

# Capital Markets Update

## Summer 2022

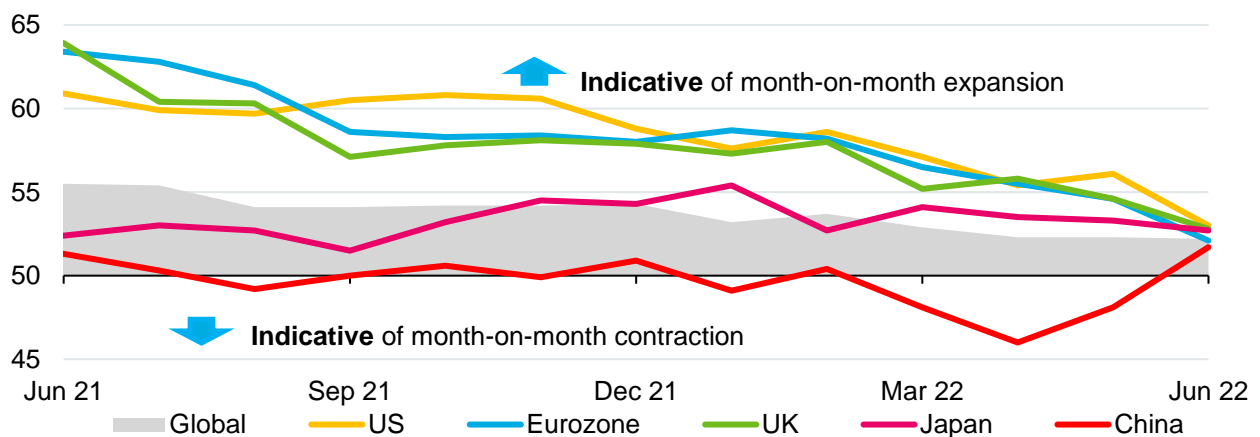
Inflation continued to surprise to the upside, sending inflation forecasts higher. Subsequent increases in interest-rate projections, as well as an ongoing squeeze on consumers from higher prices and borrowing costs, have weighed on growth forecasts.

Sovereign bond prices fell and yields rose, significantly. Equity and industrial metal prices fell, credit spreads rose sharply, and the dollar continued to strengthen.

### Global themes

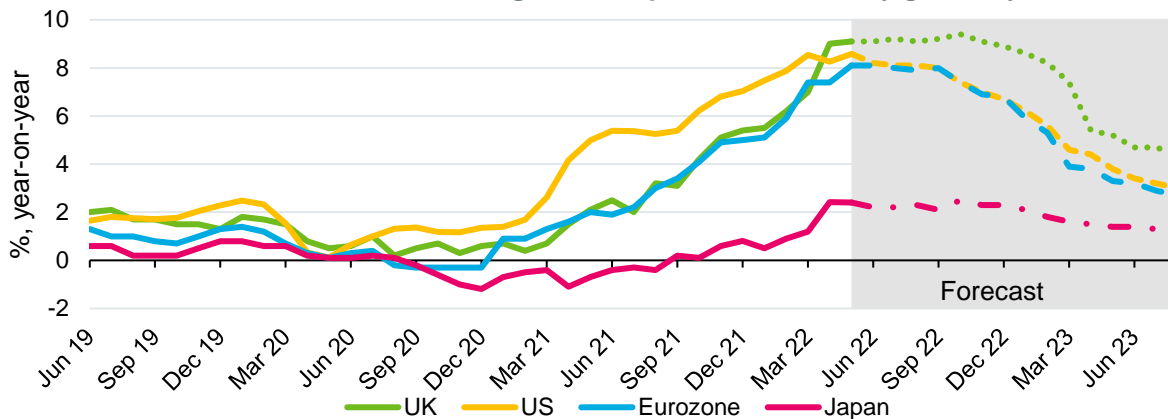
Consumer confidence has plunged in the major advanced economies as inflationary pressures and higher borrowing costs squeeze consumers' real incomes. Consumer confidence surveys in the US, UK and Eurozone have all fallen to levels typically consistent with recession. Business confidence has declined more modestly, particularly in June, although it remains at a level consistent with expansion. The global manufacturing purchasing managers' index (PMI) fell to a near two-year low in June (Chart 1), despite an increase in the output sub-index as China eased COVID restrictions. New orders stagnated, business optimism fell, and manufacturers faced ongoing supply chain stresses. While increases in input costs, output prices and supplier delivery times eased slightly, they are still elevated.

**Chart 1: Global manufacturing PMI near two-year low, despite a rebound in China**



Raw materials costs and producer prices and tight labour markets, particularly in the US and UK, have maintained upwards pressure on inflation. In the UK, where currency weakness compounded the problem, headline CPI increased to 9.1% year-on-year and though core inflation, which excludes volatile energy and food prices, eased slightly, it is well above target at 5.9% year-on-year. Consensus forecasts suggest the UK will not only experience the highest headline inflation of the major advanced economies in 2022 (Chart 2), but also significant underlying price pressures, with core inflation also expected to outstrip peers.

**Chart 2: Headline CPI inflation is still rising and is expected to ease only gradually**

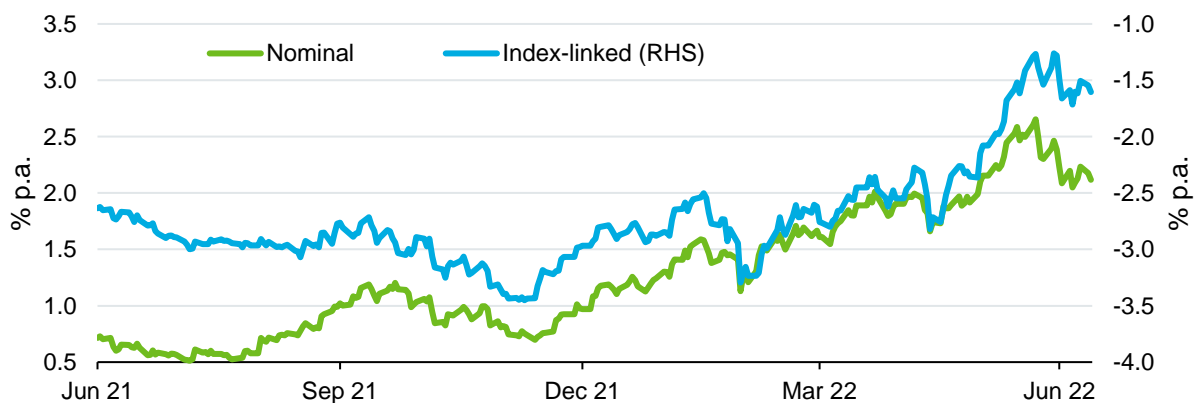


Against this backdrop, global growth forecasts are falling and inflation forecasts are rising. Central banks are increasingly focussing on inflation, concerned the risks that it becomes entrenched are growing. In response, the Bank of England raised rates for the fifth time since December in June, to 1.25% p.a., and the US Federal Reserve delivered a bumper 0.75% p.a., increasing the Fed Funds rate to 1.75% p.a. The European Central Bank has indicated that it's likely to raise rates in July and move them above zero by the end of September 2022. Markets now expect interest rates to rise to 3.4% p.a., 3.0% p.a. and 1.6% p.a. in the US, UK and Europe, respectively. As central banks concentrate on their primary task, an even faster increase in interest rates than markets expect cannot be ruled out, which would increase the chances of recession.

### Government bonds

Despite the risk of higher-than-anticipated rates, nominal yields have risen significantly (Chart 3) and are at levels where bonds could provide some downside protection should recession risks materialise, provided inflation moderates. Nominal yields are at, or near, our assessment of longer-term fair value. Due to inflation risks and the shape of the forward curve, we retain a preference for the front end of the curve.

**Chart 3: 10-year nominal and real yields have risen sharply, and implied inflation has fallen in Q2**



Gilt-implied inflation has fallen significantly over the quarter as the rise in real yields outpaced that in nominal yields. Real yields still look a little low relative to our assessment of longer-term fair value, but high inflation, alongside below-trend real growth, feels like decent fundamental support for index-linked gilt markets. As a result, the recent rise in real yields and fall in implied inflation potentially presents a more attractive entry point to index-linked gilts, offering both a hedge against inflation and a drop in real growth. This makes us more neutral in our relative views of nominal and index-linked gilts.

## Credit

Global credit spreads have risen significantly (Chart 4), as high inflation and waning central bank support weighed on investor sentiment. Slowing corporate earnings growth and rising interest rates will weaken credit fundamentals, but corporate balance sheets are starting from a relatively strong position. While upside risks to inflation remain, attractive levels of credit spreads provide some offset to potential further moves higher in yields.

At current spread levels, investment-grade credit looks attractive relative to nominal gilts. We are more neutral in our relative views of investment-grade corporate credit and asset-backed securities (ABS), which have substantial exposure to consumer loans. Because of rising living costs, we think that the consumer outlook is a little weaker than that of corporates, where earnings forecasts point to companies retaining a degree of pricing power. While ABS spreads are also approaching attractive levels relative to history, the premium over similarly rated corporate credit has narrowed substantially.

The economic outlook has weakened, but speculative-grade credit spreads are at levels which should provide compensation against a material increase in defaults from current levels, which are very low. Within speculative grade markets, we are broadly neutral between high-yield bonds and traded loans. Leverage is higher and interest coverage is lower in the leveraged loan market versus high-yield markets, and interest rate rises are likely to increase servicing costs more quickly for loans. However, loan spreads have risen very sharply recently, and are approaching very attractive levels.

**Chart 4: Recent spread widening has restored a degree of value to credit markets**



## Equities

The FTSE All World total return index fell 13.3% in the second quarter, taking the year-to-date decline to 17.3%. The technology sector, and the US market, underperformed. The cost-of-living squeeze was perhaps reflected in the contrasting performance of consumer sectors: those dependent on discretionary spending lagged while consumer staples outperformed, as investors perhaps placed a premium on the sector's defensive characteristics and inherent pricing power. Energy also outperformed, though still fell in Q2, and is the only positive sector return over the first half, rising 16.2%.

**Chart 5: Cyclically adjusted global equity valuations have fallen to long-term median levels**

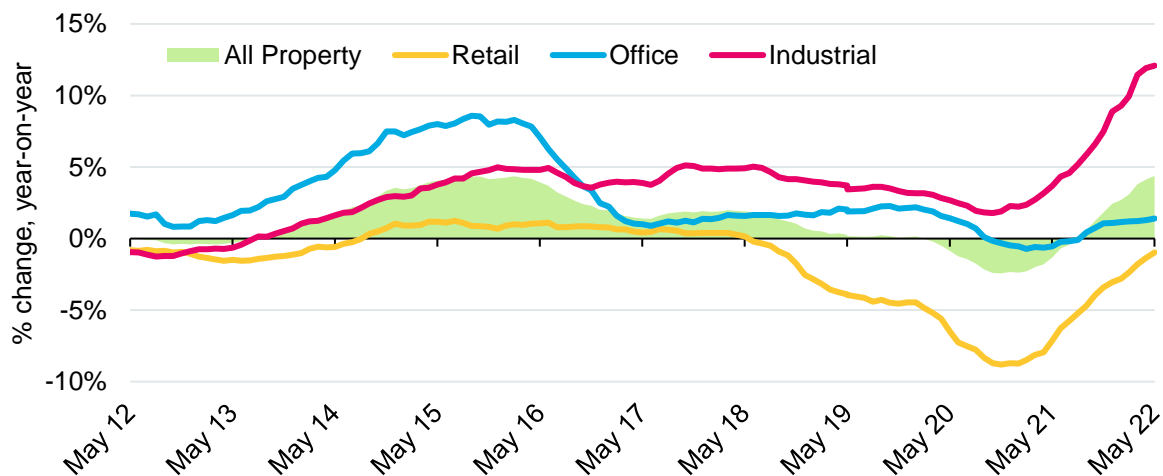


Year-to-date price declines have been driven by a contraction in price-to-earnings ratios, as rising real yields have increased discount rates. Cyclically adjusted valuations have fallen significantly and are now broadly in line with long-term median levels (Chart 5). Despite this significant cheapening, we retain a degree of caution on global equities because of concerns about the fundamental outlook. Global corporate earnings are still forecast to see reasonable growth this year and next, and two-year aggregate forecasts have actually risen since the start of the year. This optimism looks increasingly vulnerable to downwards revisions amid the deteriorating growth and inflation outlook.

### Property

For the second quarter, property was a relative bright spot: the Morgan Stanley Capital International (MSCI) UK Investment Property Databank (IPD) total return index rose 8.8% in the first six months of the year. UK commercial property fundamentals continue to improve. Rental growth, as measured by MSCI UK IPD, has continued to increase (Chart 6) amid evidence of a healthy occupational market. The most recent RICS Commercial Property Survey points to rising occupier demand and rent expectations, and falling availability and inducements offered to attract tenants.

**Chart 6: Annual rental growth is on an improving trend across UK commercial property sectors**



However, valuations are looking increasingly stretched, both in absolute terms but also, increasingly, relative to other asset classes as equity and bond prices have fallen. The potential inflation linkage in property rents, particularly in the long-lease sector, may provide support to valuations, but with property prices holding up well and still-healthy transaction volumes, property may become vulnerable to rebalancing flows as investors look to exploit better buying opportunities elsewhere.

## Conclusion

Although an even faster increase in interest rates than anticipated cannot be ruled out, core sovereign bond yields have risen substantially and are at a level that could provide ballast if increased recession risks materialise, assuming inflation moderates. Credit spreads have also risen substantially given the weakening outlook and valuations are attractive relative to their long-term history. Investment-grade credit looks attractive relative to gilts, while speculative-grade credit spreads are at levels that provide compensation against a material rise in defaults. We would be comfortable investing some surplus cash in credit markets, based on end-June spread levels.

Equity valuations have fallen significantly and, for the first time since the market recovery took hold, no longer look stretched versus longer-term averages. However, earnings forecasts look increasingly vulnerable to downwards revisions and valuations may not yet fully reflect growing downside risks. UK commercial property fundamentals and performance have held up well, but the asset class is looking increasingly expensive in absolute terms, and also relative to bonds and equity.



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