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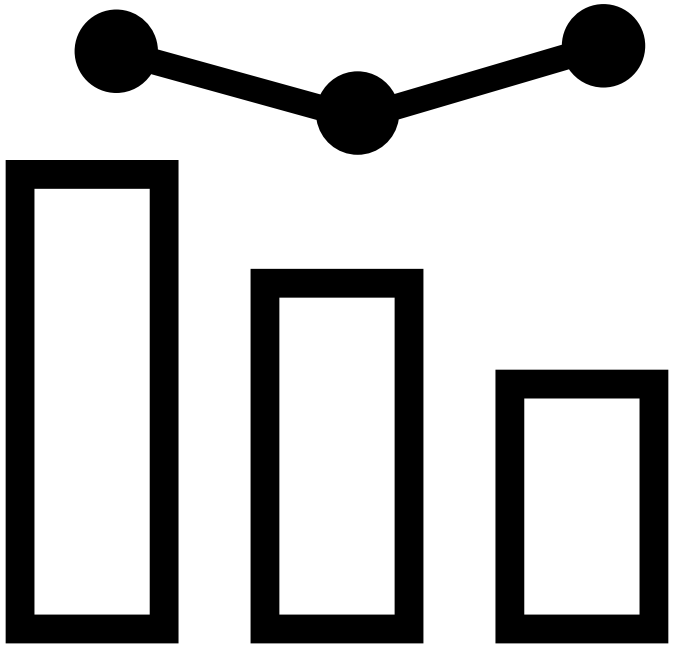

Marketupdate

July 2022

July 2022: Recovery in the financial markets

The financial markets partially recovered the losses of the first half of the year at the beginning of the second half of 2022, but it is too soon to speak of a trend reversal.

In sharp contrast to the first half of 2022, which was poor to very poor for all asset classes, July saw all asset classes deliver positive returns. Equities were the best-performing asset class, and within equities, European listed real estate was the positive outlier with a monthly return of no less than 13.9%. This too is in sharp contrast to the previous six months, when listed real estate was by far the worst-performing asset class. Even with July's gains, listed real estate is still the worst performer in 2022 and over the past 12 months. Real estate is still down in value by more than a quarter compared to a year ago.

The second best-performing equity segment was US equities, helped by the US dollar once again appreciating against the euro and even briefly reaching parity (1 euro = 1 dollar) in mid-July. The MSCI North America index was up 11% in euro terms in July, while the MSCI Europe Index increased 'only' 7.6% in value. On the other hand, European equities outperformed Asian equities, with a monthly return of +3.5%, and emerging market equities, which gained 1.5%.

The price increases in equities and real estate appeared to be at least partly due to lower bond yields. The lower bond yields also meant positive returns on bonds, with the riskiest bonds performing best (euro high yield was up 5.1% in July) and 'safe' European government bonds underperforming in relative terms with a monthly return of +4.1%. Investment grade corporate bonds, which are also relatively safe, delivered a return of +4.7%, between that of government bonds and high yield bonds.

Despite the positive sentiment in July, almost all asset classes are still in negative territory, both since the beginning of 2022 and over the last 12 months, with the most notable negative returns in real estate and bonds. It has been a long time since bonds have fallen so sharply in value in one year. The only asset class that did deliver a positive return last year was US equities, but that was mainly due to the appreciation of the US dollar.

The returns on the various asset classes were as follows:

Return (total return, in euros)	july	Q3	2022	12 mos.
Bloomberg Barclays Eurozone Staatsobligaties	4,1%	4,1%	-8,6%	-10,7%
Bloomberg Barclays Euro Bedrijfsobligaties	4,7%	4,7%	-7,7%	-9,3%
Bloomberg Barclays Euro High Yield Bedrijfsobligaties	5,1%	5,1%	-10,1%	-10,1%
MSCI Europe Onroerend Goed	13,9%	13,9%	-22,4%	-25,4%
MSCI Europe Aandelen	7,6%	7,6%	-7,3%	-1,3%
MSCI North America Aandelen	11,0%	11,0%	-4,0%	7,9%
MSCI Asia Pacific Aandelen	3,5%	3,5%	-6,2%	-3,3%
MSCI World Developed Markets Aandelen	9,8%	9,8%	-5,5%	3,9%
MSCI Emerging Markets Aandelen	1,5%	1,5%	-8,6%	-7,2%
EUR/USD	-1,7%	-1,7%	-10,1%	-13,9%

Source: Bloomberg

Europe is not yet in recession, with emphasis on 'yet', but the US is and, in fact, so is China

Is a global economic recession inevitable, or is it still possible to avoid it? This appears to be the main question on the minds of economists and investors at the moment. To start with the 'good' news: according to the latest economic growth figures, a recession has not yet begun, at least in Europe. In the second quarter of this year, the eurozone still recorded positive (and higher than expected) quarterly economic growth of 0.7% (compared to the first quarter). In contrast, the US economy contracted in the second quarter, by 0.9% year-on-year (just over 0.2% quarter-on-quarter). Since growth in the first quarter was also negative, this means that the US is now in recession, at least according to the accepted definition of two consecutive quarters of negative growth.

In China, the economy still grew slightly in the second quarter by 0.4% year-on-year, but by Chinese standards this can be considered a recession. Until the 'corona recession' of 2020, the growth rate of the Chinese economy had not fallen below 5% for decades. The ongoing corona lockdowns and the instability of China's huge real estate sector are clearly causing problems for the Chinese economy. Its neighbour Japan already showed negative growth of 0.1% in the first quarter of this year, but this is not so unusual: over the past 30 years, growth in Japan has continuously fluctuated around 0%. On balance, the world economy still grew in the second quarter, but clearly not by much.

Predictive indicators do not bode well for the coming months

The fact that at least the European economy has escaped recession so far this year does not mean that it will continue to do so. Based on 'predictive' indicators, such as business confidence figures, a recession in the coming months can certainly not be ruled out. The main producer confidence indicators in the eurozone fell below the 'neutral' 50-point mark last month for the first time since the low point of the corona crisis two years ago. Consumer confidence has also fallen sharply recently in both Europe and North America. European consumer confidence has actually collapsed from a 40-year high to a 40-year low in just 12 months.

Remarkably, both producers and consumers, and both in Europe and the US, indicate that their pessimism is not so much about the current economic situation, but rather reflects their concerns about the future of the economy over a six- to twelve-month horizon. High inflation is cited as the main cause of the negative sentiment. The sharp rise in food and energy prices, for example, is now clearly being felt in consumers' pockets, and at least so far has not been sufficiently compensated for by pay increases. Companies are also seeing higher prices reflected in the costs of their products and services, and are increasingly wondering whether they can pass them on to end customers.

IMF does not see a recession as yet, but cites numerous risks and longer-lasting high inflation

In its most recent update of the 'World Economic Outlook', the IMF has also again revised its growth forecast for the world economy to the downside, expecting the world economy to grow at around 3% per year in 2022 and 2023. A few months ago, its growth forecast for both years was still around 3.5%. Growth of 3% still does not mean recession, but the IMF sees many risks and few opportunities in the near future, due to the war in Ukraine, a possible revival of Covid-19, high inflation and rising interest rates. A further downward revision of its growth forecast cannot therefore be ruled out.

Along with its downward revision to its expected economic growth, the IMF has increased its forecast for global inflation in 2022 and 2023 by almost a percentage point, to 8.3% and 5.7% respectively. This in itself is hardly surprising, as the latest inflation figures again exceeded analyst expectations. Inflation in the US was higher than 9% for the first time since the end of 1981, and European inflation also reached a new record level in July, at 8.9% year-on-year. The only bright spot is that core inflation (excluding food and energy prices) in the US has been on a slight downward trend in recent months and is now below 6% year-on-year. In the euro area, it actually increased further in July to 4% year-on-year.

Central banks: higher interest rates initially in any case, but what about 2023?

The combination of deteriorating growth prospects and (excessively) high inflation poses a dilemma for the central banks. The current priority is to get inflation under control. In July, the ECB raised interest rates for the first time in over 10 years, and by more than expected: by 0.5% instead of 0.25%. This brings the European base rate (deposit rate) to 0%, and the era of negative interest rates finally seems to be coming to an end. More rate hikes are expected in the coming months, with the base rate expected to be around 1% by the end of 2022. In the US, the Fed is already well ahead of the ECB. After another interest rate increase of 0.75% at the end of July, the US base rate has risen rapidly from 0.25% to 2.5% this year. And this would not appear to be the last such increase in the US. The financial markets expect the US base rate to be around 3-3.5% by the end of this year.

The question now is: what will the central banks do in 2023 if inflation remains unexpectedly high and the global economy may have slipped into recession by then? Currently, the market expects that the economic situation will force the Fed to cut interest rates slightly in the course of 2023, while the ECB may need to raise rates a little further to get inflation under control. However, it should be noted that these market expectations have not been very stable recently. What does not help here is that central bankers themselves have also indicated that they will issue less 'forward guidance': in other words they will give financial markets less advance notice of future monetary policy and act more 'as they see fit'.

Fear of recession or fear of inflation: financial markets don't seem to have made up their minds yet

The uncertainty in the financial markets with regard to economic developments and how the central banks will respond is evident. However, the emphasis in recent weeks seems to have shifted from fear of inflation to fear of an impending recession. This is particularly evident in interest-rate markets. Until mid-June, for example, the European 10-year swap rate had risen to 2.5%, mainly on higher inflation expectations, but has since fallen back to 1.75%. What is striking is that the stock markets have shown a more or less opposite movement. For example, the EuroStoxx 50 Index fell by around 20% in the first half of the year, but has since shown a partial recovery. Equity markets thus seem less concerned about an impending recession than interest-rate markets, although it should be noted that lower interest rates will also have contributed to higher equity prices.

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