

Edition  
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# Cave's Quarterly

## Q2 2022 Round Up

### Recession Risk

**There have been very few places for investors to hide throughout the first half of this year, with confidence rattled by Covid-related lockdowns across China, the impact of the war in Ukraine, and the continued upsurge in global inflation. Tightening monetary policy and rampant inflation are having a dramatic impact on financial market conditions and investors have endured eye-watering levels of volatility in recent months.**

From the US to China, developed economies to emerging markets, most global indices have suffered double-digit drawdowns year to date, with many crossing the -20% 'bear market' threshold. Adding insult to injury, government and corporate bonds have also been hit hard,

failing to perform their traditional role of capital preservation when risk assets have sold off aggressively.

Tightening financial conditions are being felt everywhere, with the cost of borrowing rising and the impact of inflation and higher energy prices reducing consumption and demand for goods. The latest consumer confidence figures showed a sharp drop in sentiment across the world, further exacerbating fears over slowing economic activity. The market backdrop remains challenging and highly uncertain, with inflation at multi-decade highs, unemployment at historical lows and supply chain disruption still lingering as the world heals from the pandemic. Central bankers have been forced into action and now find themselves behind the curve and in the unenviable position of trying to rein in runaway inflation, without triggering a deep and prolonged recession.

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## Global Equities

**The Bank of England (BoE) has hiked interest rates five times since December, taking the current base rate to 1.25%. Signs of a slowdown in the UK economy are emerging, with gross domestic product (GDP) declining and households struggling to cope with persistently high energy prices and rising mortgage rates.**

Whilst former chancellor, Rishi Sunak, has unveiled additional measures to help with the cost-of-living crisis, the BoE continues to warn of higher inflation and has raised its estimate for peak CPI to 11% in October, reflecting higher household energy prices following the projected large rise in the Ofgem price cap.

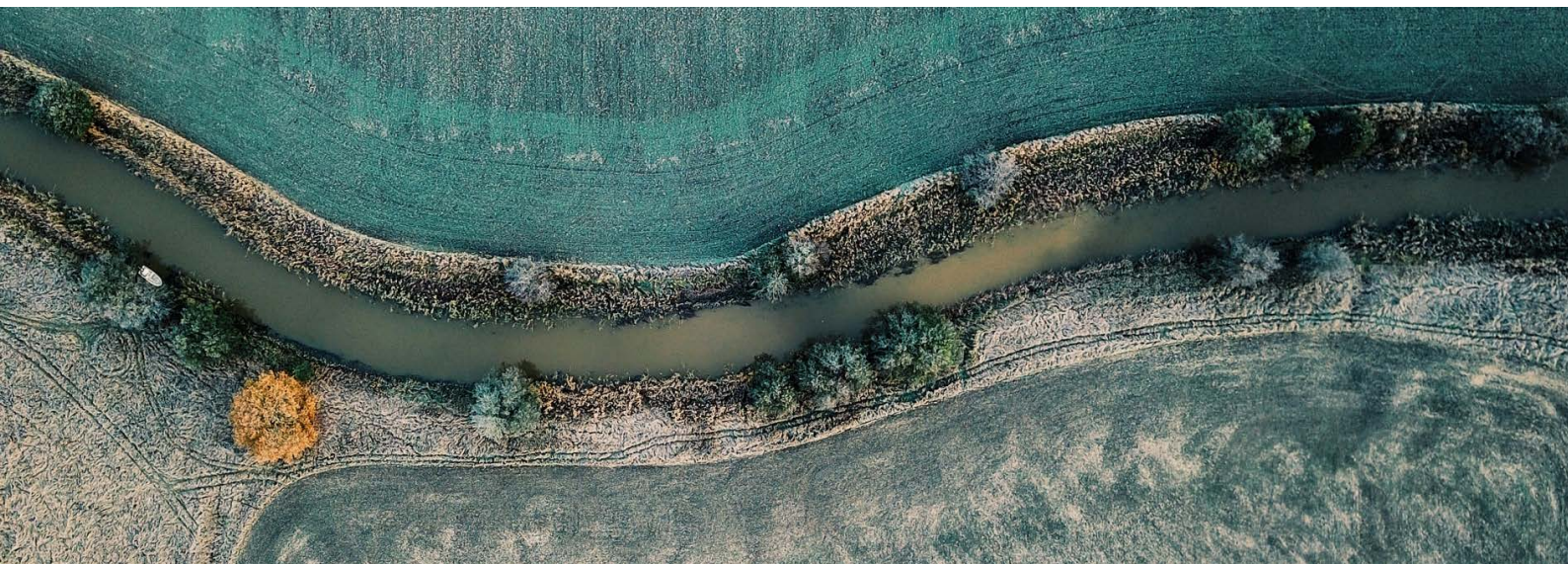
In a global context, UK equities have proven somewhat resilient, with the FTSE All-Share Index registering a decline of 6% over the 3-month period. Buoyed by its high exposure to commodity prices and financial stocks that are benefitting from the rising interest rate environment, our domestic FTSE100 index continues to represent the cheapest and best-performing major equity market this year.

The US economy unexpectedly shrank 1.6% in the first quarter of the year, as the Omicron variant fuelled a record surge in Covid cases. It's now increasingly likely that US GDP will be around or below zero for the second quarter, meaning the country is heading for a 'technical' recession. A large and protracted inflation overshoot has seen the US Federal Reserve (the Fed) pivot forcefully from extraordinarily supportive policy to aggressive tightening in recent months. Fed Chair, Jerome Powell remains hopeful that the Fed can achieve a so-called 'soft landing' but acknowledged the task of bringing inflation down without triggering a recession would be challenging. A severe pullback in US stocks has seen more than \$9tn in market value wiped out in the first six months of 2022, with equities on Wall Street recording

their worst start to a year since 1970. The S&P500 index dropped a further 16% through the second quarter, whilst the technology-heavy Nasdaq index declined 22%.

At their last policy meeting in June, the European Central Bank (ECB) said they would be ditching post-pandemic stimulus measures and turned decidedly hawkish on interest rates, with President, Christine Lagarde, confirming the Central Bank would hike in July for the first time in 11 years, and again in September in a bid to stem inflation, which is running above 8% across the 19 countries using the euro. The outlook for the Eurozone continues to look bleak, with consumer confidence plummeting and concerns mounting over a tit-for-tat reduction in gas supplies coming from Russia, following the EU's embargo of Russian oil exports. European equities, as measured by the Euro Stoxx 50 index, moved 11% lower over the quarter.

Chinese equities have been through a turbulent period over the last 12 months, experiencing a significant valuation derating and widespread investor capitulation. The country's zero-Covid strategy has seen recent lockdowns put the brakes on economic activity through the second quarter, but there are early signs of a tentative reopening. The People's Bank of China has cut interest rates and the government has announced intentions to reduce uncertainty around last year's broad-based regulatory clamp down, alongside more infrastructure spending. China's Hang Seng index recorded a negative return of 0.5% since the end of March. The Japanese yen has depreciated to its lowest level versus the US dollar for 20 years, intensifying pressure on the domestic economy which is already being challenged by significantly higher import prices for food and energy. The Japanese stock market registered a negative return of 5% over the 3-month period.



## Fixed Interest

**The aggressive sell-off in the fixed income markets has been widespread, with returns across government bonds, investment grade and high yield corporate bonds deeply negative year-to-date.**

Fixed income investors have suffered through the period against a backdrop of rapidly rising yields, hawkish Central Bank rhetoric and investors reappraising global interest rate expectations. The yield on the US 10-Year Treasury Note and the UK 10-Year Gilt increased from 2.35% and 1.61%, to close out the second quarter at 3.02% and 2.24% correspondingly. Corporate bonds underperformed government bonds, as spreads widened to reflect credit risk and concerns over rising default rates in the event of a severe economic downturn. With a potential recession flagged later this year, returns in high yield credit, or 'junk bonds' were particularly weak.

## Alternatives

**Commodities were the only asset class to post a positive return across the period and remain the best-performing asset class this year.**

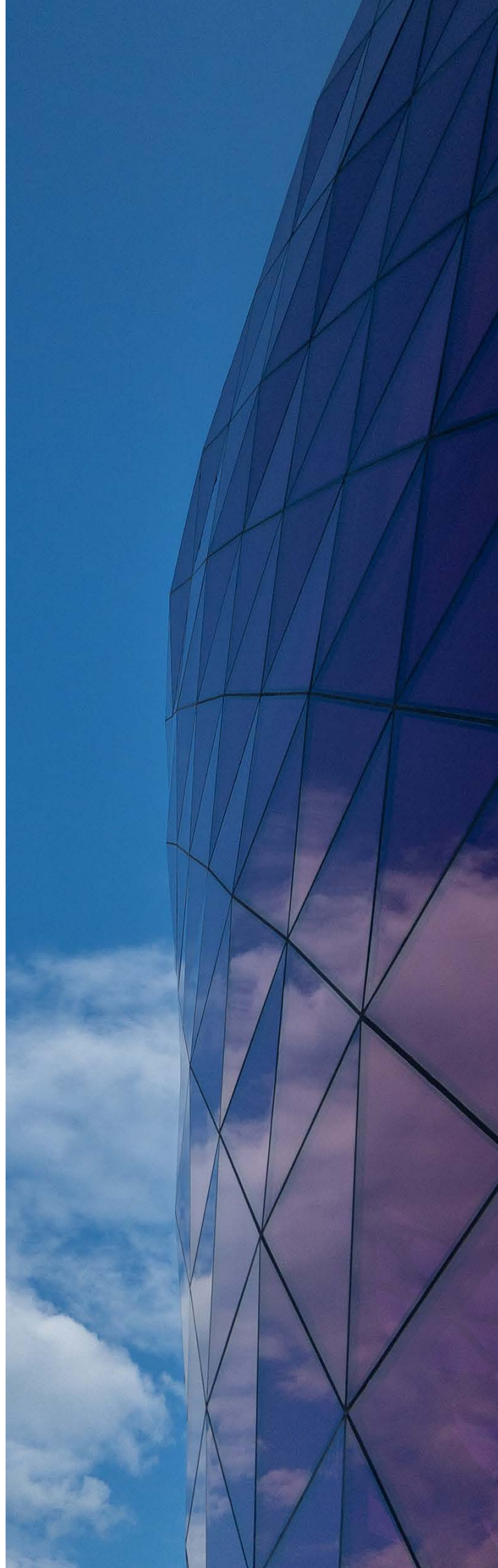
Energy and agricultural prices have surged during the Russia/Ukraine war and look set to remain elevated until a resolution in the conflict is achieved. The price of Brent oil rose through the quarter, before falling back to \$109 per barrel, as concerns over weaker global demand offset low inventory levels.

As a non-interest-bearing asset, rising global interest rates and treasury yields have increased the opportunity cost of holding gold. A surging US Dollar (which has reached its highest level since 2002) has also dented the appeal of the yellow metal among overseas buyers. Gold moved lower over the second quarter, ending the period at \$1,807 an ounce.

## Commercial Property

**The outlook for UK commercial property, as with most asset classes, has been blurred by heightened macroeconomic and geopolitical uncertainty in recent months.**

Rising inflation, global supply chain issues, increased construction costs and the squeeze on household incomes are challenging corporate confidence and consumer sentiment, which are key drivers of the real estate investment market. Share prices trended lower across London-listed Real Estate Investment Trusts (REITs), with notable falls witnessed in the industrial and logistics specialists, following Amazon's bleak earnings report, which confirmed the ecommerce group had over-leased warehouse space during the pandemic.



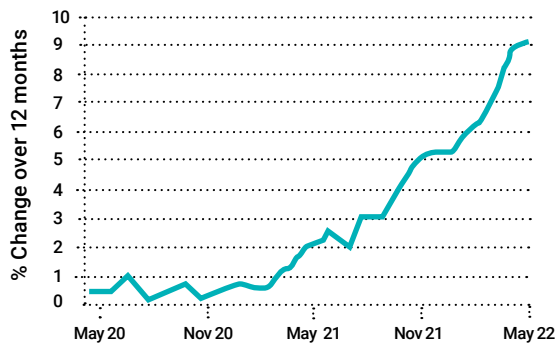
# Outlook

Equity and bond markets have experienced double-digit declines this year. With stock market valuations in many countries now trading below their historical average, we do not anticipate significant further downside for the second half absent an escalation of the Ukraine war into a wider conflict, or unforeseen macroeconomic shocks.

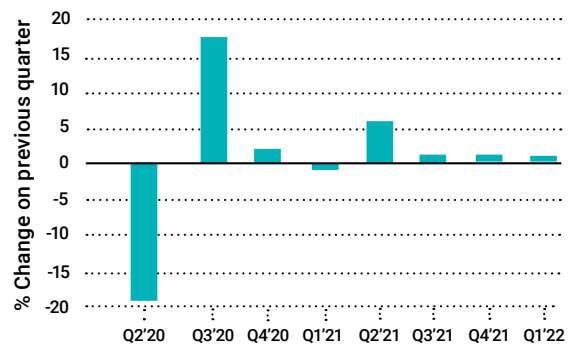
A myriad of risks remain, however, and volatility is likely to stay elevated as investors wait for confirmation that inflation has peaked across developed countries, labour markets have cooled, and Central Banks have responded in a way that delivers a soft landing.

As ever, periods of panic in markets can often provide the best opportunities for long-term investors. We maintain a balanced allocation to risk assets and believe well-diversified investment portfolios have the potential to emerge in a position of strength, as some of the current macroeconomic headwinds subside.

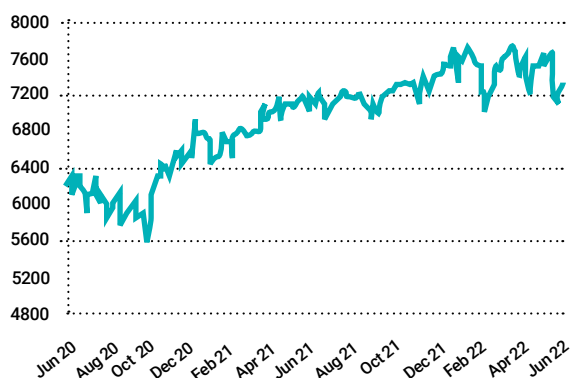
UK Consumer Prices Index (CPI)



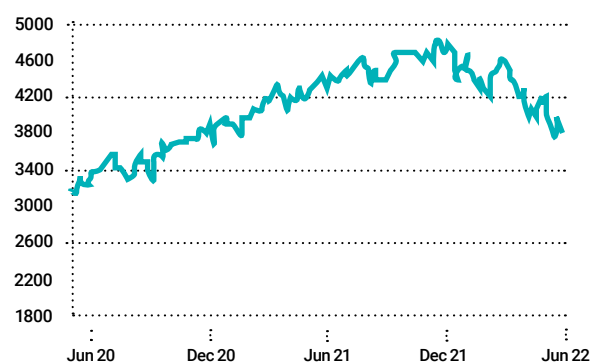
UK Gross Domestic Product



FTSE 100 Index



S&P 500 Index



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