# The Way We See It

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## *Mid-Year Check Point – Review & Outlook*

**INSIDE THIS ISSUE**

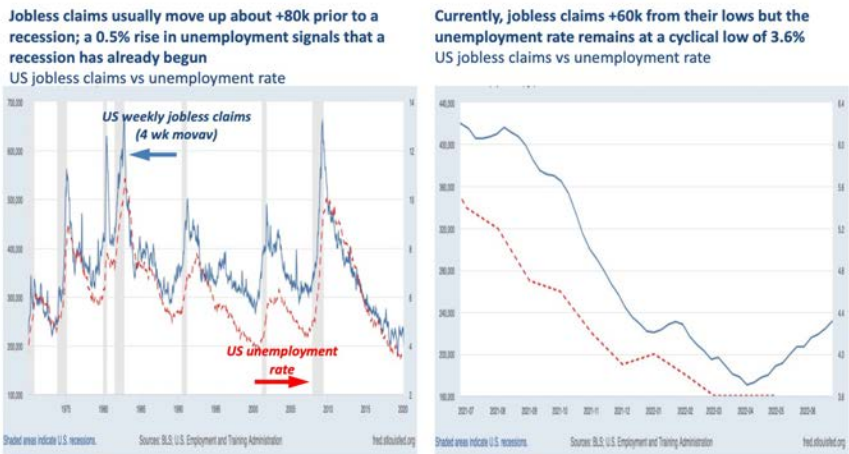


A brief update report which serves to review the first two quarters, as well as offering our outlook for the rest of the year and beyond.

**Review of Developments**
- H1'22: Economic Development & Financial Markets

Following the release of a negative US GDP quarterly data in Q1, investors are eagerly waiting for the release of the Q2 data in order to assess whether the US economy is already in a technical recession or just stagnating (while the US Fed claims that the US economy is very buoyant at present).

**What would be worrying in the US labor market – jobless claims +80k and unemployment rate + 0.5% from their cycle lows**




Source: John Normand on LinkedIn, 6th July 2022

Elsewhere in the world, slow and or negative growth seems to be the common theme. Disruptions in the global supply chain, together with sanctions imposed against Russian energy and grain exports and the structural imbalances in the labour force following the massive layoffs associated with the Covid pandemic, have been the chief causes of both sluggish economic growth and very high inflation.

Elevated inflationary pressures, which are being felt most strongly in G7 nations (following a massive injection of fiscal and monetary incentives over the past two and a half years), have forced their central bankers to tighten monetary policy. The latter is well known for its bluntness, inefficiency and long lags, in terms of their desired impact on growth, let alone inflation, which is not solely caused by strong conventional demand, but by external and structural factors mentioned above.

Consequently, investors in G7 feared that their central banks will hike rates and implement quantitative tightening too aggressively to tame this seemingly uncontrollable inflation monster, which could ultimately push the US and the global economy into a deep recession.

**Global sell-off in Q2 reflecting the accelerated inflation and monetary tightening.**

As a result, in Q2, global investors continued to sell their holdings in bonds, stocks and growth-sensitive commodities. Only USD (and HKD) cash was a safe haven.

In order to appreciate the magnitude of the sell-off in Q2 and H1 of 2022, we feel it is useful to look back at what happened in the prior six months.

| Asset Class | US Equities | Global Equities | GEM Equities |
| --- | --- | --- | --- |
| Index | MSCI USA | MSCI World | MSCI EM |
| H2 2021 | 10.53% | 7.96% | -9.12% |
| H1 2022 | -21.11% | -20.29% | -17.47% |
| 1Y at 2022Q2 | -12.80% | -13.94% | -25.00% |

| Asset Class | US Corporate | US Treasury | US Aggregate |
| --- | --- | --- | --- |
| Index | Bloomberg US Corporate | Bloomberg US Treasury | Bloomberg US Agg |
| H2 2021 | 0.23% | 0.26% | 0.06% |
| H1 2022 | -14.39% | -9.14% | -10.35% |
| 1Y at 2022Q2 | -14.19% | -8.90% | -10.29% |

| Asset Class | Global Govt Bonds | Global Aggregate | Global Commodities |
| --- | --- | --- | --- |
| Index | FTSE WGBI | Bloomberg Global Agg | CBR |
| H2 2021 | -2.33% | -1.55% | 8.90% |
| H1 2022 | -14.79% | -13.92% | 25.29% |
| 1Y at 2022Q2 | -16.77% | -15.25% | 36.44% |

Source: GOJI, MSCI, Bloomberg

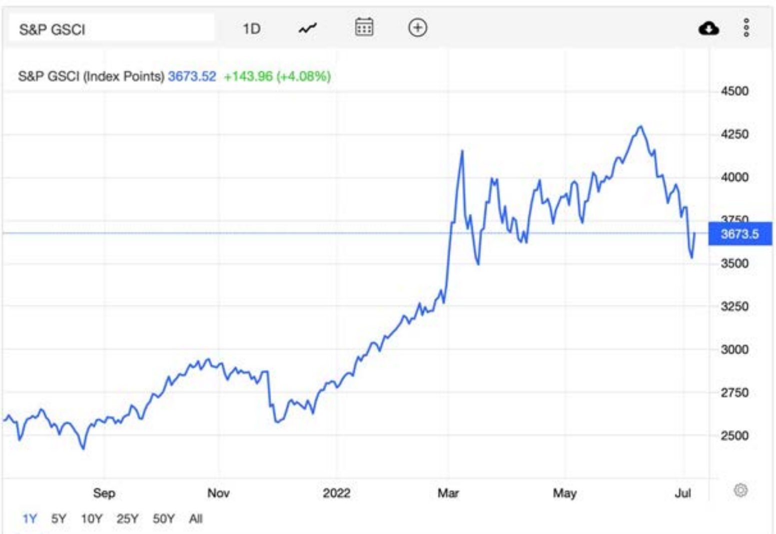
A number of observations can be made:

a) Investors reduced exposure to all liquid assets aggressively in Q2. They appeared to be convinced that not only will inflation remain high, but that the aggressiveness of the US Fed has increased the probability of a deep US and G7 recession in the coming 12 months;

b) The more crowded the asset classes and/or stocks were, and the more popular they were amongst the dominant quantitative- and algorithm-based funds in 2021, the larger their falls in H1 '22 (Crypto, NASDAQ, Disruptive Technology, High Yield bonds, etc). No surprise here.

c) Three interesting themes can be highlighted towards the end of Q2:

    (i) Investors appeared to be warming up to China and Asian again recently, as the Chinese authorities eased their tight grip on their monetary, fiscal and Covid policies;
    (ii) Investors appeared to start to lock in high bond yields in quality fixed income sectors to hedge against a recessionary scenario, evidenced by the short-term peak in the US 10 year government bond rate at 3.50% p.a.
    (iii) Despite the continuing Russian-Ukranian conflict, commodity prices, including oil, appeared to have peaked in early June.




Source: Trading Economics

## Market Outlook: The Way We See It

While there are both positive and negative factors operating in the world economy in the next few months, the negatives are likely to influence the US and world economy more significantly.

As outlined in our June report, positives include: the gradual re-opening of China's major commercial cities and easing of Covid rules, following a strict lockdown. In addition, as the majority of countries have started to re-open and encouraged tourists and foreign workers to return, this will add to growth and help to alleviate the shortage of labour in many countries. Global PMI surveys also suggest that the world economy continues to grow, albeit at a slower pace.

Regarding inflation, while the year-on-year rate in major economies remains high (from a low base last year), the 3-month annualised rate has started to show a gradual decline, as commodity prices appear to have peaked in March, and have started to decline. Lastly, the US is engaging in internal debates to potentially lower the tariffs on certain imported goods, with the hope to lower inflation (where they politically and economically can).


Source: YCharts

Negatives, the more significant forces, include: the continuing supply-side bottlenecks (particularly sanctions against Russian energy and agricultural exports, combined with the logistics blockage of Ukranian agricultural exports, and China's zero-Covid policy), gradual tightening of monetary policy by major central banks in the OECD bloc, and the continuing acute shortage of manual workers everywhere in the world, particularly in the services everywhere in the world, particular in the services sector.

In brief, the world economy is in a fragile phase of growth at this juncture. Should the US Fed remain ultra-hawkish and fixated by the desire to lower the US inflation rate back to 2% within a short timeframe, then the current 'stagflationary' environment may turn into a ‘recessionary’ one.

## Global Markets and Investment Thematics

Against the above economic, monetary, and geopolitically unbalanced backdrop, in a not too dissimilar fashion through the first half of this year, global financial markets are likely to trade within a wide range, in a volatile manner, with a downward bias.

Consequently, it would be sensible for investors to continue to adopt a defensive strategy in overall terms, an investment stance that we had advocated since November of last year. This translates into a strong focus on quality and lowly-geared assets that can deliver predictable cash flows, and USD cash. In addition, as a number of growth stocks with a strong business franchise and good management have witnessed a substantial fall in their share prices, long-term investors should take advantage of these opportunities to selectively add to their equity and bond exposures.

From an investor's sentiment and positioning perspective, we note that quantitative- and algorithm-focused funds appear to have reduced their exposure to risky assets relatively significantly (some are net short). Fundamental long-only investors appear to have started to reduce exposure to equities and low-quality corporate bonds, after a substantial buying binge last year and the first five months of this year. They remain the potential source of liquidation risk of risky assets, should newsflows worsen and panic sets in.

In brief, a sustainable bull market in equities and corporate bonds will return at some stage, but only when valuations are lower and, more importantly, when the US Federal Reserve and other major central banks switch from the current tightening to an easing mode.

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