Investment review – EUR

Second quarter 2022

Capital markets experienced a turbulent quarter. Global equities fell by 10.2% in euro terms, their worst quarterly decline since the initial pandemic downturn. Meanwhile, German 10-year bund returns declined by 6.0% (unhedged, euro terms).

Volatility was particularly elevated over the quarter: the S&P 500 exhibited daily moves of more than +/-2% on nearly a third of trading days. The MOVE Index – a measure of US bond market implied volatility – also briefly jumped to its highest reading since the start of the pandemic.

Central to this volatility were the prospects of faster normalisation in interest rates, persistent inflation, and mounting global growth concerns. The geopolitical landscape continued to be challenging during the quarter, as Russia's invasion of Ukraine showed no signs of resolution in the near future. To date, the humanitarian and economic costs from Russia's invasion have been immense. The global community have further severed financial ties through sanctions, alongside renewed efforts to reduce their dependence on Russian energy. Europe, for instance, is set to halt seaborne Russian oil imports later this year. Meanwhile, NATO remains on 'high alert', increasing the number of troops in the region more than sevenfold.

The economic data continued to paint a mixed, albeit positive picture.

After posting modest expansions at the start of the year (the US was the notable exception, contracting by 0.4% in the first quarter), global activity momentum slowed into the second quarter. However, most major economies reported expansionary (albeit softer) PMI readings between April and June. The closely-watched US ISM Manufacturing PMI also expanded in June (though the forward-looking new orders contracted for the first time in over two years). US business inventory ratios also remained below pre-pandemic levels – restocking may provide one tailwind to growth going forward. Most encouragingly, labour markets remained resilient on both sides of the Atlantic. The latest unemployment rates in the US (3.6%), eurozone (6.6%) and UK (3.8%) were close to (or even at) record lows, with wages creeping slowly higher.

Headline inflation rates moved higher, now at new multi-decade highs in the US (8.6% year-on-year), eurozone (8.6%) and the UK (9.1%). The supply shock induced by Russia's invasion – primarily through energy and food shortages – remained a big contributor. These elevated inflation rates may not have peaked yet in some countries. The Bank of England (BoE) warned that UK consumer price inflation could rise above 11% towards the end of this year.

With inflation well above target and the labour market close to full employment, monetary policymakers are now acting more decisively. The Federal Reserve (Fed) raised its target rate by 1.25% to 1.50–1.75% over its two most recent meetings and signalled further tightening to 3.25–3.50% by the end of the year. It also began scaling back its bloated balance sheet.

The European Central Bank (ECB) stated that it would begin hiking rates from July onwards, after concluding its pandemic asset purchase programme. It also unveiled its new anti-fragmentation tool for July, designed to alleviate widening pressure on peripheral eurozone countries' bond spreads.

Elsewhere, the BoE delivered further tightening this quarter, taking the base rate to 1.25%. Yet the biggest surprise was the Swiss National Bank (SNB), which unexpectedly tightened rates by 0.5% to -0.25%. Out of the major developed market central banks, the Bank of Japan (BoJ) bucked the trend – given weak domestic demand and muted inflation dynamics –

which contributed to a further weakening of the Japanese yen, falling to a 24-year low against the US dollar.

Economic and geopolitical risks of a different variety plagued China. Regulatory skirmishes, a contracting real estate sector and geopolitical tensions were still in focus. Yet the most important development this quarter was renewed lockdowns, particularly in Shanghai. Full-year growth estimates were trimmed given the inevitable contraction in the second quarter. However, policymakers have maintained their accommodative stance and signalled possible further fiscal and monetary stimulus should be warranted.

Covid-19 cases also started to reaccelerate in the US and Europe towards the end of the quarter. At the same time, the political pressure from the cost-of-living crisis continued to mount. In the UK, the search for a successor to Boris Johnson as leader of the Conservative Party and prime minister is underway. In France, Macron secured his second term in office, but his alliance lost the parliamentary majority to disparate parties located at more extreme ends of the political spectrum. In the US, Biden's approval ratings collapsed to fresh lows, a worrying sign for the Democrats ahead of this year's midterm elections.

MARKET REVIEW

Global equities fell in the second quarter, alongside bonds.

Both developed markets and emerging markets fell by 14.3% and 8.1%, respectively (in local currency terms). This weakness was broad-based across regions: North America was down by 16.7% and Europe ex-UK was down by 10.5%. The UK (-2.9%) was the best performer, likely benefiting from its relatively greater weighting in energy. EM Asia was only down by 6.3%, helped by some cities in China reopening after the recent Covid wave.

In terms of sectors, energy outperformed again, though it still declined by 2.7% over the quarter (in local currency terms). Defensive sectors – such as consumer staples (-3.8%), healthcare (-5.4%) and utilities (-5.4%) – also had more limited losses. On the other hand, the prospect of higher interest rates continued to spook the consumer discretionary (-22.0%) and technology (-21.1%) sectors.

In fixed income, the US benchmark 10-year bond yield almost touched 3.50%, before moderating down to 3.01% at quarter-end. This was on the back of higher inflation and interest rate expectations. US 10-year real yields also turned positive, ending the quarter at 0.67%. Similarly, UK 10-year gilt yields surpassed 2.50% and ended the quarter at 2.23%. Strikingly, the yield on the German 10-year bund almost reached 1.80% and the Italian equivalent breached 4.00% (the spread almost widened to 2.50%). There was a broad-based rally during the second half of June, though, with the German 10-year falling to 1.33% and Italian 10-year to 3.26%.

The commodities markets were extremely volatile in the second quarter. Brent Crude rose by 6.4% to end the quarter at $114.80/bbl (but touched a daily high of $123.60/bbl during the quarter), while the World Trade Index was up by 5.5% to $105.80/bbl (its high was $120.90/bbl). Natural gas futures were also volatile throughout the quarter, influenced heavily by Russian supply concerns. Endex TTF futures – a proxy for European prices – were up 13.9% over the past three months. Yet the US and UK equivalents actually experienced declines. Industrial metal and agricultural product prices were perhaps the biggest surprise: copper (-20.4%), iron ore (-18.9%) and wheat (-13.6%) all fell, likely related to global demand concerns. Gold also moved lower, down 6.7% to $1,807/oz.

In currencies, the yen still depreciated against a basket of most major currencies (-7.3% on a trade-weighted basis), followed by the euro (-1.9%). US dollar strength continued, up 5.0% on the quarter.

Cryptocurrencies were perhaps the wildcard over the past few months, as much of the talk surrounding the potential of these assets to provide an inflation hedge was proved untrue. Several coins collapsed in value, including TerraUSD (a supposed 'stablecoin'). Bitcoin fell below the $20,000 mark, while Ethereum dipped below $1,000. Bloomberg's Galaxy Crypto Index – a measure of the largest cryptocurrencies traded in US dollars – fell over 60% this quarter.

All investment returns quoted are in local currency terms and sourced from Avaloq.

Index returns are sourced from Bloomberg.

Notes

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