Lanka stock market index has dropped over 64% YTD with long-term prospects looking incredibly bleak.

An exception to this trend is India. YTD performance for the MSCI India index is 3.72%, 1 year performance is 18.57% and 5 year performance is 56.80%. Although India is not immune from the economic risks stemming from rising prices, the long-term outlook based on high economic growth and a highly digitised population presents an attractive investment case.

As always, diversification is key for managing investment risk. Performance across countries in the emerging markets sector varies considerably. If MSCI tracker funds for individual countries are used then careful analysis of the underlying economic fundamentals of each country is crucial.

There will continue to be high variance between the returns of individual emerging market funds, and selecting the right investment fund is essential when investing in this sector.

Robert Dougherty, Associate IFA
August 2022.

This article is not a recommendation to invest and should not be construed as advice. The value of an investment can go down as well as up, and you may get less back than you invested.