State of Play

2022 Half Year Review

7 July 2022

As we move into the second half of 2022, let's reflect on how asset classes performed in the first half of the year and why. Given investors have endured such a rollercoaster thus far, what are the prospects for the second half of the year? Our Senior Investment Specialist, Simon Durling, shares his thoughts in this week's State of Play.

Rocky road

It's no secret 2022 thus far has been a very tough year. Against a backdrop of rising prices and central banks responding with corresponding interest rate rises, all asset classes have suffered and regardless of the type of investment portfolio, no doubt most investors will have felt the pain too.

Shares

Investors in shares have seen significant falls as market participants have repriced values based on the changing expectations for interest rates and rising costs. Higher borrowing and costs are difficult to pass onto consumers in full, so profit margins are squeezed and future earnings are adjusted to reflect this change of economic outlook. The UK stock market has underperformed other international markets over the last 20 years as the value of the FTSE All Share index has only risen by 74% (excluding dividends), when compared to the US which has seen the S&P 500 index risen by 380%.[1] Since the start of this year however, the UK has only fallen 4.5%, beaten only by stock markets in the Far East (excluding Japan), which are down 2% year-to-date due to the positive contribution from China since the start of

May.[2] The NASDAQ 100 index in the US has fallen over 21% since the start of the year due to the technology and growth companies which make up a high proportion of the constituents.[3] Growth stocks benefited from lockdowns and the subsequent economic reopening which has seen their share prices soar, reaching recent highs towards the end of last year.[4] However, the subsequent concerns about inflation, interest rate rises and economic growth prospects has seen a sharp re-pricing.[5]

Bonds

As I have explained previously, high inflation and rising interest rates detrimentally affect bond returns. Whilst the expectations for interest rates increased in response to rising prices, bond values have suffered. Based on the Bank of America ICE bond indices, UK corporate bonds have fallen in value (excluding coupons paid) by over -16%, closely followed by UK Government bonds, which have fallen just shy of -15%.[6] The best performing are US Corporate bonds which have fallen nearly -6% and US high yield which has fallen nearly -7%.[7] This is directly correlated to the rise in yields since the start of January. UK 10-year Government bond yields have risen from 1% at the beginning of January to hit a high of 2.74% in mid-June before tailing off to be 2% at the time of writing.[8] US bond yields tell a similar story.[9] Market participants always look to the future and price in what they expect interest rates to reach until new information leads to a change in outlook. This could be where we see bond yields flatten, or if rising prices remain for longer than expected, yields could rise much further, again hurting bond values in the process.

Have investments markets reached the bottom yet?

When investors suffer significant falls in the value of their portfolio the most common questions are:

- Is it going to get worse?
- Have we hit the bottom?
- Is now a good time to invest?
- Should I remain invested?

Clearly, regardless of your experience, skills or expertise, it is impossible for anyone, professional investor or not, to provide any certainty about what the future holds. Even when historically dealing with more 'normal' market conditions, predicting what will happen next with any accuracy is challenging. Following the global COVID-19 pandemic (which has not yet concluded), a return of high inflation, the ending of quantitative easing and low interest rates, the level of uncertainty currently is, putting it mildly, very high. Couple this together with the ongoing war in Ukraine, slowing global growth, and the prospect of a changing political climate after the US mid-term elections later this year, it could be foolish to make predictions with any confidence. So, what are the key drivers of market direction in the remaining half of 2022?

Has inflation peaked?

Regardless of whether you are an investor or not, I am fairly certain top of mind for most people at present is soaring prices. With the energy cap due to rise significantly again in October and many companies, both in the UK and abroad, warning that they intend to put their prices up in response to higher wage demands and increased input costs,[10] the next few months will be crucial to see how both central banks and investors react. Whilst some of the supply side inflation pressure has eased in recent weeks as China comes out of the targeted lockdowns and some commodity prices ease, the change in conditions for companies since the start of the year has not fully emerged yet to give a clear picture on both future earnings and how this is likely to impact on economic growth data. Only time will tell whether bringing inflation down to the central bank targets of 2% will take two years, three years or even longer.

Will central banks stand firm?

In my view, central banks have faced a credibility problem in recent months. Having predicted inflation to be transitory and failing to act sooner, investors have in some respect ignored their initial rhetoric. Now that central banks have recognised how serious the threat of rising prices are to price and economic stability, since the start of this year they have taken action by raising rates. Last month saw the Federal Reserve increase by 0.75% and the Bank of England (BoE) implement the fifth consecutive rise in as many meetings with the Monetary Policy Committee (MPC) members even disagreeing on how much to increase rates by.[11]

There is the possibility that the BoE could go much further, with an outside chance that in the next meeting on 4 August they will increase rates by as much as 0.75%, taking the base rate to 2%. Their decision may be influenced by the Federal Reserve, who meets on 27 July, as if they yet again raise rates aggressively, this may tip the balance for the MPC. One of the consequences for the UK is that when our currency devalues against the dollar and the euro, regardless of economic demand, the decline in value triggers imported inflation through increases in the cost of raw materials and goods from abroad which will feed through into higher prices. The interconnection between central bank decision-making has never been more important given the consequences to economic growth, rising prices and investor reaction.

Is now a good time to invest?

Whilst this is an impossible question to answer, it is possible to consider the current market environment and the prospects for the future. As I have covered in past editions of State of Play, attempting to time the market is very difficult to achieve without a great deal of luck. If your investment objectives and time horizons are many years, perhaps even decades into the future, today's pricing point is a matter of degrees. The cost-of-living crisis and changing monetary approach, with rising interest rates and the reverse of quantitative easing into quantitative tightening, will directly affect the prospects for all asset classes in the years to come. Investing after such significant falls in asset values can at least help new investors to buy assets at a discount. The prospects for different asset classes can be assessed with different experts attempting to predict what they may think will happen and why.

Remember the principles of investing

If we return to the principles of investing, we are reminded that it pays to sit down and work out a long-term plan. It makes sense to employ an unemotional third party to help guide you in building this plan to consider your current circumstances, your attitude to risk and your time horizons. Once you have completed this exercise and implemented your decisions, revisiting these from time to time and remaining patient will usually help you to achieve your long-term goals. A diversified portfolio appropriate to your risk comfort, time horizon and objectives is normally the best way to approach uncertainty.

Staying in cash with a proportion of your savings may be the best course of action for you individually, especially if you have short-term plans and want to keep back a savings buffer in case of an emergency. However, for the remaining savings that can be invested for the longer term, remember that the purchasing power of your money will erode over time if the interest you receive falls well below the rise in the cost of the goods and services you may consume in the future. Inflation is disliked by nearly all of us, mainly because it affects our day-to-day wealth and standard of living we enjoy, but it also remains one of the biggest threats to our future wealth and well-being.

Learn more!

Our Head of Systematic Research for TAA and Alpha, Stefano Amato, discusses the latest rate rises from central banks and whether this will be enough to cool inflation. Listen to Market Views here.

Note: Data as at 6 July 2022.

[1] FE Fund Info, 30 June 2022
[2] FE Fund Info, 30 June 2022
[3] FE Fund Info, 30 June 2022
[4] Nasdaq.com, 6 July 2022
[5] FE Fund Info, 30 June 2022
[6] FE Fund Info, 30 June 2022
[7] FE Fund Info, 30 June 2022
[8] Investing.com, 6 July 2022
[9] Investing.com, 6 July 2022
[10] The Telegraph, 29 May 2022
[11] Bank of England, 16 June 2022

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