# ROCQ CAPITAL

## Second Quarter 2022

The continuation of tough market conditions has led 2022 to record the weakest first half in equity markets since 1970 (measured by the S&P 500), driven in part by central banks raising interest rates and their hawkish narrative suggesting significant further increases over the remainder of the year. Equity prices are far from alone in having seen a substantial drawdown year to date though, with bond markets also falling considerably. The benchmark ten-year UK Gilt yield moved up 1.26%, from 0.97% to 2.23% over the first half, the largest move in the first half of a year since 1993 (when the starting yield was over 6%), and the largest in either half year since the Global Financial Crisis in 2008.

Russia's invasion of Ukraine dominated news in the first part of the quarter and whilst the conflict appears no nearer resolution, financial news has shifted to focus on the extraordinary levels of inflation seen around the globe, and the increased possibility of recessions being triggered. US CPI year-on-year was measured at 8.6% in June, the highest level since 1981, with wage growth continuing to run hot. We expect the Fed to continue hiking rates throughout the remainder of the year although the supply-driven nature of inflation, exacerbated by lockdowns in China and the Russian invasion, means some market participants remain sceptical of their ability to tame the beast. European inflation is similarly running high, although the European Central Bank has less control than the Federal Reserve, with some nations – Germany in particular – beholden to Russian gas supplies for energy, which is a key component of inflation indices. The Bank of England made their fifth hike of the current cycle towards quarter end, whilst moving inflation forecasts up further, to 11%, as the UK suffers from both a tight labour market (like the US, and therefore wage growth) and energy supply issues (like Europe).

Both growth and value equity styles lost money in the second quarter, although value protected capital to a slightly greater extent than growth stocks.  The latter suffered more from valuations de-rating in the face of higher sovereign bond yields. Geographically, the commodity and financials focused UK FTSE 100 (-3.8%), and Japan's TOPIX index, notably outperformed the EuroStoxx and S&P 500 (-16.1%). Emerging Markets also had a weak quarter (MSCI Emerging Markets -11.4%), with Chinese equities the sole bright light as the government begins to reopen their economy and data showed growth in factory activity in June.

Credit markets continued their risk-off move from the first quarter and spreads widened quite notably as investors remain cautious over the strength of economic growth. USD and GBP investment grade spreads widened 0.40%-0.50%. The impact in euros was even larger, and from a lower starting point, moving from 0.63% at the end of Q1 to 1.30% at the end of Q2. The combination of such pronounced spread widening, and sovereign bond yields moving up significantly, also created a negative environment for fixed income investors in the second quarter.

Volatility in commodity markets remained elevated; oil continued trending upwards – albeit in a whipsaw fashion – for most of the quarter before rolling over somewhat towards quarter-end. Natural gas saw similar moves although in a much more extreme fashion as supply constraints continue to rise. Elsewhere in commodities though, the threat of an economic slowdown hurt metals markets. Copper, often seen as a leading economic indicator due to the wide use cases for the metal, fell almost 22%, with the majority of the move coming in the last three weeks of the quarter. Gold fell as well, albeit to a lesser extent, perhaps suggesting that inflation may be nearing a peak.

## Outlook

High inflation combined with little or no growth is not a positive economic outlook, however nor is it our base case. We expect inflation to start to fall into year end, although still remain elevated above central bank targets for quite some time. As we noted in our last outlook, the US Federal Reserve is generally accepted to have reached their unemployment goal, so inflation is their sole focus. Combined with the views published by members of the board of governors, this leads us to believe they will continue to hike rates even if the economy starts to experience a slowdown.

The reopening of the Chinese economy will reduce supply chain pressures as ports reopen and container ships can dock, although the problem may simply move around the world to the US and Europe with ships moving in the same direction at the same time, reducing the positive effect. Closer to home, the outcome of the Russian invasion of Ukraine is even less predictable than financial markets, with much depending on how far President Putin is willing to go. The impact on energy markets, and eventually food supplies, is likely to have significant effects on Europe in particular.

Volatility across asset classes is likely to remain elevated, and returns across sectors and regions could be quite diverse. For those reasons, we continue to highly value the allocation in portfolios to the Alternatives sector which can take advantage of the most idiosyncratic moves. An increased holding to such funds is likely to be seen in third quarter valuations.

Falls in both equity and fixed income markets have been substantial so far, however markets are now priced at what appear to be very attractive levels for an investor looking to own for the medium term. Whilst we cannot predict when bond yields will peak, or equity markets might bottom, almost double digit yields in some cases for a diversified bond portfolio and equity markets trading at historic averages despite being considerably higher quality, give a positive tilt to the investment outlook going forward.