A Month in the Markets

By Stefano Amato

July 2022

In this latest edition our Head of Systematic Research for TAA and Alpha, Stefano Amato, looks at how continued high inflation and rising interest rates affected the investment landscape around the world in June.

Stefano Amato
Head of Systematic Research for TAA and Alpha

Market Overview

Investors faced another challenging month in June as high inflation and rising interest rates weighed on most stock markets around the world. For the second month in a row, both the Bank of England[1] (BoE) and the US Federal Reserve[2] (Fed) raised interest rates as they attempted to reel in rising consumer prices. Elsewhere, despite suggestions that China may begin to ease its strict COVID-19 restrictions, President Xi Jinping reaffirmed the country's zero-tolerance approach to the virus.[3] These ongoing restrictions have hampered China's manufacturing sector and contributed to supply chain disruptions around the world.[4]

Global stock markets were, on average, negative during June[5] as inflation, higher interest rates, concerns about slowing growth and fears of recession dampened the mood among investors. The US and Europe fared the worst over the month, followed by the emerging markets, Japan, the UK and Asia Pacific excluding Japan.[6] China's stock market was one of the rare bright spots, recording good performance following a prolonged negative period.[7]

The bond market was also broadly negative for the month as interest rate hikes caused prices to fall and yields to rise (bond yields move in the opposite direction of prices).[8] In general, government bonds outperformed corporate bonds, and both rebounded in the second half of the month. However, these rebounds were not enough to compensate for the fall in prices at the start of the month when interest rates were hiked. High yield bonds in general performed worse than corporate bonds and did not rebound in the second half of the month.

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UK and Europe

The BoE raised its benchmark interest rate to 1.25% from 1% during its meeting in June[9], stating larger increases may be necessary in the future if inflation proves to be persistent[10]. The inflation rate reached a new 40-year high of 9.1%[11], with most of this driven by higher prices for food and non-alcoholic drinks. Along with higher consumer prices, the UK also faced stalling economic growth and the prospect of a recession.[12] While periods of high inflation often mean stronger economic growth, it is different this time around. Prices have risen around the world as the global economy has struggled to recover from the pandemic and the ongoing war in Ukraine has caused spikes in commodity and energy prices.[13]

There was little change to the situation in Europe, where inflation remained at high levels. What did change, however, was the European Central Bank's (ECB) announcement it would soon be raising interest rates. Previously, the ECB said it would hold off raising rates until the final three months of the year[14], but decided to change course early in an attempt to pull inflation back down to its 2% target[15]. Overall, the European economies faced several challenges in June including falling manufacturing output and demand due to the higher cost of living.[16] This has been accompanied by concerns about rising energy costs and snarled supply chains due to the war in Ukraine.

US

Any hope that consumer price inflation in the US had reached its peak were dashed in June. Official figures showed that it had in fact spiked to a new 40-year high of 8.6%.[17] The Fed announced a 0.75% interest rate hike[18] in June in its attempt to curtail price rises and signalled that similarly sized rate increases were likely in the future[19]. The Bureau of Economic Analysis also released updated figures that showed the economy shrank by 1.6%[20] in the first three months of the year[21]. Similar to other parts of the world, there are signs the US economy is beginning to slow down. There are concerns that this weaker growth, high inflation and large interest rate hikes will plunge the economy into recession.

Asia Pacific

Countries in the Asia Pacific region continued to be affected by the COVID-19 pandemic, global inflationary pressures and supply chain disruptions. China began to see some positive news after it lifted its lockdown in Shanghai, with growth in both its manufacturing and services sectors.[22] Since the beginning of the pandemic, China has sought a zero-COVID-19 policy with strict measures such as lockdowns in major cities. While it was initially believed the country would drop these policies, President Xi reaffirmed them during a visit to Wuhan in late June, stating that the policy was the most effective and economic approach for the country.[23]

In Japan, inflation continued to rise, albeit at lower levels than many other parts of the world. Up until recently, Japan struggled to generate inflation and often dealt with deflationary pressures owing to its ageing population and weak economic growth. However, in June it was reported that its inflation rate reached 2.5% in May, up from 2.1% in April, and above the Bank of Japan's target of 2%.[24] The good news for Japan was that fresh figures from the Cabinet Office showed that the economy shrank less than expected in the first three months of the year, at -0.5% as opposed to -1%.[25]

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Outlook

There is no sugar-coating that June was a difficult month, though it was not entirely unexpected. Throughout the year so far, the general trend has been for higher inflation, rising interest rates and weaker growth. Much of what we have observed in stock markets up until now has been a direct response to all these factors, as well as the economic effect of the ongoing pandemic and the war in Ukraine.

It is clear that governments and central banks around the world have been somewhat complacent about inflation in the belief that it will resolve itself sooner rather than later. That no longer appears to be the case and central banks are now trying to determine how much firepower they need to unleash to pull back rising prices. We believe that interest rates will continue to rise throughout the year as central banks attempt to quell demand.

We remain cautious at this time and believe our decisions must be made on data and real-world factors. We are constantly monitoring the economy and financial markets, and believe there may be further downward movement in stock markets if inflation persists and global supply chains are further disrupted.

All data as at 30 June 2022.

[1] The Guardian, 16 June 2022
[2] Reuters, 28 June 2022
[3] CNN, 29 June 2022
[4] The Guardian, 9 June 2022
[5] BBC, 1 July 2022
[6] Refinitiv Datastream, 6 July 2022
[7] Refinitiv Datastream, 6 July 2022
[8] Refinitiv Datastream, 6 July 2022
[9] The Guardian, 16 June 2022
[10] Reuters, 29 June 2022
[11] Office for National Statistics, 22 June 2022
[12] KPMG, 27 June 2022
[13] World Bank Blogs, 5 May 2022
[14] Reuters, 10 March 2022
[15] BBC News, 9 June 2022
[16] PMI by S&P Global, 23 June 2022
[17] U.S Bureau of Labor Statistics, 10 June 2022
[18] Trading Economics, 2022
[19] Reuters, 28 June 2022
[20] CNN, 29 June 2022
[21] U.S. Bureau of Economic Analysis, 29 June 2022
[22] Reuters,30 June 2022
[23] CNN, 29 June 2022
[24] Statistics Bureau of Japan, May 2022
[25] Reuters, 8 June 2022

Portfolio positioning

As at 30 June 2022

The fundamental approach

An update on positioning for the following fund ranges:

- Santander Atlas Portfolios
- Santander Multi Index
- Santander Portfolio Investments (Santander Max 100% Shares, Santander Max 30% Income Shares and Santander Max 60% Income Shares Portfolios)
- Santander Vista Model Portfolios

Our asset allocation across portfolios has evolved along with our views on markets and the economy. At the beginning of June, our portfolios were in a neutral position towards shares and bonds relative to the benchmark (where appropriate). However, given the sharp downward movement we observed in stock markets during the month, we reversed this decision and moved portfolios back to an underweight stance in shares and bonds relative to the benchmark (where appropriate). The Vista Model Portfolios did not require any asset allocation changes in June as they were already cautiously positioned.

Overall, our current positioning is cautious, and we believe the risks in markets are leaning towards the downside. That said, there is always the potential for a rebound in markets. For this reason, in some portfolios where permitted, we have put in place call options in both the US and European stock markets that will capture some of the upside if there is a bounce back. Call options are contracts to buy shares at a set price in the future. If the price of the shares goes up, the investor can exercise the call option to buy at the agreed price, resulting in a financial gain.

The systematic approach

An update on positioning for the following funds within the Portfolio Investments range:

- Santander Max 30% Shares Portfolio
- Santander Max 50% Shares Portfolio
- Santander Max 70% Shares Portfolio

Most asset classes had yet another difficult month in June as high inflation and rising interest rates continued to weigh on sentiment. Both shares and bonds were negative for the month[26], providing investors with few places to hide as markets fell. While shares experienced a rebound at the end of May, this was short-lived and markets fell sharply in the first half of June.[27] This was due to interest rate hikes from major central banks and pessimism around inflation and economic growth.

Stock markets staged a moderate recovery in the second half of the month, but this was not enough to erase the previous losses and most major indices recorded negative returns for June.[28] The story was very much the same for bonds, which fell in unison with shares.[29] While bond prices recovered slightly in the second half of June, the asset class still ended the month in negative territory.[30] Against a backdrop of market volatility and high correlations between the major asset classes, our systematic, rules-based investment strategy struggled to find shelter over the month.

[26] Refinitiv Datastream, 30 June 2022
[27] Refinitiv Datastream, 30 June 2022
[28] Refinitiv Datastream, 30 June 2022
[29] Reuters, 19 May 2022
[30] Refinitiv Datastream, 30 June 2022

Portfolio positioning

Private Banking

As at 30 June 2022

How the portfolios' positions are derived

Portfolio positioning is based on a combination of the principles of risk parity and momentum. Through risk parity, we aim to balance the level of volatility among, and correlation towards, each of the various asset classes in the portfolio. This enables the portfolio to favour assets with lower volatility and lower correlation, as a measure to manage the portfolio's risk.

Through momentum we aim to choose the assets with the strongest growth potential over the medium to long-term, while seeking opportunistic entry and exit points for investments in the short-term. This means the portfolio may act in a seemingly opposite way to which markets are moving, in order to capture opportunities that arise during market corrections. To do this, we map the consistency and quality of asset price movements over time.

As markets fell sharply at the beginning of June, the models increased exposure to equities and therefore benefited from the recovery towards the end of the month. This was partially reversed towards the end of the month as the portfolios sought to reduce their exposure to the main source of risk in portfolios.
For Santander Max 30% Shares Portfolio this meant allocations to shares and bonds were increased. Whilst for Santander Max 50% Shares and Santander Max 70% Shares Portfolios this meant reducing bonds and increasing shares.

For more information on the systematic rules-based investment process, please refer to the Fund's Prospectus which can be found within our **Fund Centre**.

All data as at 30 June 2022.

Note: The Portfolio Investments and Atlas Portfolios are Multi-asset, globally diversified portfolios. Although the portfolios may share similar underlying investments in terms of asset and fund selection, they will differ in terms of the way the funds are managed and the proposition in which they are held. Please refer to the Key Investor Information Document (KIID) for details on the objectives of the individual funds. If you have any questions relating to specific differences of the Portfolio Investments or Atlas Portfolios fund ranges, please contact your Private Banker.

The views expressed in this document are of Stefano Amato and the Multi Asset Solutions Team at Santander Asset Management UK Limited or where appropriate the Sub-Investment Manager, are subject to change and do not necessarily reflect the views of Santander Asset Management UK Limited or Santander UK plc (as a whole or any part thereof).