

2022

HALF YEAR EQUITY MARKETS REPORT



Singer
Capital Markets



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AN INTRODUCTION

We wrote at the end of 2021 that the forthcoming “End to Free Money” could drive a repositioning for financial markets and that we could be witnessing a seminal change for markets. That has certainly proved to be the case! There will be many books written on this period of economic and financial change after, what we would argue, were too many years of the afore mentioned 'free money'.

To add to the equation, we have had the Russian invasion of Ukraine, so yet another 'left-field' challenge for markets to adjust to – they just seem to keep on coming! This has added to the existing inflation problem that we have been highlighting over the past few reports now.

Inflation has risen significantly higher than forecasted at year end '21, as food and hard commodity prices (amongst others) have accelerated higher. This has left Central Banks looking even further behind the curve on monetary policy.

In the 2021 annual review we noted how the UK and US central banks had finally retired their 'transitional' view. The European Central Bank ('ECB') has now nearly got there but circumstances, including the Ukraine war, may have caught up with them. More on this in pages to



come.

Against this backdrop, sovereign bond yields have rocketed higher. As we enter the second half of the year, markets are perhaps starting to move towards worrying more about economic growth than inflation. We later look at whether the peak for inflation is in sight.

Interest rates are rising as we forecast, with over 50 countries putting through increases of over 50 basis points.

Growth forecasts have come down, as you would have expected given the above. The UK FTSE 100 has delivered strong outperformance in H1 2022 driven by its exposure to inflation hedges like mining & oil and financials (which are likely to benefit from interest rates rises, steepening yield curves and defensive growth). That has been far from the case for the smaller cap indices, though. Markets look forward and have adjusted down, so we will finish this report with a look at what could drive the start of the recovery for small and mid-cap equities.

First, our usual tour around the world...





ASIA PACIFIC





The way that the Omicron Covid wave has moved has meant that Asia has been the last area to come out of restrictions. In fact, China and Hong Kong with their 'Covid-zero' policy are still intermittently dipping back into lockdowns, which is hitting their economic growth prospects. At least New Zealand and Australia have now fully reopened.

As the half year has progressed, China growth forecasts have been progressively reduced. The government view is that they will achieve 5.5% 2022 GDP growth, although independent forecasts are lower and currently around 4%. Property remains a major problem with developers defaulting and overall property sales were down -23.5% year-to-date to end of May. That said, growth is expected to rebound in H2 2022 and the delta against a slowing Western world will be noticeable. As we trailed at year end, they have already cut interest rates and more cuts are expected, whilst the Western world tightens monetary policy. Growth is unlikely to get much help from exports then, and in addition, Western companies are reshoring and taking production out of China. The government is funding and promoting infrastructure investment. China's economy is increasingly likely to become an internalised one (again). The West is tired of them selling goods below cost to knock out the Western competitors, with various

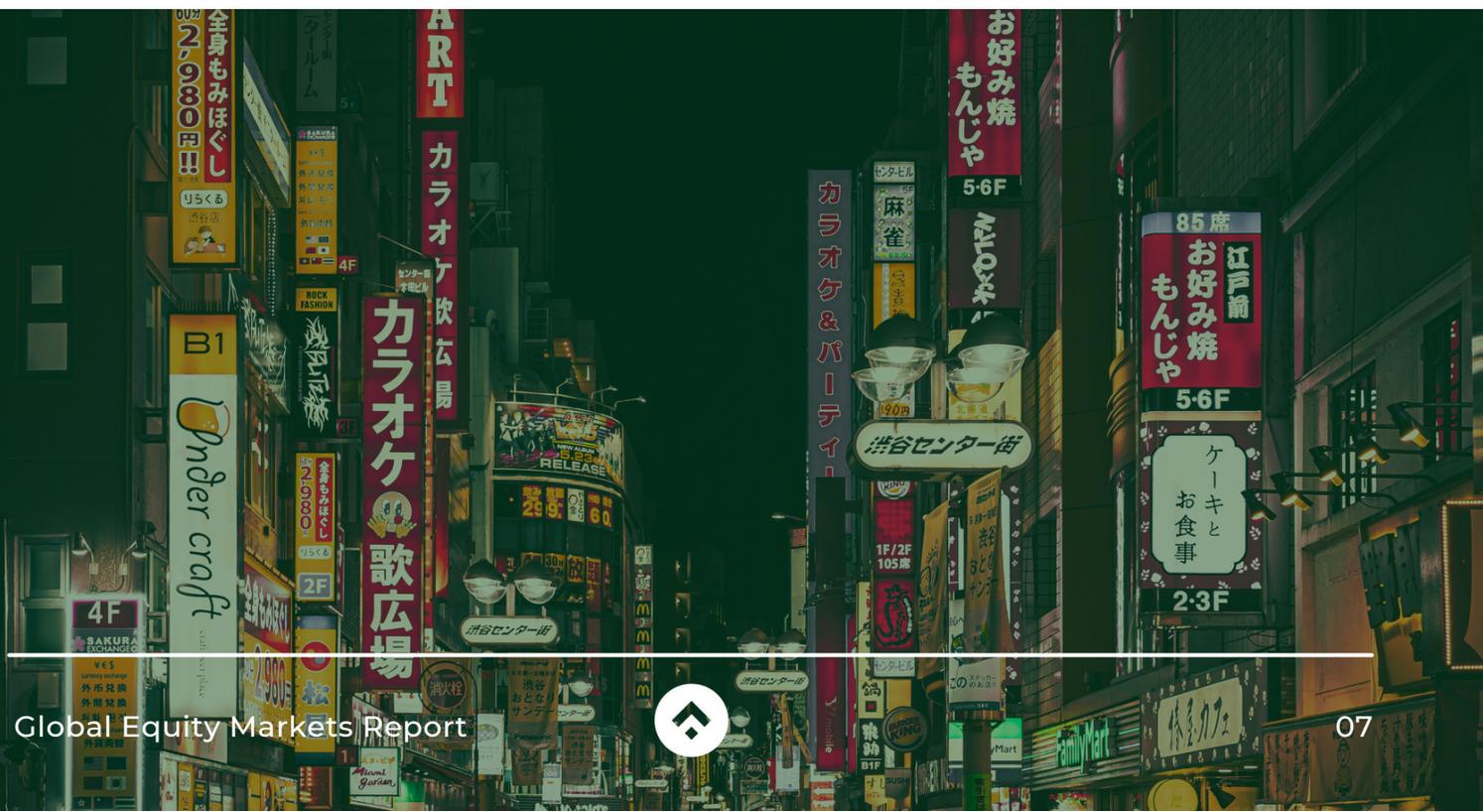


countries globally looking to re-establish domestic and/or regional supply.

Elsewhere in Asia, inflation is not so much the problem as it is in the West, but will this remain the case on re-opening? Growth is likely to be constrained by the slowing Western export markets – at least in the shorter term – with countries like Germany perhaps seeing enforced shutdowns, and their supply of many intermediate goods could constrain countries growth, too.

Japan is still clinging to its policy of a 0.25% yield ceiling for their 10 year JGB.

Equity markets were down in Asia, but by less than elsewhere with the Nikkei -8.3%, Hang Seng -6.6% and CSI300 -9.2%.





EUROPE





The closer you are to Ukraine and to Russia, both geographically and politically, then the greater the impact from the conflict. Look at Germany who has become dependent on Russian gas post their decision to close nuclear power stations and wind down coal as part of their attempt to hit environmental targets. The shutting down of coal may now be up for review – desperate times bring desperate measures. Germany even saw a trade deficit in May, their first since 1991! How times are a changing...

The ECB are finally starting to catch up with the realities on inflation – more on that later – but are economies catching up with them? The Ukraine crisis has (for now) papered over the cracks in the European club (e.g. the EU rift with Poland), as they present a pretty unified front against Putin. This winter will most probably lead to strains again, especially if Putin continues to constrain gas supply so as to not allow storage to fill up.

In Germany they are already talking of power rationing for industry and there could be the same in other countries, too. An ongoing drought could add further to the problem on power both for hydroelectric plants and for nuclear, particularly in France where river water is used for cooling. The EU Covid recovery funds have now been

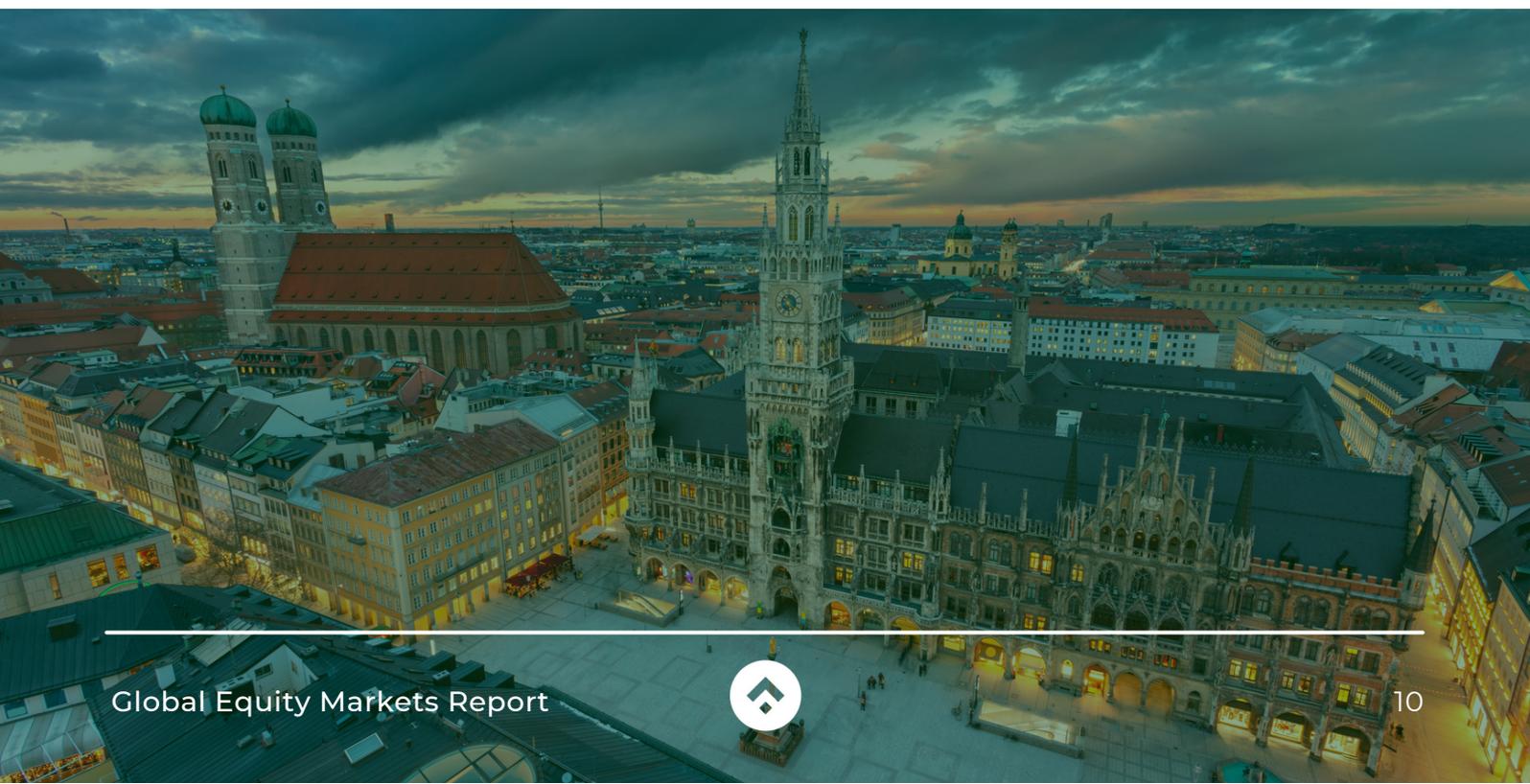


handed out and the key will be to drive longer term wealth creation for countries as the monies are spent.

Macron we re-elected but he has lost his majority, which will make policy progression all that harder in his second term.

EU GDP forecasts for 2022 have come back from 4.3% at the start of 2022 to 2.8%, with CPI up from 2.45% to 7.2% at year-end 2022. Starkly contrasting moves, and against the 2021 bounce back GDP growth of 5.4%, the delta is going to be very noticeable. Consumer confidence measures are hitting record lows and, with Western economies (to varying degrees) dominated by the service sector, the squeeze on disposable incomes from rising inflation is starting to hurt. The ECB are thus going to face a difficult choice – defeat inflation by raising interest rates (they are still at -0.5%) but what will that do to already slowing growth? At the same time, the recent end to QE is leading to a potential 'fragmentation' problem for EU bonds where, for example, the Italian yield spread over Germany widens to crisis-provoking levels. If the Italy-Germany 10 year spread widens beyond 250 basis points towards 300, expect some fireworks. Markets have challenged the ECB once and are now awaiting sight of what their plan may be to prevent this.

Equity markets have taken this all badly, with capital flight from





Europe – for example, US investors repatriating funds given countries proximity and, to varying degrees, relationships with Russia. The Euro has been weak against the dollar as flows move markets with the Euro hitting 20 year lows.

Equity markets saw the Dax -19.5% in H1, the CAC – 17.4% and FTSE MIB -22.1%.





US





Fed Governor Powell has had a 'road to Damascus' conversion from transitory to fighting inflation. The Fed are now seemingly in a race to get to above the neutral rate for interest rates – i.e. neither stimulatory nor contractionary, which is seen at circa 2.5%. We support moving rates up fast – even if they started late – as more early should mean the peak (in interest rates) should be lower. Interest rate futures have the Fed rate at 3.25-3.5% by year-end 2022. You have to say “wow” as we started the year at 0.1%!

Employment is a lagging indicator and we still have record vacancies in the US economy. The key question is whether the US economy is strong enough to withstand the monetary tightening? Powell certainly thinks so, but it is becoming a tighter and tighter call. US 2022 GDP growth forecasts have moved from the beginning of 2022 circa 3.75% to 2.6%. Not such a downgrade as in Europe, but the debate now is whether the US will enter a recession, whether it may already be in one and, if so, how deep could it be? Still, strong job creation suggests all is okay for now. The 2023 GDP growth consensus is for 1.9% but some see a recession in Q2-Q3. US CPI is ending H1 at 8.6% (May reading).

Has the landscape for the mid-term elections in November been



changed by the Supreme Court's decision to overturn the Roe v. Wade judgement? With the economy fighting to keep growth going against monetary tightening, it wasn't looking good for Biden with the final part of his 'Build Back Better' legislation stalled, possibly, permanently. He now seemingly has a new mandate to fight the mid-terms on. The sad fact is that this decision is likely to make an already fractious US even more so.

Markets move fast – is the peak for US interest rates now in sight? We will come to that a bit later.

Equity markets have had a tough start to 2022 with the S&P having its worst H1 since 1970 falling by some 20.8%. Nasdaq fell by 29.1% and the Dow Jones -15.3%. The Russell 2000 Smaller Companies Index was -23.9%.





UK





If you just looked at the FTSE 100 then you may ask what all the fuss is about, as it fell by just 2.9% in H1. Look down the size bands and the picture is a lot like the US, with the FTSE 250 falling 20.5%, Small Cap -16.4% and AIM -28%.

We expected the UK consumer to see disposable income squeezed, but that squeeze has tightened even more with the rise in the energy cap in April, food prices now rising by some 7-8% year-on-year and petrol/diesel approaching 200p per litre to go with tax rises and the tax take at the highest level since the 1950's. The government has announced some extra support for consumers, but consider that mortgage rates have doubled since lows in Q4 2021, the scale of the pressures can be seen. It appears that consumers are continuing to spend their pandemic 'enforced savings' and consumer credit is growing again. Looking forward, the energy cap is likely to rise considerably again in October if Putin continues to choke down on gas supplies to Europe.

The forecast for UK CPI in 2022 started the year at 6% and it is now expected to hit double digits and perhaps 11% in Q4, with it already hitting 40 year highs! That has ramifications for the government, with pensions and benefits setting off the September reading, although



inflation does help them somewhat on VAT receipts, for example. As with wage rises expect higher PAYE / NI receipts, too. Markets remain concerned over a wage-price spiral. Here, the number of public sector or quasi public sector strikes is growing, with offers of 1-2% not surprisingly not cutting the mustard. The media talk of a move up to 5% being necessary. In the private sector, wage rises are already at much higher levels of 7-8%. Like the US, the UK continues to see a record number of job vacancies at some 1.3 million – double the number of unemployed! Employment is a notoriously lagging indicator, but this time around we have the post pandemic 'Great Resignation' and Brexit influencing the readings.

The Bank of England has managed to raise interest rates 5 times to reach 1.25% against CPI forecast to reach over 10%. My economic training has certain problems with that! The UK is moving into a similar situation as the EU – if the Bank of England's economic forecasts are right. GDP growth, from forecast 4.7% at the start of the year, is now forecast to contract by 1.25% in Q4 from a 0.8% quarterly gain in Q1 and 2022 to grow 3.75% year-on-year – pretty much all delivered in Q1 – before contracting by 0.25% year-on-year in 2023. Does the Bank of England raise interest rates to tackle inflation (which is its mandate), or do they concentrate on growth? Their confusing and poor communication appears to be aping the government!





Where will interest rates peak, then? The Bank of England see the neutral rate as circa 2%, so we would think they have to, at least, get to that level. Interest rate futures markets have then peaking closer to 3% and staying there longer than, for example, the peak in the US.

We spoke of the government stumbling from crisis to crisis in our 2021 Annual Report, and quite incredibly the situation has got worse. The result is that Sterling is in a bit of a competition with the Euro as to who can be a weaker currency. Those with long memories may remember the UK's historic propensity to import inflation, so this is not helpful at all, although the Bank of England Governor Bailey says he isn't too worried! One thing that the weakness has helped to continue to drive is continued buoyant M&A, with UK companies looking even cheaper to overseas aggressors.

It now looks like H2 2022 will see a new UK Prime Minister. What new policies that will bring, and the uncertainty on that, may give the Bank of England more excuses to pause on raising interest rates. We would see that as another mistake.





SUMMARY



IN SUMMARY OR "THE RAMIFICATIONS OF THE END TO FREE MONEY"

We will start with bonds which, you may recall, we said to avoid at the start of the year.

1. Bonds

The moves year-to-date have been extreme, with volatility continuing to be very high and at levels not seen in this century. Equities have had a tough H1, but for bonds, they have seen falls unprecedented for decades. A selection of those moves below:

- **UK:** the 2 year gilt yield started the year at 0.64%. The yield peaked at 2.28% and closed at 1.82%, with the 10 year yield starting at 0.96%, peaked at 2.65% and closed H1 at 2.23%.
- **US:** the 2 year treasury yield started the year at 0.73%. The yield peaked at 3.43% and closed at 2.95%, with the 10 year yield floor at 2.34%, peaked at 3.47% and closed at 3.01%.
- **Germany:** the 2 year Bund floor was -0.98% yield. It peaked at 1.21% and closed at 0.61%, with the 10 year floor at 0.5% yield, peaked at 1.76% and closing at 1.33%.



- **Italy:** the 2 year floor was at 0.27% yield. It peaked at 2.11% and closed at 1.17%, with the 10 year floor at 2.0% yield, peaked at 4.16% and closed at 3.25%.

Yields have thus (at least for now) started to fall back. Why are yields falling? Because growth prospects are falling, but also because financial markets have started to search for the peak in inflation.

2. Inflation & Interest Rates - is the peak in sight?

Commodity prices have rolled over for metals like iron ore and copper. Given its fall, 'Dr Copper' could be said to be signalling a significant economic slowdown. Oil remains above USD\$100 a barrel, although it is perhaps gas that is now a lot more important to the global economy. Putin is manipulating the gas price through choking down on supply to Europe. How the price moves this coming winter will be a key determinant to how financial markets and economies, particularly in Europe, perform.

We see the key inflation parameter as being US CPI and/or the Federal Reserves preferred measure, the 'PCE', starting to fall in a meaningful manner. Prior to the Russian invasion of Ukraine, it had looked like that might happen through May/June as some high monthly readings from 2021 dropped out of the year-on-year





calculation. That has not happened with the June reading 9.1% year-on-year. Looking at CPI for July and August, the monthly rises in 2021 were 0.4% and 0.3%, which is around where it stays, until it jumps to 0.8% in October. It thus looks like we will see the US year-on-year CPI reading starting to ratchet back in the Autumn, subject to no further extraneous influences. We would expect it to be quite sticky on the way down and the very low inflation, free money, era to have ended. Markets saw the peak for US interest rates as being in Q4 2023 but that has recently moved forward to Q1 2023 as the Fed has been more aggressive with a 75bps rise and with growth expected to slow. The Fed has, so far, raised interest rates to 1.75% despite starting much later than the UK and the peak is seen at circa 3.25-3.5% at the turn of the year (2022).

That should be positive for equities and in particular Small Cap growth stocks. Share prices should start to recover before the end of the slowdown has occurred with typically 'Quality Growth' stocks leading the way and outperforming. This is because firstly, companies that can deliver growth in a slowing growth environment, should see that growth valued relatively more highly. Secondly, the discount rate on future earnings should start to fall again as bonds are valued more highly – i.e. yields fall on risk free assets.



3. Equities

Bonds have been volatile and so have equities, as detailed in the country sections. The end to free money should, we argue, be positive for companies and returns looking forward. Positive interest rates reassert a 'positive carry' in markets, which should mean financial markets operate more efficiently. The 'zombie' companies that drove down the returns for all as they operated to just generate cash to service debt, are no longer likely to be supported by the banks as money is no longer free. Thirdly, as they disappear, that should improve returns on investment, drive more capex and, we would hope, drive up productivity.

4. Themes

They should not change too much from what we outlined in the 2021 Annual Report, as themes are meant to endure. So we continue with those such as reshoring and near shoring. We see a drive for a reindustrialisation in developed countries like the UK as supply chains are shortened. Inflation – well, I think that is well established. Capital investment should be picking up, partly as a result of other themes like reshoring and nearshoring. Digital transformation was accelerated by the pandemic. Overlaying these are Singer's headline four "Growth Economy Themes" – namely Health & Wellbeing of the





Population; the Transition to a Sustainable Economy; Innovation & Emerging Technologies; and Geopolitics & Demographics.

Markets seem to move ever more rapidly and, as we enter H2 2022, then the focus looks to be moving from worries on inflation to worries on growth. Inflation is not dead yet, and it is still unclear whether or not it has become endemic in the system again. The Ukraine conflict has amplified the issue from when we closed 2021. The propensity for wage rises is key to where it goes now. Every company we speak to is putting through, often substantial, price rises and seeing little pushback. The wage-price spiral is a factor we will be keeping a close eye on as we move through the balance of 2022.

Central banks through their earlier inaction/mistakes are walking a tightrope of maintaining growth whilst they bear down on inflation with interest rate rises. The result no one wants is stagflation. It is a risk but not the result we see today. We are going to see a slowdown in growth – a truism post the boost from the post-pandemic restart of the global economy – with the risk that defeating inflation could cause a recession.



To finish then, the first half of 2022 has been a veritable roller coaster for financial markets, geopolitics and UK politics! For financial markets and equities in particular, we have seen a de-rating for UK Small and Mid-Cap stocks. Investors await what an expected economic slowdown may mean for equities. Seeing the top in for inflation is now key to an improving investment environment. Keep an eye on Europe for any systemic risk.





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