Outlook: Second half 2022

William Davies, Global Chief Investment Officer

As we've gone through 2022 and we've seen expectations of interest rates rise, we've seen uncertainty as a result of Russia's invasion of the Ukraine, the fear has moved --well, inflation is still a fear -- but it's also aligned with a slowdown in economies. And that slowdown in economies, potentially, is going to result in recession.

If we look at the U.S., we saw negative growth at the beginning of this year in the first quarter, quite possibly the second quarter is going to flirt with negative growth as well, which would be the definition of a recession, two negative quarters in a row. So, yes, flirting with recession.

But, do we expect it to be a *deep* recession? That's what we think is really important. We think that the slowdown will bring about recession, be that in Europe, potentially in the US as well. But we don't believe it's going to be deep recession like we saw in the global financial crisis of 2008 / 9.

Markets have struggled. Will this continue?

So, if we look at markets over the first half of 22, it's been an incredibly unusual time. We've seen the worst performance in global bonds since 1970 or so. We've seen significant weakness in equities. Normally, you would expect one to offset the other, and that has not been the case in the first half of 2022. Yes, we have seen pockets of resilience. We've seen real estate being resilient. We've seen commodity prices rising markedly over the first half of this year. And so, yes, it's a very unusual time, but we would look at that and say that it's unlikely to persist into the second half of this year given the amount of pessimism in markets and what has been discounted by those falls in bond markets, by those falls in equity markets over the first half of 22. So, maybe some stability, maybe a little bit more resilience as we go through the second half of 22.

What's your forecast for equities?

If we look at equity markets, profitability across equities in aggregate has been incredibly resilient. As we start to see a slowdown in economies across the world, and, yes, we have those pressures from supply chains as well, commodity prices being high, some pressure on the consumer as well, partly because of disposable income going down with the high oil prices and food prices also. We would expect to see increasing pressure on the profitability of companies.

However, on the other hand, we also look at the discount rate we think it's quite possible that the expectations around discount rates will have peaked. So, some pressure on profitability, but actually the discount rate no longer rising and, in fact, may be a bit lower than people have feared at certain stages of the first half of this year.

So, in terms of the outlook for equities, we have to be a bit careful because we are seeing changes in consumers attitudes in where there is spending and we need to identify where that may be resilient, where that may be coming under pressure. But in aggregate, given the falls we've already seen in equities thus far this year, we'd be more constructive around equities as we go into the second half of 2022.

Where are bond yields headed?

If we look at bond yields thus far in 2022, we've seen bond yields rise across the whole curve due to the expectations of higher inflation and higher interest rates. And really the speed of that increase in yields has been unprecedented over the first half of this year.

At the moment, there's a lot of negativity around, certainly in terms of inflation, the persistence of inflation, interest rates needing to rise further around the world. We agree with that. But, that's why yields have risen as far as they have done already across the curve. So, as we go, into the second half and people start to look more at the potential slowdown in economies, that's when we reckon that actually bond yields are not going to rise further from where we are right now. So, we saw them reach in the US ten years around about three and a half percent. We would expect ten year yields in the US to be 3% and below as we go through the second half of this year. So, those big increases we saw in the first half of this year, we won't see those increases repeated as we go through the second half.

How should investors be positioned for the future?

If we look at asset allocation as we move forward from here, I think it's very important to look at what is discounted in markets by the poor performance over the first half of this year. If we look at credit, though, we would remain more favorably positioned towards the higher quality credit rather than the lower quality credit, partly because of leverage, partly nature of the fact that we're going to see an economic slowdown and we would expect the higher quality credit to outperform in such an environment.

Within equities, if you can find pricing power in this environment, if you can find sustainably, sustainably high earnings or returns within companies, we believe those types of companies are going to produce attractive returns as we move forward because in an environment where we see pressure on economic activity, if you can show resilience that will be rewarded.

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