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June 2022
Quarter in Review

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CENTRAL BANKS SAIL BETWEEN SCYLLA AND CHARYBDIS

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Equities and bonds were both pushed lower over the second quarter in an environment of higher inflation, tighter monetary policy, growth concerns and risks related to the Russia/Ukraine conflict. As inflation rose to 40-year highs, central banks were forced to become more aggressive in terms of the pace of monetary policy tightening which, in turn, pushed bond yields to multi-year highs. Equities were negatively impacted by the rise in yields, while expectations of higher interest rates posed risks to the global growth outlook. Declining business and consumer confidence, and signs of slowing economic momentum, all contributed to growing risks and speculation over a possible recession in 2023.

Inflation for longer

Having dipped slightly in April, US inflation rose to a new cycle high of 8.6% year-on-year in May, with energy and food prices remaining firm while inflation broadened out across the economy. In Europe, inflation rose to 8.1% year-on-year at the headline level, although core inflation was more contained at only 3.8%. Oil prices remained firm as Europe placed an embargo on Russian oil imports, hopes for a nuclear deal between the US and Iran faded and global supplies remained tighter than anticipated. European gas prices remained high given risks of further disruptions in supplies from Russia. The greatest risk to Europe remains around gas supplies, and concerns increased as Russian gas supplies via the Nord Stream 1 pipeline were reduced by almost 50% in late June. Food inflation continued to rise due to the disruption of grain exports from Ukraine, poor global growing conditions, and rising fertiliser costs. The expected peak in inflation has now been pushed out several months, with the highs in the US and Europe expected in mid-to-late summer.

Central banks forced to act

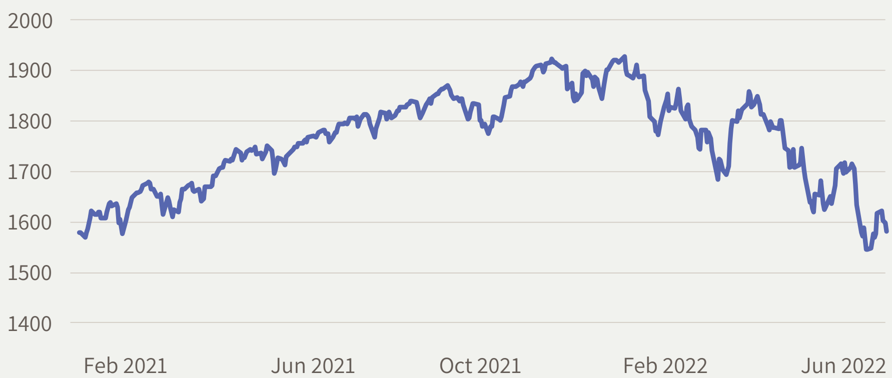
Central banks were forced to react to the persistence of higher inflation with more aggressive policy guidance and interest rate rises. The US Federal Reserve (Fed) reaffirmed its commitment to bring inflation back to its 2% target and raised interest rates by 125 basis points (bps) during the quarter, including the first 75bps hike in almost 30 years. The Fed suggested it would raise rates by another 2.00% by year-end with the federal funds rate potentially peaking at 3.75-4.00% this cycle, well into restrictive territory. It also brought forward the start of quantitative tightening and, in June, began reducing the balance sheet by $47.5bn per month; this is set to increase to $95bn per month in September. The European Central Bank (ECB) announced that net asset purchases would end on 1 July and that it would increase interest rates by 25bps at the late July policy meeting.

Global growth downgraded

Global growth forecasts for 2022 continue to be downgraded – from 4.2% at the start of the year to 2.9% – with forecasts for 2023 being revised further to 2.5% as fears of a possible recession in 2023 grew. Contributing to the downgrades was the unexpected contraction in the Chinese economy in the second quarter following the country's 'zero tolerance' Covid-19 policy lockdowns. Economic releases generally disappointed, with consumption easing as rising inflation eroded purchasing power and financial conditions tightened. Despite labour markets remaining strong, consumer confidence levels across many regions fell to multi-year lows, while business sentiment surveys also declined on rising costs and easing demand.

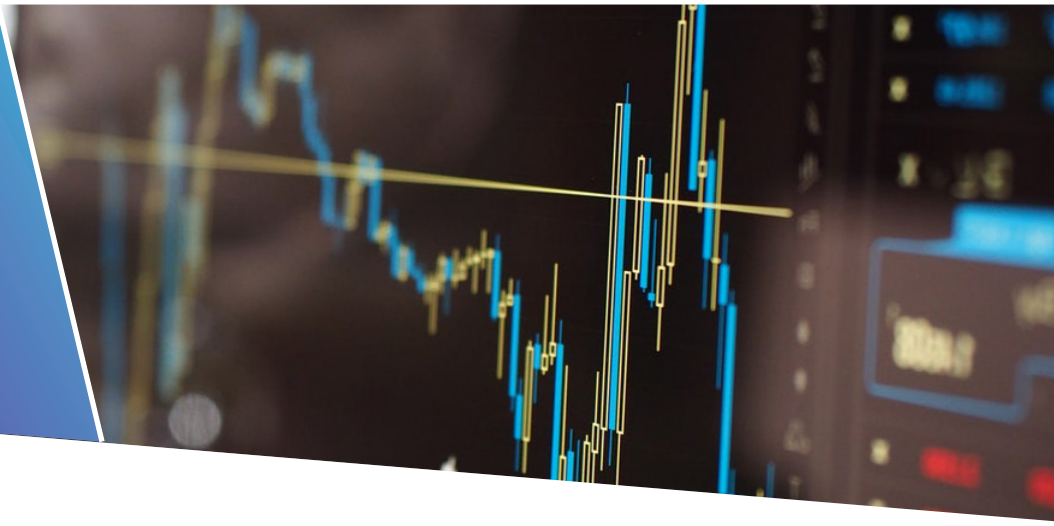
CHART OF THE QUARTER

Global Equities



Source: ILIM, Bloomberg. Data is accurate as at 1 July 2022.

MARKET ROUND-UP



Equities

Over the quarter, the MSCI AC World equity benchmark fell -13.5% (-10.1% in euros) as central banks turned increasingly aggressive on fighting inflation, bond yields rose further, and there were rising concerns around the growth backdrop. The US fell -16.8% (-11.4% in euros) as the Fed, in response to upward surprises in inflation, guided towards a faster pace of interest rate rises and balance sheet reduction. Europe ex-UK fell -10.0% (-9.9% in euros) as the ECB announced a major policy pivot and guided towards a more rapid removal of policy accommodation while growth concerns increased. The UK outperformed, falling only -2.9% (-4.7% in euros), benefiting from its higher weight in energy and commodity stocks and defensive sectors such as consumer staples and health care. Japan also outperformed, falling -4.4% (-9.1% in euros) as the Bank of Japan committed to supporting its low bond yields and the Yen weakened which was supportive of exporters.

Bonds

Global bonds fell over the quarter as yields continued to rise on hawkish guidance and policy actions from major global central banks as inflation again surprised to the upside. US 10-year yields rose from 2.34% to 3.01% as the Fed raised interest rates by 125bps, announcing the first 75bps increase in almost 30 years while guiding towards an additional 200bps of rises before year end.

UK 10-year yields rose from 1.61% to 2.23% with the Bank of England raising interest rates for the fifth time this cycle to 1.25% with further rate rises to come. The bank predicted inflation will peak at over 11%.

Japanese 10-year yields were the exception, rising only 2bps to 0.23% as Bank of Japan's asset purchases continued to cap the upside in yields.

The ICE BofA Merrill Lynch Eurozone > 5-year sovereign bond benchmark fell -10.4% over the quarter as eurozone inflation rose to a record high of 8.1% year-on-year, forcing the ECB to announce the cessation of asset purchases on 1st July and to guide towards the first interest rate rise in 11 years at the upcoming policy meeting in late July.

10-year German yields rose from 0.55% to 1.34%, having hit their highest level since early 2014 in mid-June at 1.93%. Peripheral spreads also widened further during the quarter as the ECB guided towards a significant reduction in policy accommodation. At the end of June, Italian 10-year spreads against Germany had risen to 192bps while Spanish spreads were 108bps, although both were off their highs as the ECB committed to introducing tools to combat the rise in spreads.

European investment grade (IG) corporate bonds fell -7.4% with global high yield (HY) credit down -9.7%. Higher sovereign bond yields pulled yields in IG bonds up to 3.11% with spreads widening to 211bps. In high yield corporate bonds, yields rose 258bps through the quarter to 7.94% with spreads 218bps higher at 536bps.

Currencies and commodities

The euro fell to 1.0483 against the US dollar as the dollar benefited from its safe haven status in the risk-off environment and rising interest rates. The euro was negatively impacted by the widening in peripheral bond spreads and fears of fragmentation across the eurozone as the ECB begins to tighten monetary policy. Increasing concerns around the European growth outlook and its vulnerability to the Russia/Ukraine crisis also impacted the euro.

Commodities rose 2.0% (8.6% in euro terms) but were off their highs. Tightness in energy supplies resulted in oil and gas prices remaining firm. With Europe announcing plans to place an embargo on Russian oil imports by year-end and, with hopes fading for a US/Iran nuclear deal that would free up additional oil supplies, West Texas Intermediate oil rose to a high of $122 per barrel (bbl) during the quarter. By the end of June, the price had fallen back to $105/bbl as there were increasing concerns around demand in the slowing growth environment, leaving it 5.5% higher on the quarter.

European gas prices rose 18.4% as Russian supplies to Europe were reduced towards the end of June; Russia is thought to be 'weaponising' gas supplies in response to sanctions by the West.

Food prices were strong given supply disruptions associated with the war in Ukraine and poor growing conditions, with wheat prices up 16.0% in the quarter.

Metal prices were generally lower in the slower growth backdrop, particularly given the weakness in the Chinese economy. Gold fell -6.9%, despite the risk-off environment, with the higher US dollar and higher US real yields acting as a drag.

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	QTD Return (%)	YTD Return (%)	2021 Return (%)
MSCI Ireland	-14.3	-29.9	17.1
MSCI United Kingdom	-4.7	-0.8	27.5
MSCI Europe ex UK	-9.9	-16.9	25.4
MSCI North America	-11.4	-13.7	36.6
MSCI Japan	-9.1	-13.1	9.8
MSCI EM (Emerging Markets)	-5.6	-10.2	5.2
MSCI AC World	-10.1	-12.9	28.1

10-Year Yields	Yield Last Month (%)	2021 Yield (%)	2020 Yield (%)
US	3.01	1.51	0.91
Germany	1.34	-0.18	-0.57
UK	2.23	0.97	0.20
Japan	0.23	0.07	0.02
Ireland	1.98	0.24	-0.30
Italy	3.26	1.17	0.54
Greece	3.62	1.34	0.63
Portugal	2.42	0.47	0.03
Spain	2.42	0.57	0.05

FX Rates	End last month	2021 Rates	2020 Rates
U.S. Dollar per Euro	1.05	1.14	1.22
British Pounds per Euro	0.86	0.84	0.90
U.S. Dollar per British Pounds	1.22	1.35	1.37

Commodities (USD)	QTD Return (%)	YTD Return (%)	2021 Return (%)
Oil (WTI)	5.5	40.6	55.0
Gold (Oz)	-6.9	-1.1	-3.4
S&P Goldman Sachs Commodity Index	2.0	35.8	40.4

Source: ILIM, Bloomberg. Data is accurate as at 1 July 2022.

THE ILIM VIEW – LOOKING AHEAD

The outlook for equity markets over the next twelve months is dependent on several factors, including central bank policy, growth, inflation (both expected and realised) and the evolution of the Russia/Ukraine crisis.

Equities have declined year-to-date as central banks have tightened policy, bond yields have risen and growth forecasts have fallen.

Post the falls, equities now look attractive on an absolute valuation basis, trading on a 12-month forward price-to-earnings multiple of 13.9x against a long-term average of 16.0x.

If consensus economic and earnings forecasts prove to be correct and we are just in a mid-cycle slowdown, there is double-digit upside in equity markets on a one-year view. A moderation in inflation with no additional policy tightening beyond what is currently discounted in markets would also be supportive.

However, equities continue to face several headwinds. Due to the persistence of high inflation, central banks continue to tighten policy and withdraw policy accommodation, which has been supportive of equity markets in recent years. Given the significant rise in bond yields, equities are no longer cheap on a relative valuation basis and are expensive on some measures versus bonds. In addition, earnings are at risk of being downgraded due to margin pressures from input and labour costs.

For equities to begin to recover from their recent falls, investors need to believe we are at the peak of policy tightening and growth risks are fading. Given the risks around inflation and central banks' policy responses, potential downside in growth and earnings forecasts, the failure to find resolutions to geopolitical issues and the removal of the undervaluation of equities versus bonds in the higher yield environment, we see risks in equities as still being skewed to the downside.

Navigating equity markets is difficult, even in a benign environment, but it has become more arduous in the current backdrop with heightened uncertainty on many issues. As a result, the increased volatility that has been evident this year is likely to continue.

While our outlook for equity markets suggests limited upside in the short term, the outlook remains positive over the medium to long term, with an upside of approximately 5% per year expected on a 5-10 year view.

THE MONTH AHEAD

Economic data releases

13 July	US Inflation rate YoY (June) GB GDP (May)
15 July	US Retail Sales MoM (June) China GDP Growth rate YoY (Q2)
19 July	GB Unemployment Rate
20 July	GB Inflation Rate YoY (June)
21 July	ECB Interest Rate Decision Japan Interest Rate Decision Japan Balance of Trade (June)
22 July	Japan Inflation Rate GB Retail Sales MoM (June)
27 July	US Fed Interest Rate Decision
29 July	EA Inflation Rate YoY Flash (July)

Source: ILIM, Trading Economics. Data is accurate as at 30 June 2022.

Events to watch

20 July	BoJ meeting
21 July	ECB meeting
26 July	US Fed meeting

Source: BlackRock geopolitical calendar. Data is accurate as at 30 June 2022.

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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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