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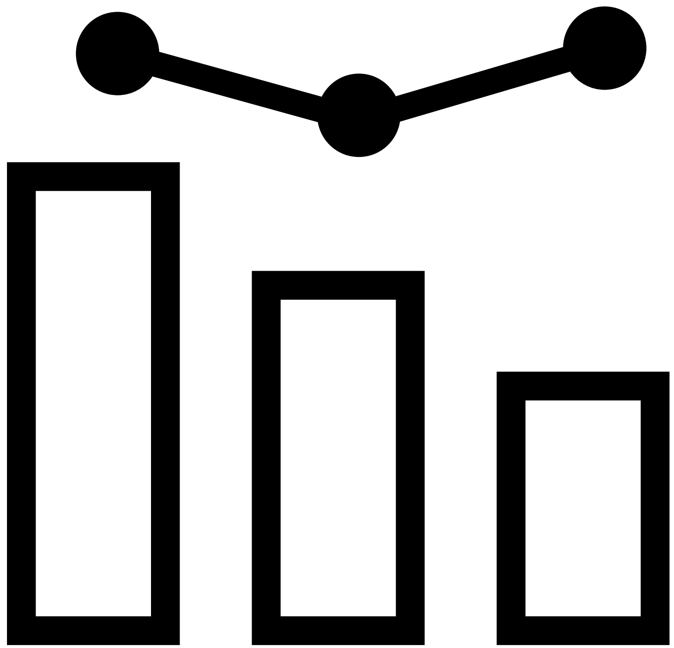

Marketupdate

August 2022

August 2022: ‘summer rally’ nipped in the bud

After a brief but strong recovery in July, financial markets showed the same overall picture in August as they did in the first six months of 2022: one of rising interest rates and falling share prices.

After a disastrous first half-year, the stock market price rally in fact lasted not one but two months: from mid June to mid August. It came very close to a good old-fashioned ‘summer rally’. Unfortunately, that rally not only proved short-lived in the second half of August, but also was far from strong enough to make up for the losses sustained in the first half of the year. After gaining nearly 10% in July, the MSCI World Developed Markets index dropped by 2% overall in August. As a result, the full-year loss is still some 7.5% to date. The regional differences are worth noting, however.

Shedding nearly 5%, European equities lagged behind their US counterparts in August, as US losses on equities were limited to around 1.5%. This, however, was partly on the back of the 2.5% strengthening of the US dollar against the euro in August. After reaching 'parity' in July – however briefly – a little over one euro had to be paid for one US dollar at the end of August, something that had not happened in two decades.

August's best performing equity regions were Asia and emerging markets, which added 1.5% to 3%. Nevertheless, these regions are equally looking back on 2022 to date as a disappointing year for equity investments. The year 2022 to date has been particularly disappointing for investors in listed European real estate, which lost approx. 12.5% in August and nearly a third since the beginning of the year.

One possible explanation for the recurrence of poor stock market sentiment is that interest rates have been going up again since August, after a brief period of falling rates that started in the middle of June. This translated into negative returns on European government bonds of around 5% overall in August. Corporate bonds were also hurt by the rate increase, but losses were quite limited: the relatively safe investment grade corporate bonds delivered a monthly return of -4.2% while the riskier high yield bonds stood at -1.2%.

The returns on the various asset classes were as follows:

Returns (total return, in euros)	aug.	Q3	2022	12 mos.
Bloomberg Barclays Eurozone Staatsobligaties	-5.2%	-1.3%	-13.4%	-14.9%
Bloomberg Barclays Euro Bedrijfsobligaties	-4.2%	0.3%	-11.6%	-12.8%
Bloomberg Barclays Euro High Yield Bedrijfsobligaties	-1.2%	3.8%	-11.2%	-11.5%
MSCI Europe Onroerend Goed	-12.7%	-0.5%	-32.2%	-36.0%
MSCI Europe Aandelen	-4.9%	2.3%	-11.8%	-7.9%
MSCI North America Aandelen	-1.6%	9.2%	-5.5%	3.0%
MSCI Asia Pacific Aandelen	1.5%	5.1%	-4.8%	-4.6%
MSCI World Developed Markets Aandelen	-2.0%	7.6%	-7.4%	-0.8%
MSCI Emerging Markets Aandelen	2.9%	4.4%	-6.0%	-7.3%
EUR/USD	-2.4%	-4.1%	-12.2%	-15.7%

Source: Bloomberg

Inflation back on investors' radar, especially after Jackson Hole

The main reason for the combination of higher interest rates and lower share prices in August is probably the fact that inflation was fully back on investors' radar. This was especially the case in the second half of August, in part due to the Jackson Hole summit that took place in that period. At this annual gathering of central bankers, the US central bank's chairman, Jerome Powell, made it clear that the Fed is very much committed to ending today's high inflationary pressures. Powell had to make up for past mistakes in that regard: at last year's Jackson Hole conference, he had said that the high level of inflation was only 'temporary', giving investors the impression that the Fed would not be hitting the brakes of higher interest rates all that much.

At that time, in August 2021, US inflation stood at around 5.5% and the Fed had kept the US base rate unchanged at 0-0.25% for around a year and a half, since the beginning of the Covid crisis in the spring of 2020. One year on and US inflation has risen to over 9%, and the Fed has raised the base rate in four increments to 2.5%, including the last two 'mega increments' of 0.75 percentage point each in June and July 2022. Jerome Powell's statements at the Jackson Hole conference made it clear that the end of the rate hikes is not yet in sight. Interest rate markets now believe the Fed will hike rates further to around 3.5-4% in the next six months.

The Fed will continue to raise interest rates, even though US inflation may already have peaked

A thorny issue for the Fed is the fact that today's inflation is for a large part caused by factors on the supply side of the economy, particularly the high energy prices (in part the result of the war in Ukraine) and supply chain disruptions, including due to China's zero Covid policy. These factors are not sensitive to higher interest rates, or hardly so. Still, rate hikes can help cool economic demand, which got overheated in part by pent-up demand following Covid. Too many rate hikes, however, will also be problematic, as they increase the risk of a recession, which nobody wants, especially not so soon after the 2020-2021 'Covid recession'.

For now, economists and financial markets seem to assume that the Fed will succeed in putting a lid on inflation without plunging the US economy into recession. While economists now believe there is a 50% chance of a recession in the coming quarters, for the entire 2022-2024 period they expect positive growth figures of 1-2% at least on an annual basis. The consensus expectations for US inflation are now that it will fall to 3.5% in 2023 and 2.5% in 2024. The latest economic data seems to confirm this relatively favourable picture. US producer confidence remained fairly stable at slightly above-average levels in recent months, while consumer confidence climbed out of a deep trough last month. At the same time, the US inflation peak may already be behind us: in August, inflation reached 8.5%, down from its level of 9.1% one month earlier, the highest level in over 40 years.

ECB faces even bigger challenge than Fed

While the Fed might seem to be in a difficult position, the ECB is facing even bigger challenges. At 9.1% year-on-year, eurozone inflation is now as high as it was in the US one month ago and core inflation has risen to 4.3% year-on-year, but unlike in the US, inflation does not seem to have peaked yet. Moreover, the European economy is more vulnerable to the development of energy prices than the US economy, and the ECB can do very little about it. In addition, the ECB must avoid a potential new euro crisis, which is particularly challenging given the parliamentary elections coming up in Italy. Finally, the ECB will want to avoid a further slide of the euro against the US dollar. While a low euro rate of exchange is good for the eurozone's export position, it also creates 'import inflation', and higher inflationary pressure is the last thing the ECB (and most Europeans) wants.

All things considered, the ECB has no choice but to raise interest rates further at an accelerated pace as well, if only to prevent the interest rate spread with the US from widening much further. The gap between the US and European base rates has widened recently to 2.5 percentage points, which explains at least part of the appreciation of the US dollar. With further rate hikes in the US on the horizon, the ECB may very well equally opt for a 0.75 percentage point rate hike in September, an unprecedented step by ECB standards. Financial markets are in any case already factoring in this possibility, and assume that the ECB will raise the base rate (which currently stands at 0%) to 2-2.25% over the following months. In that scenario, the interest rate spread with the US will at least slowly narrow over the next six months, and that should in principle support the euro exchange rate.

Gloomy economic outlook for Europe, despite silver linings

With high energy prices and rising interest rates, European consumers are facing a chilly winter, with potentially historic losses of purchasing power. Given this situation, a recession seems increasingly inevitable in the quarters ahead. Meanwhile, economists believe the eurozone economy will grow by around 0% in the next three quarters and estimate the probability of a genuine recession at 55%. As a result, Europe is at a higher risk of 'stagflation' than the US. But still, it could be worse: the economic growth outlook is even bleaker for the United Kingdom, with a 60% likelihood of recession, while inflation (already more than 10%) could rise further to 20% in the most pessimistic estimates.

Despite all the gloom about the European economy, there are still some silver linings. While most economic data has not been good recently, it still firmly overshot analysts' expectations in August, as can be inferred from Citigroup's 'surprise index'. In addition, energy prices, and the price of gas in particular, are still at an all-time high, but at least they have not risen further recently. After peaking at nearly 130 US dollars per barrel at the beginning of March, the oil price gradually declined in recent months towards 90 US dollars per barrel. Meanwhile, the gas price fell from its peak by almost a quarter in the last week of August. Nevertheless, gas is still over five times more expensive than it was a year ago.

Higher interest rates continue to speak against bonds, but are not exactly in favour of equities either

Unlike in the US, inflation does not yet seem to have peaked in the eurozone, but partly because of the – until recently – lower energy prices and the ECB's upcoming rate hikes, economists nevertheless do not believe inflation will rise much further here either. Inflationary pressures should ease off already in the last quarter of this year, and an inflation rate of 'only' 4% is expected for the whole of 2023. An important uncertain factor is how wages will develop. To date, wage development has lagged behind inflation in both Europe and the US, but with today's historically low unemployment rate (about 6.5% in the eurozone and 3.5% in the US), the question is how much longer this will be the case.

An impending 'wage-price spiral' may force central banks to raise the base rates even further than currently anticipated, but even if it does not come, the coming period will in all probability be marked by higher interest rates for investors. This applies in particular to 'short-term' interest rates (e.g. savings rates), but longer rates may also rise even further. In our view, this continues to speak in favour of maintaining an above-average cash position and against holding government bonds. Equity and real estate investors can trust for the long run that these asset classes will provide a hedge against high inflation (at least more so than government bonds), but in the short run higher interest rates mean that future company cash flows must be discounted at higher rates, which undermines the valuation of equities. In addition, the above-average macroeconomic and geopolitical uncertainty may cause increased volatility, which is also not favourable for equities in the short term.

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