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September 2022
Quarter in Review

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PUTTING THE PIVOT TO BED

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The third quarter began with a strong rally for equities and bonds on the back of falling commodity prices and expectations of a possible US Federal Reserve (Fed) policy pivot and interest rate cuts in 2023. However, from mid-August, this mood gave way to acceptance of tighter monetary policy for some time to come; the Fed and other central banks stressed that policy tightening would continue until inflation is clearly falling back towards the banks' 2% targets. The commitment to continue raising rates caused global bond yields to rise to their highest levels in 10-12 years. Contagion from the surge in UK gilt yields, following the announcement of a large, unfunded fiscal package, also contributed to the rise in yields. Weak global economic data and several profit warnings from large corporates added to the pressure on equities, as did fears over an escalation of the Russia/Ukraine conflict. By quarter end, global equities and bonds had fallen to new year-to-date lows.

Inflation – peaked in the US?

While it appears that US inflation may have peaked, with the headline reading down from a high of 9.1% year-on-year (y/y) to 8.3% y/y, the monthly reading for August surprised to the upside. Core inflation was double its expected level at 0.6% month-on-month, rising to 6.3% y/y. In the Eurozone, inflation hit a new all-time high of 10.0% y/y, with core up to 4.8% y/y.

The Fed – putting the pivot to bed

Following speculation earlier in the quarter about a possible shift to more dovish policy stances, central banks pushed back. The Fed has suggested that there is a requirement to create slack in the labour market in order to ease second-round inflation pressures through wage inflation. The US central bank raised interest rates by 150 basis points (bps) over the quarter and, in September, doubled the pace of its balance sheet run-off to $97bn per month. It has guided to another 125bps of rate rises before year end, with an additional 25bps rise in 2023 before rates are expected to peak.

The ECB – more tightening ahead

In July, the European Central Bank (ECB) raised interest rates for the first time in 11 years and ended asset purchases earlier than had been expected. In September, it raised rates by 75bps, the largest ever increase, bringing the deposit rate to 0.75%. Commentary and rhetoric from ECB council members has become much more hawkish, suggesting further rate rises are likely, with the market now discounting a deposit rate of 1.75% at year end and a peak of 2.75% in 2023.

Gas crisis – a tough winter for Europe

The European Energy Crisis is severely impacting manufacturing and other industries, with a recession in Europe likely, despite government support packages being put in place to aid consumers and businesses with energy costs.

The BoE – intervention in the bond market

In the UK, Liz Truss was elected leader of the Conservative Party and appointed Prime Minister, following Boris Johnson's resignation. She immediately announced a large energy support package of approximately 5% of GDP, capping household energy bills at an average of £2,500 p.a. Subsequently, a mini-budget provided additional stimulus via tax cuts, with much of the giveaway being unfunded and resulting in a large increase in the UK fiscal deficit.

The market reaction was extremely negative, with sterling and UK gilts selling off sharply. The turmoil was so severe that some UK pension funds were at risk of failing given the scale of margin calls made on their large exposures to UK long-dated gilts and inflation linked bonds, held via derivatives. The Bank of England (BoE) was forced to announce that it would conduct temporary purchases of long dated gilts until 14 October to restore orderly market conditions.

Global growth – recessionary fears

Global growth forecasts for 2022 have been revised down to 2.8% from 4.2% at the start of the year, while forecasts for 2023 have been revised down to 1.9%, with growing fears of a possible recession in 2023. However, in the US, retail sales, the labour market, regional manufacturing indices, ISM sentiment surveys and durable goods orders were all ahead of expectations, suggesting that the US economy was recovering somewhat after a weak first half. Elsewhere, data generally remained soft and continued to deteriorate. The global composite PMI fell to its lowest level since June 2020. Activity data and sentiment readings across Europe continued to remain very weak. Consumer confidence fell to new all-time lows in both the Eurozone and the UK.

MARKET ROUND-UP

Equities

Over the quarter, the MSCI AC World equity benchmark fell -4.7% (-0.4% in euros) as centrals banks reaffirmed their commitment to tighten monetary policy, bond yields rose to multi-year highs and concerns over the global growth outlook increased.

The US fell -4.7% (+1.7% in euros) as expectations for the peak in the federal funds rate rose on more hawkish commentary and guidance from the Fed. Technology stocks underperformed given the continued rise in bond yields.

The UK outperformed, falling -2.9% (-4.8% in euros) as the weakness in sterling supported overseas earners. A higher relative weight in defensive sectors, such as pharmaceuticals and staples, also supported the UK.

Japan also outperformed, falling -1.5% (-1.3% in euros), with the weaker yen supporting exporters as the Bank of Japan, in contrast to other central banks, remains committed to maintaining an accommodative monetary policy stance. An improvement in economic data, as Covid-19 restrictions were lifted, also supported the market.

Emerging market (EM) equities fell -8.0% (-5.5% in euros). The Chinese market underperformed due to difficulties in the property market and restrictions remaining in place given the country's ongoing 'zero tolerance' Covid-19 policy.

Bonds

Despite an initial strong rally, global bonds fell over the quarter as yields rose to multi-year highs on central banks' continued monetary policy tightening in response to persistently high inflation. The announcement of a large, unfunded fiscal package in the UK, which drew criticism from many sources, led to a sharp correction in UK assets, particularly gilts. This caused some contagion to global bond markets and added to the upward pressure on bond yields at quarter end.

The ICE BofA Merrill Lynch Eurozone > 5-year sovereign bond benchmark fell -6.9%. The German 10-year yield rose 77bps to 2.11%, having hit a high of 2.35%, as Eurozone inflation rose to a record high of 10.0% y/y. Upward pressure on yields also came from the ending of ECB asset purchases on 1 July, the raising of interest rates for the first time in 11 years and guidance from the ECB that further significant rises in interest rates were likely in coming months. Peripheral spreads widened during the quarter on expectations of reduced policy accommodation and uncertainty associated with the Italian general election. At the end of September, Italian 10-year spreads against Germany had risen to 240bps while Spanish spreads were 118bps.

European investment-grade (IG) corporate bonds fell -3.3%, with global high yield (HY) credit down -0.8%. Higher sovereign bond yields pulled yields in IG bonds up 1.02% to 4.13%, with spreads widening 9bps to 220bps. In high yield corporate bonds, yields rose 61bps through the quarter to 8.55%, although spreads were 51bps lower at 485bps.

EM local debt stood out across fixed income markets, rising 1.4%. While yields rose slightly to 7.39%, the relatively large carry via higher yields provided some offset, while EM currencies were also slightly stronger against the euro. EM hard currency debt fell -4.7% as yields rose 90bps to 8.72%, pulled higher by the rise in global and US bond yields on the back of continued monetary tightening and more hawkish central bank commentary.

Currencies and commodities

The euro fell below parity to 0.9802 against the US dollar. The euro weakened as concerns rose over the outlook for European growth amid the continued deterioration in economic data and the surge in natural gas prices; Russia significantly reduced supplies to Europe over the quarter, ahead of the suspected sabotage of the Nord Stream pipelines in September. The US dollar benefited from the more hawkish guidance from the Fed and its 'safe haven' status in the risk-off environment.

Commodities fell -10.3% (-4.3% in euros). Increasing concerns over the outlook for commodity demand in the slowing growth backdrop, particularly given the weakness in the Chinese economy, caused commodity prices to fall.

Brent oil fell -23.4%, despite OPEC announcing a production cut of 100,000 barrels per day.

European gas rose, although it was off the highs where it had been up 233% compared to the end of June. The rise in gas storage levels across Europe beyond targeted levels eased the pressure on prices towards quarter end.

Food prices remained firm as weather conditions impacted expected production levels, with wheat up 3.2%.

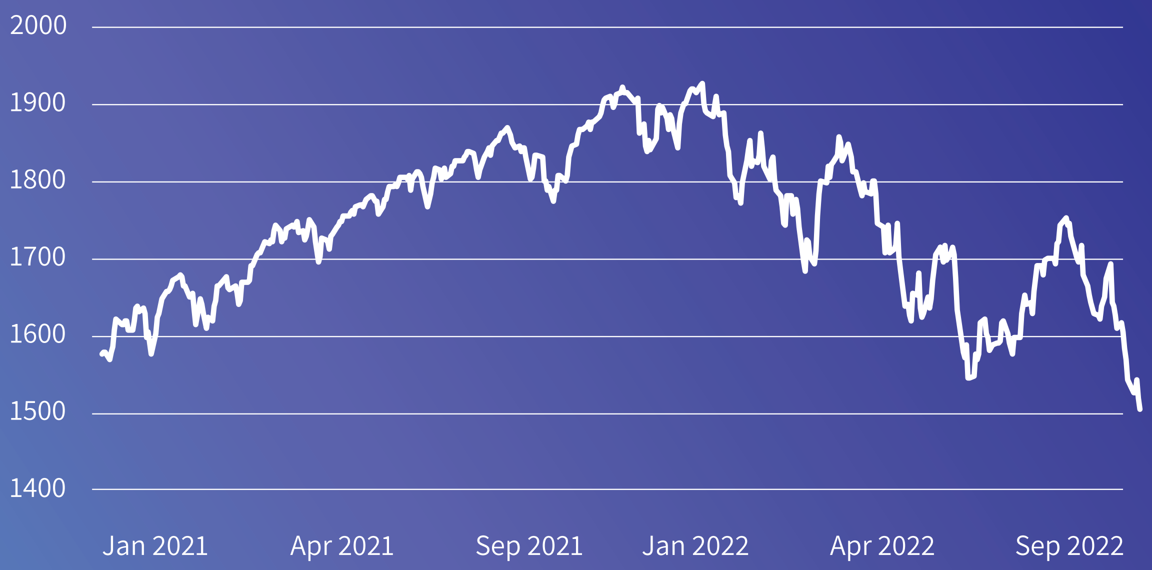
Metal prices were generally soft, with aluminium down -11.6% and copper -8.5% due to slower growth and weaker demand.

Gold fell -8.3% due to the stronger US dollar and higher US real yields.

MARKET ROUND-UP continued

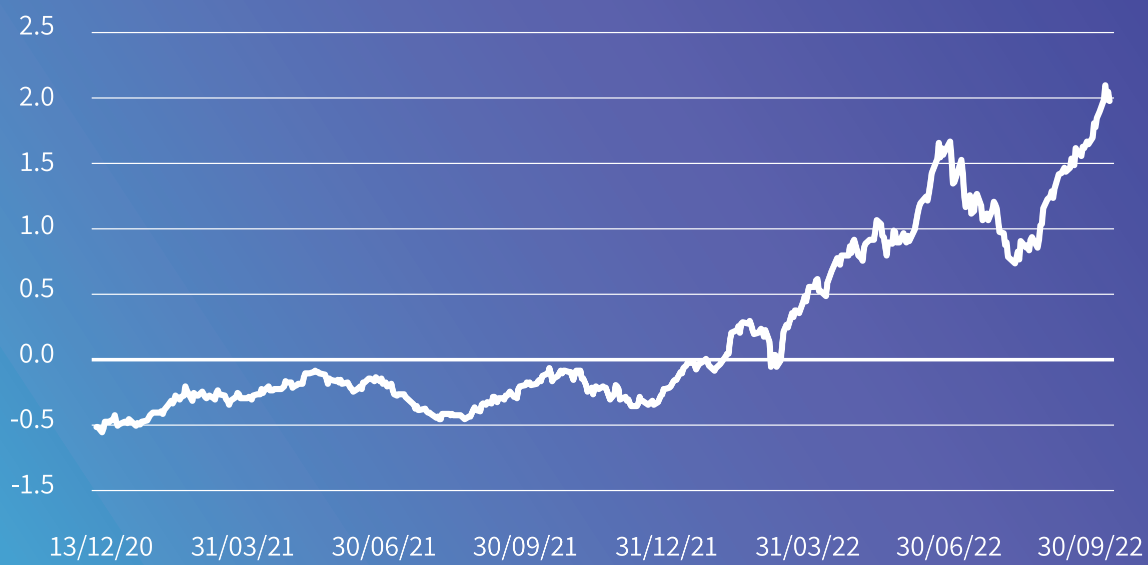
CHARTS OF THE QUARTER

Global Equities



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

Bonds – German 10-year yield



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

MARKET SNAPSHOT

Market returns (EUR)

Equity Markets (EUR)	QTD Return (%)	YTD Return (%)	2021 Return (%)
MSCI Ireland	0.9	-29.2	17.1
MSCI United Kingdom	-4.8	-5.6	27.5
MSCI Europe ex UK	-3.8	-20.1	25.4
MSCI North America	1.5	-12.4	36.6
MSCI Japan	-1.3	-14.2	9.8
MSCI EM (Emerging Markets)	-5.5	-15.1	5.2
MSCI AC World	-0.4	-13.3	28.1
10-Year Yields	**Yield Last Month (%)**	**2021 Yield (%)**	**2020 Yield (%)**
US	3.83	1.51	0.91
Germany	2.11	-0.18	-0.57
UK	4.09	0.97	0.20
Japan	0.24	0.07	0.02
Ireland	2.69	0.24	-0.30
Italy	4.51	1.17	0.54
Greece	4.86	1.34	0.63
Portugal	3.18	0.47	0.03
Spain	3.29	0.57	0.05
FX Rates	**End last month**	**2021 Rates**	**2020 Rates**
U.S. Dollar per Euro	0.98	1.14	1.22
British Pounds per Euro	0.88	0.84	0.90
U.S. Dollar per British Pounds	1.12	1.35	1.37
Commodities (USD)	**QTD Return (%)**	**YTD Return (%)**	**2021 Return (%)**
Oil (Brent)	-23.4	5.7	55.0
Gold (Oz)	-8.3	-9.2	-3.4
S&P Goldman Sachs Commodity Index	-10.3	21.8	40.4

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

THE ILIM VIEW – LOOKING AHEAD

The outlook for equity markets over the next twelve months is dependent on factors including central bank policy, growth, inflation 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 13.2x against a long-term average of 16.0x.

If 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 now expensive versus bonds. Earnings are at risk of being downgraded due to margin pressures from higher input and labour costs with risks also to top-line growth in a slowing growth environment.

For equities to bottom, investors need to believe that we are at the peak of policy tightening and that growth risks are fading. Given the risks around inflation and central banks' policy responses, growth and earnings forecasts, 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 against the current backdrop. As a result, the increased volatility evident this year is likely to continue.

While our outlook for equity markets suggests limited upside in the short term, the prospects remain positive over the medium to long term, with upside of approximately 6% p.a. expected on a 5-10 year view.

THE MONTH AHEAD

OCTOBER

13
US inflation rate y/y (Sep)

14
US retail sales m/m (Sep)

19
GB inflation rate y/y (Sep)

21
GB inflation rate y/y (Sep)

26
US new home sales (Sep)

27
ECB interest rate decision

31
EA growth rate y/y flash Q3

EA inflation rate y/y flash (Oct)

EVENTS TO WATCH OVER THE QUARTER

OCTOBER

27 October
ECB meeting
BoJ meeting

NOVEMBER

1 November
Fed meeting

8 November
US midterm elections

DECEMBER

13 December
Fed meeting

15 December
ECB meeting

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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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