Marlborough

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Global Investment Commentary

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- ***Equities rallied strongly in July, but potential for further volatility remains***
- ***Recession risks rising, although UK economy proving resilient***
- ***Potential for rebound if rate hikes not as bad as feared***

Throughout 2022, inflation has been the key concern for investors. Latterly, growth concerns have been added into the mix, as investors weigh up the increased risk of central bank policy error - the possibility that by cooling inflation they plunge economies into recession. Yet despite inflation reaching record levels in several regions in July, and the US economy posting a second consecutive quarter of negative growth, equity and bond markets enjoyed positive returns. US equities were particularly strong, gaining over 9% in the month.

So why the disconnect? Part of the answer lies in the fact that markets have already discounted the difficult economic conditions, and that valuations are now quite reasonable. With central banks having front-loaded their rate hikes (in other words, implementing larger rate increases early on, in the hope that later rises will be smaller), fears of long-term inflation staying at elevated levels have declined. And that means investors are now expecting policy rates to peak sooner, and at levels lower than previously feared.

Investors are also seeing company earnings levels that are surprisingly resilient in the face of tough trading conditions. By rebounding so strongly, equity markets are effectively pricing in a soft landing whereby inflation is tamed, and recession is averted.

But this positive mood belies the fact that economic conditions are worsening, and risks of recession rising. As noted above, GDP growth has declined in most areas. But that is a backwards-looking measure, telling us what happened in Q2. Worryingly, forward-looking measures such as the composite PMI* are falling into contractionary territory.

In the past few months, we have included in these commentaries charts of freight costs and delays. Here's another one, this time showing freight delivery times which have experienced a significant decline. On the face of it, this would seem to indicate that supply issues are easing, and this will help tame inflation. But a big part of the decline is the result of falling end-consumer demand. This is another indicator of a fragile economy.

*Investopedia.com: Purchasing Managers' Index (PMI) is an index of the prevailing direction of economic trends in the manufacturing and service sectors. It consists of a diffusion index that summarises whether market conditions, as viewed by purchasing managers, are expanding, staying the same, or contracting. The purpose of the PMI is to provide information about current and future business conditions to company decision makers, analysts, and investors.

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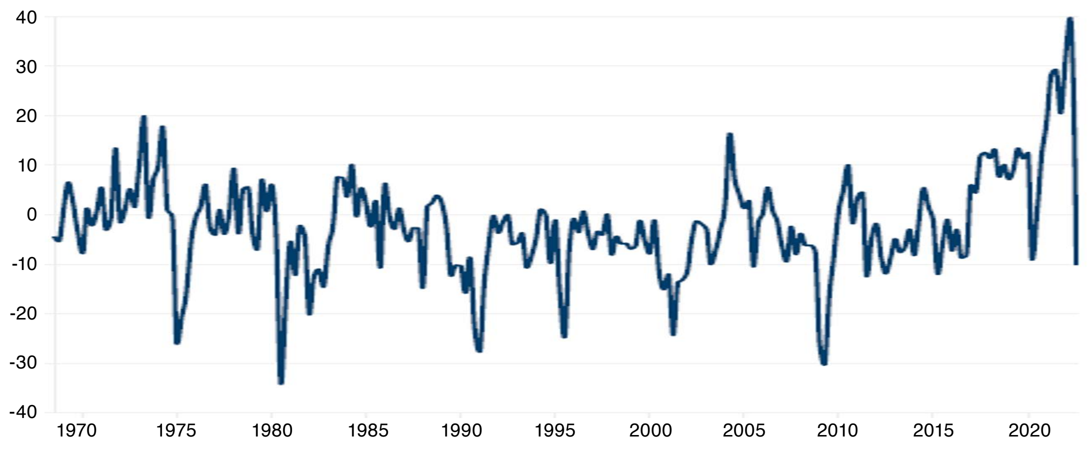
Business Outlook Survey - Delivery Times



Source: Federal Reserve Bank of Philadelphia; as of 26 July 2022.

Given these worrying signals, we are maintaining our cautious view. Although our overall equity positioning is neutral, the portfolios remain tilted towards lower-risk, defensive funds focusing on companies that can deliver stable earnings and dividends. And on the fixed income side, we have continued slowly to increase exposure to secure sovereign debt which would perform well in a recessionary environment.

UK

- ***Surprising economic strength, but short-term equity performance muted***

Contrary to other regions, UK economic data has till now actually been quite resilient: although growth has slowed, momentum is still positive - at least according to the latest available data. The composite PMI for July came it at 52.8, well above the 50 level that separates expansion from contraction. And the latest GDP reading of +0.5% growth for May was well ahead of expectations (although this figure is already several months old). In response to this data, some economists saw the risk of recession coming down, but Bank of England governor Andrew Bailey poured cold water on that sentiment in his comments following the latest rate hike.

UK shares did not participate fully in the global equity rally in July but had not suffered as much on the way down, and so the UK remains comfortably ahead of other regions on a year-to-date basis.

Our stance in the UK has not changed: we remain overweight, although we have shifted some exposures to dividend-focused funds which offer good defensive characteristics.

US

- ***Strong share price rally despite weakening economic outlook***

Most data points in the US in July were negative: companies have been reporting their Q2 results, and although earnings are still increasing, they are beating estimates by less than normal. This is leading analysts to revise down their estimates for Q3 and beyond.

Secondly, the US Federal Reserve Open Market Committee raised rates in July by 0.75% - the second consecutive increase of that magnitude.

And finally, Q2 US GDP growth was -0.9% (a second consecutive negative quarter), and the composite PMI was 47.5, well into contractionary territory.

But despite all this bad news, US shares rallied strongly in the month. Investors focused on Fed chair Powell's comments which suggested that the future pace of rate hikes might be lower than current expectations suggest. Mr Powell noted that the full effect of the recent rate moves have not yet been fully reflected in the economic data.

We are holding a neutral stance on US equities, but here too we are tilting towards equity income funds which favour companies paying steady and growing dividends.

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Europe

- ***Gloomy economic picture, but already discounted by markets***

The European Central Bank (ECB) also raised rates in July, by 0.5%, ending the era of negative rates. However, the ECB faces even more of a challenge than the other central banks, as the risk of recession is higher. Although gas supplies from Russia resumed after the Nord Stream 1 pipeline was shut down for scheduled maintenance (there was some doubt whether this would happen), it is only at 40% of maximum capacity. This means European countries are struggling to build up supplies ahead of winter and are considering strategies to reduce consumption - including rationing. This will add to the headwinds facing the economy.

But as with the US, European shares shrugged off the gloomy outlook to post strong gains in July; as we suggested last month, much of the bad news has already been discounted. We remain neutrally positioned.

Asia and Emerging Markets

- ***Property concerns in China***

In China there are renewed fears of a property collapse as the massive property company Evergrande failed to meet their obligations under a debt restructuring plan they proposed after defaulting on their loans last year. In addition to this, there is a growing mortgage boycott. Many mortgages for purchases of new developments require repayments before the houses are completed. A cash crunch amongst developers has meant many developments have been delayed, leaving buyers paying for houses they can't occupy, hence the boycott.

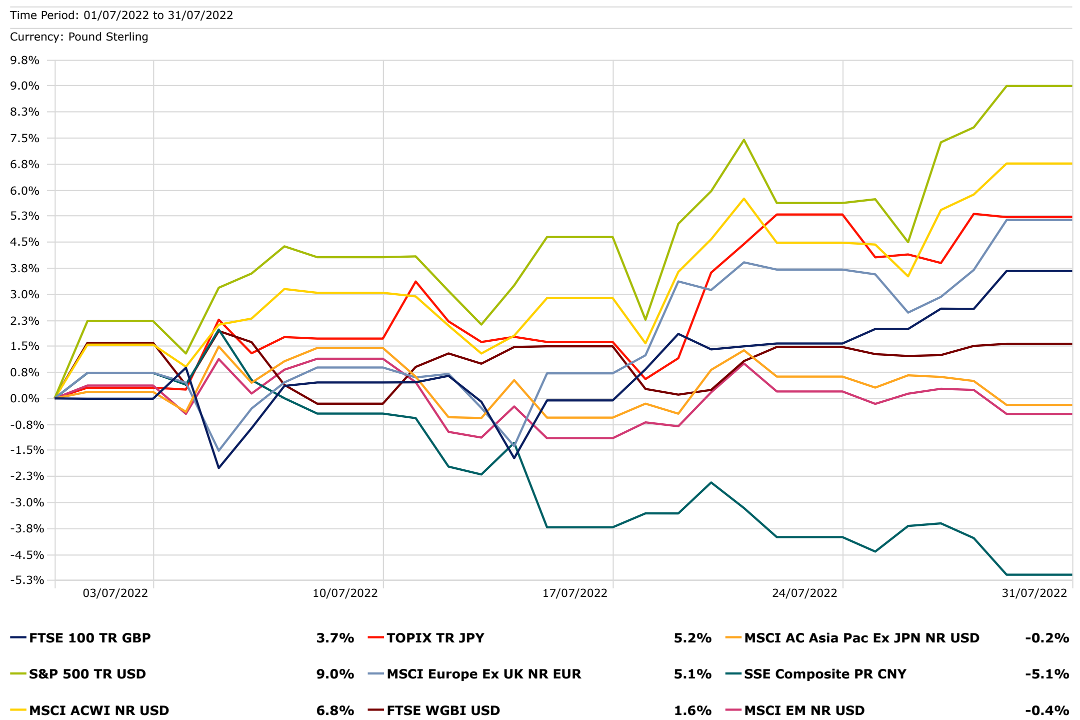
In Japan, the Yen reached a 24-year low against the US dollar. Like the UK, a weak currency is positive for the economy, as exports become more competitively priced, and share prices reacted positively.

Fixed Income

- ***Bonds doing well despite rate hikes and higher inflation***

Despite the inexorable rise of inflation, and central bank rate hikes, fixed income markets performed relatively well in July. The inflation/rate hike story is now fully discounted, and bond prices are now reflecting the rising potential for recession. We have moved back to a neutral position in this asset class.

July 2022 Performance



Source: Morningstar Direct

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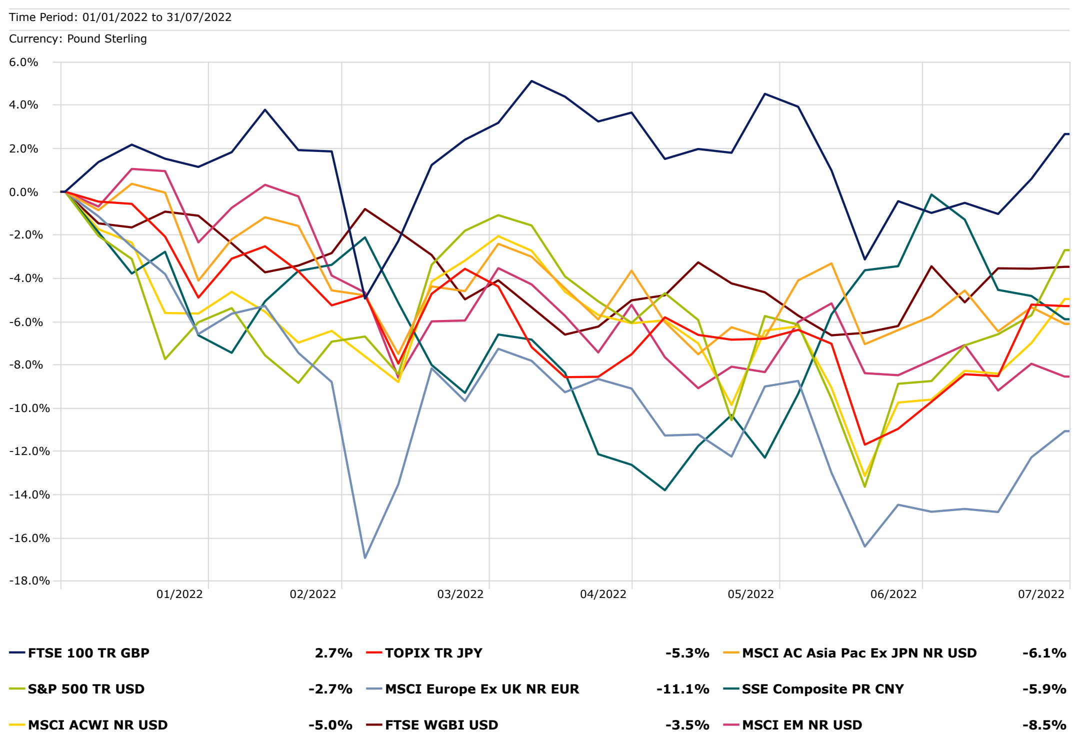
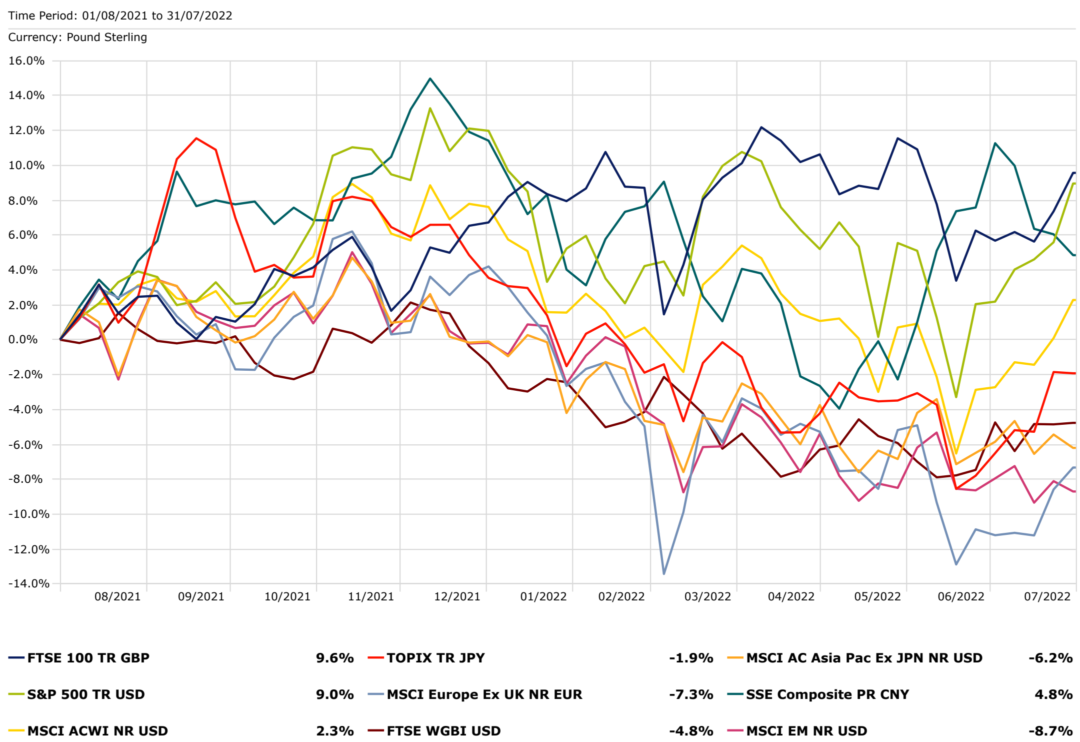
Year to Date Performance



Source: Morningstar Direct

12 Month Performance



Source: Morningstar Direct

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Market Round Up

Performance of major markets	July		Year to Date		12 months to 31st July	
	Sterling Terms	Local Currency	Sterling Terms	Local Currency	Sterling Terms	Local Currency
UK (FTSE 100)	+3.67%	+3.67%	+2.66%	+2.66%	+9.56%	+9.56%
US (S&P 500)	+9.00%	+9.22%	-2.70%	-12.58%	+8.95%	-4.64%
Europe (MSCI Europe Ex UK)	+5.14%	+8.02%	-11.06%	-10.88%	-7.33%	-5.67%
Asia (MSCI Asia Pac Ex Japan)	-0.19%	+0.01%	-6.11%	-15.64%	-6.20%	-17.90%
Japan (TOPIX TR JPY)	+5.22%	+3.72%	-5.28%	-1.23%	-1.92%	+4.53%
China (SSE Composite)	-5.08%	-4.28%	-5.89%	-10.62%	+4.85%	-4.24%
Emerging Markets (MSCI EM)	-0.45%	-0.25%	-8.54%	-17.83%	-8.70%	-20.09%
All World (MSCI ACWI)	+6.77%	+6.98%	-4.96%	-14.61%	+2.28%	-10.48%
World Govt Bonds (FTSE WGBI)	+1.57%	+1.78%	-3.47%	-13.27%	-4.77%	-16.65%

Source: Morningstar Direct

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