



Wealth  
Management US

VALUES WORTH SHARING

# Quarterly report

Q2 2022 market review





**Joseph Höger, detail from “View of Lake Gmunden near Ebensee”, 1836**

Landscape painter Josef Höger was closely connected with the Princely House of Liechtenstein through the numerous commissions he received from the family. As a result, an incredible body of his work in watercolour has been preserved in the collections. In his paintings, Höger documented the family's assets. He also frequently accompanied Prince Alois II von Liechtenstein on his travels, and therefore assumed a very special status. He captured the countries and landscapes through which they travelled, sometimes with astonishingly quick and fresh sketches, but sometimes also in large, detailed presentation drawings that demonstrate the full extent of his skill. Höger's views of Salzkammergut play an important role here. In his work, the artist painted cities such as Bad Ischl, Gmunden and Hallstatt, as well as the surrounding landscapes in which everyday life in the region is always depicted.

© LIECHTENSTEIN. The Princely Collections, Vaduz–Vienna

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## A look inside the Princely Collections

For more than 400 years, the Princes of Liechtenstein have been passionate art collectors. The Princely Collections include key works of European art stretching over five centuries and are now among the world's major private art collections. The notion of promoting fine arts for the general good enjoyed its greatest popularity during the Baroque period. The House of Liechtenstein has pursued this ideal consistently down the generations. We

make deliberate use of the works of art in the Princely Collections to accompany what we do. For us, they embody those values that form the basis for a successful partnership with our clients: a long-term focus, skill and reliability.

[www.liechtensteincollections.at](http://www.liechtensteincollections.at)

# Q2 2022 summary

The challenges that investors grappled with during the first quarter have now started to weigh on consumers, which has knocked broader confidence. Central banks moved to tighten monetary conditions rapidly to prevent wages chasing high price pressures. However, the continued war in Ukraine is hitting households by raising food and energy costs. As household incomes fail to keep pace, a cost-of-living crisis is at the core of concerns around waning consumer demand. These factors will continue to exert pressure on global growth, with the equity market falling out of favour with cyclical stocks and preferring defensive sectors. Bond prices sold off dramatically but, after the Federal Reserve (Fed) expedited its pace of tightening, found some support at the end of the quarter.

## **At a glance**

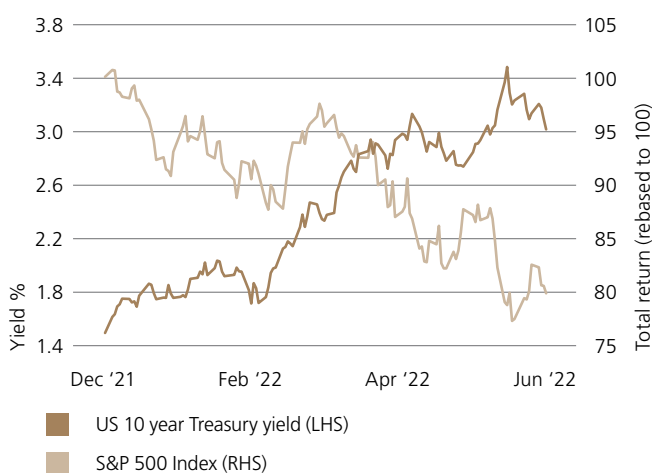
- Inflation remains high
- Real wages remain under pressure
- Pace of expected tightening from central banks accelerates
- Bond markets move lower to price in higher rates
- Equity markets correct to reflect the above challenges

# Macro summary

The last quarter saw both equity and bond markets challenged as central banks moved to tighten monetary conditions to fight persistently high levels of inflation. The war in Ukraine has seen further sanctions imposed on Russia, supporting already high energy prices. With grain supplies from Ukraine cut off and higher input costs, food prices are also sharply rising. This, combined with a higher interest rate environment, is already beginning to have an impact on consumers, fuelling fears of a recession. While interest rates are expected to rise further, bonds rallied off their lows at the end of the quarter, reflecting this reduction in demand.

Throughout the pandemic, China has maintained its “zero tolerance” COVID policy and has seen repeated shutdowns while other countries ease, or entirely abandon, previous restrictions. However, towards the end of the quarter, there were signs that China may finally emerge from the shadow of COVID and the days of city-wide lockdowns. At least on that front, supply chain constraints may be reduced, easing some inflationary pressures. Over the quarter, the Chinese equity market was one of the few to deliver a positive return.

**Both equity and bond markets have been challenged as central banks tighten monetary conditions to fight persistently high levels of inflation**



Source: Bloomberg, LGT Wealth Management

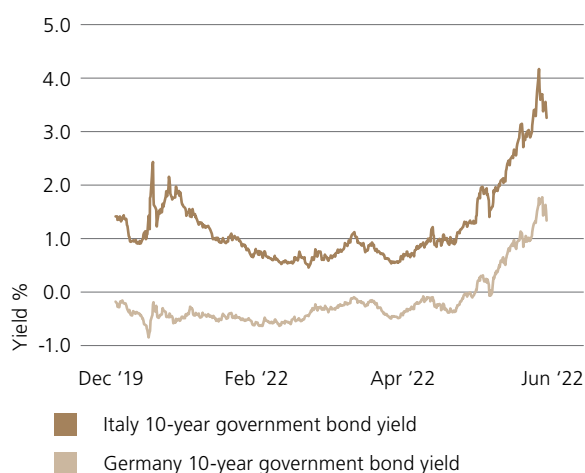
While the direction of travel is similar, the pace of central bank tightening has varied. The Bank of England (BoE) began raising rates in December last year with a 0.15% move.



Since then, they have raised rates four times by 0.25%. The Fed was slower to get going but has accelerated its incremental moves, raising its target rate by 0.75% at the June meeting. The European Central Bank (ECB) has only just suspended its bond-buying programme and is expected to make its first rate rise at the July meeting. The real outlier here is the Bank of Japan, which has held steadfast with loose monetary conditions. This has resulted in a sharp fall in the yen, which is down 15% this year. As we have noted, higher prices alone can slow the economy, so decisions are not straightforward. The ECB has a particular problem in that it must ensure smooth implementation of its policy stance across the Eurozone. While 10-year Bund yields have risen from 0.17% at the end of the year to 1.33% as at the end of June, Italian government bond yields have moved from 1.17% to 4.18% before the ECB signalled that they would take action to counter this spread widening, pushing yields back down to 3.26%. Credit

spreads have sold off sharply and, while default rates may rise, opportunities remain and the rise in bond yields means sovereign debt is likely to balance risk in portfolios once again.

**The spread between Italian and German 10-year government bond yields widened before selling off sharply more recently after the ECB signalled they will take action to counter the spread widening**



Source: Bloomberg, LGT Wealth Management

As we enter the third quarter, central banks will continue to balance the risk of recession with the need to fight inflation. The impact of the war in Ukraine may mean food and energy prices remain high due to supply-side factors beyond their control. Elsewhere, falling demand and normalising supply chains in China may ease inflationary pressures, potentially negating the need for further aggressive tightening. With higher interest rates and input costs, investing in companies with strong balance sheets and the ability to pass on price increases will be paramount.

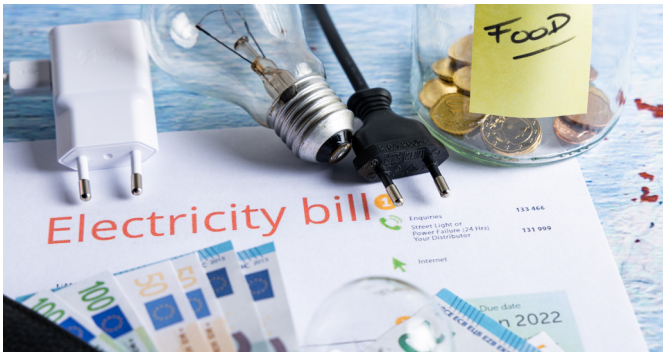
We have never advocated for cryptocurrencies and the recent sell-off has at least, in our mind, debunked the myth that they were a store of value. With inflation nearing double digits, cash is providing negative real returns. We continue to prefer to look for a stream of long-term cashflows in both bond and equity markets. Sharp downturns often lead to indiscriminate selling, which provides opportunities for active management. Financial markets typically overcorrect in response to news flow. Bonds have generally priced in more rate rises than occur during any cycle. While we remain alert to the risks in markets, we continue to see opportunities for those prepared to look through the noise.

“With higher interest rates and input costs, investing in companies with strong balance sheets and the ability to pass on price increases will be paramount.”

Jonathan Marriott, Chief Investment Officer

# Fixed income

Former Fed Chairman, William Chesney Martin, famously once said that the job of the Fed is “to take away the punch bowl just as the party gets going”. From the pace of increases we have seen this quarter from central banks, it does seem that the party has started and as such they have had to change the mood music. Looking at how consumer sentiment has evolved over the year, households are already feeling the pinch of higher food and energy costs. In the face of these challenges, central banks still continue to prioritise tackling inflation rather than promoting growth and, by extension, employment – something the market has had to come to terms with over the quarter.



After debating starting the hiking cycle with a 0.5% increase in March, the Fed instead decided to proceed cautiously with a 0.25% increase, as war had just broken out in Ukraine. When it came to their May meeting, the backdrop of rising inflation and falling unemployment confirmed to the Fed that it should

proceed with a series of 0.5% rate increases. However, the unexpected further increase of the Consumer Price Index (CPI) to a 40-year high of 8.6% strengthened the Fed’s resolve to raise rates at an even faster pace to quell price pressures. As such, they broke their previous guidance by hiking rates by 0.75%. This was the largest increase since 1994, taking rates to 1.5% - 1.75%. Furthermore, the Fed indicated that another hike of that magnitude is likely in July, before going back to smaller increases. This newfound urgency demonstrates how concerned they are that, left unchecked, higher prices could prompt workers to demand ever larger pay increases, potentially resulting in a phenomenon known as a “wage-price spiral”. By taking this approach, the Fed has clearly communicated that they now expect the economy to slow in the face of their policy stance and this is likely to lead to increased unemployment. The risk is now that they do too much, which could result in a recession, prompting US Treasury yields to fall from their cycle highs toward the end of the quarter. Staggeringly, 10-year US Treasuries suffered their worst first-half performance in over two centuries<sup>1</sup>, but that does highlight the opportunity they may provide at current levels.

“The Fed has clearly communicated that they now expect the economy to slow in the face of their policy stance and this is likely to lead to increased unemployment. The risk is now that they do too much, which could result in a recession.”

Jeremy Sterngold, Head of Fixed Income

1. Deutsche Bank, data to 1787

The Fed is not alone in fearing a wage-price spiral; other central banks have also shown a similar vigour. The BoE raised rates by a further 0.5% over the quarter, in increments of 0.25%. The urgency has increased of late given the slide in sterling, which has the propensity to magnify inflationary pressures in coming quarters, given that the UK imports much of its food and energy needs. As such, there are growing calls for a 0.5% hike in future meetings. The revisions to inflation expectations by the BoE have been stark: in March they expected it to peak over 8% in the fourth quarter, but at their latest meeting they stated that they now expect it to peak just over 11%. That revision alone is in excess of their 2% target and primarily a result of the increase in the energy price cap, illustrating just how little influence central banks have over global factors.

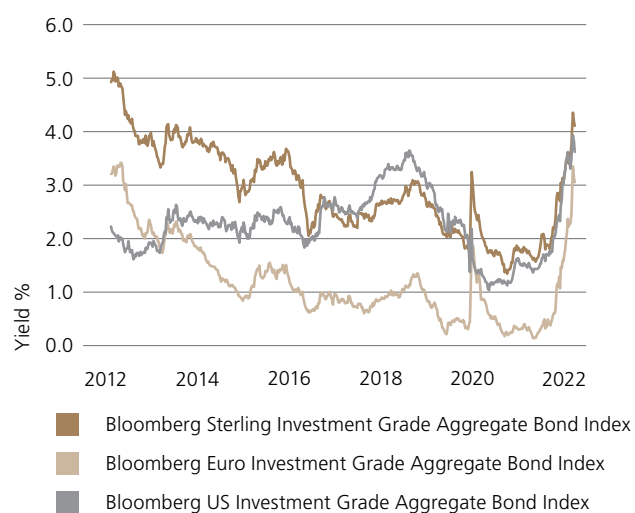
While the ECB has yet to raise rates, they have pre-announced a rate hike in July and moved to quickly halt asset purchases. So far, they have eluded to starting the hiking cycle with a 0.25% in July followed by a 0.5% increase in September, which would bring policy rates into positive territory. As unemployment has hit the lowest level since the inception of the single currency, while inflation is at its highest the ECB is having to move rates up quickly. However, the problem is that they set policy for the entire Eurozone and this quick reversal has eroded support for Peripheral Sovereign bonds, particularly Italy, which saw its 10-year yield push above 4%. This prompted a quick clarification from the ECB that it would be introducing an anti-fragmentation tool to ensure a smooth transmission of its policy across the currency bloc, thus easing the pressures.

Besides the larger central banks, the Swiss National Bank, Reserve Bank of Australia, and Bank of Korea all increased interest rates – to name a few. The exception to this hawkish shift is the Bank of Japan, which continues to purchase bonds and maintain negative interest rates. This has resulted in the yen being the weakest performer of the G-10 currencies.

Not only have most central bank asset purchase programmes come to an end, the Fed and BoE are reducing their balance sheets. These headwinds, combined with a more uncertain economic outlook, have resulted in investors demanding a greater degree of compensation to hold corporate bonds. The uncertain outlook has meant that companies looking to finance in the bond market now have to pay a higher level of interest to attract investor demand. However, with investment grade bond yields approaching multi-year highs, they have now become a good proposition for a wide array of investors.

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**With investment grade bond yields approaching multi-year highs, they have now become a good proposition for a wide array of investors**



Source: Bloomberg, LGT Wealth Management

# Equities

## International Equities

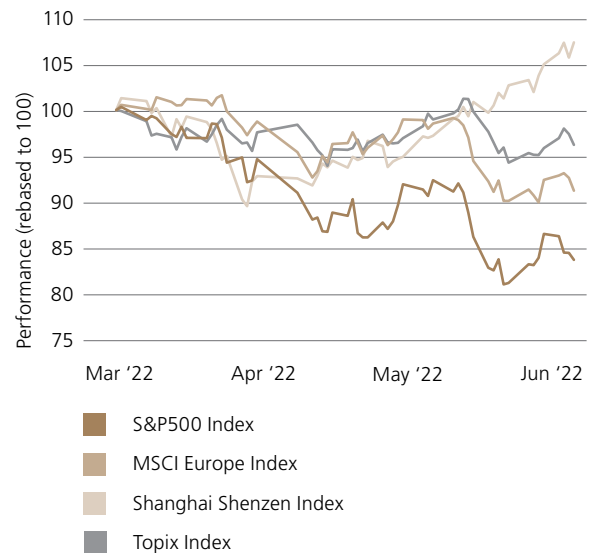
With central banks around the world raising interest rates to fight inflation, equity markets continued to slip during the second quarter. The S&P 500 declined 16% and the technology-heavy Nasdaq Composite Index fell 22%. The MSCI Europe Index held up better on a relative basis, declining just under 9% over the quarter. The sell-off has been very broad, with few places for investors to hide. Even traditionally steadfast sectors like utilities, energy, healthcare, and consumer staples declined more than 5%. The consumer discretionary sector was hardest hit during the quarter, falling more than 25% on elevated recessionary concerns and fears of shifting consumer habits. Ultimately, in the event of a recession, consumers can simply delay the purchase of many luxury items and durable goods, particularly when food and heating bills matter more.



With strict lockdowns in China throughout much of the quarter, its economy has been teetering on the brink of a recession. However, when restrictions were relaxed towards the end of the quarter and Chinese authorities signalled economic support, the Shanghai Shenzhen Index rose over 7%. The value-oriented Topix Index of Japan was on course for a positive return by the beginning of June. However, it saw its fortunes reverse towards the end of the quarter, with the Bank of Japan resolutely clinging to its highly accommodative policy stance. This caused the index to finish the

quarter down nearly 4%. With the yen having depreciated by 10% relative to the dollar during the quarter, in dollar terms the index declined by almost 14%.

## Performance of various global indices over the quarter



Source: Bloomberg, LGT Wealth Management

On an individual stock basis, it is painful to see plenty of stocks go from the height of fashion to out of fashion over just the last six months, as the market frets about growth and the possibility of recession. Amazon's share price has fallen more than 25% in nine quarters since it listed in 1997. Indeed, it has fallen in a third of all the quarters since listing. However, providing growth over the medium to long term continues to come through, this is ultimately what will decide the direction of Amazon and other companies' share prices over time. As the next earnings season gets underway, investors will be scrutinising managements' comments around inflationary pressures, changing consumer habits and continued supply chain constraints to ensure that growth can indeed be sustained.



In the face of numerous headwinds and macroeconomic uncertainties, we continue to take comfort in well-managed businesses, with pricing power and sensibly managed balance sheets. We continue to believe it is the quality companies that will fare best, as they use their pricing power to offset inflationary pressures and their sound balance sheets to fend off rising interest rates. As valuations have become more attractive, we continue to search for long-term opportunities in exactly these types of businesses that the current market volatility may provide. We believe that, by thinking about where companies might be in ten or fifteen years' time, we stand a good chance of ensuring your money is invested in the right kind of companies, that can compound away over the long term.

“As the next earnings season gets underway, investors will be scrutinising managements' comments around inflationary pressures, changing consumer habits and continued supply chain constraints.”

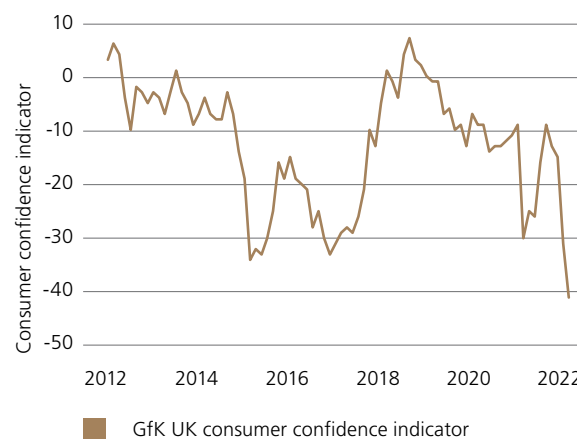
Russell Harrop, Head of International Equities

### UK Equities

Under the combined weight of recession-related fears and UK political uncertainty, the pound to US dollar exchange rate weakened from 1.35 at the end of 2021, to 1.26 at the end of May, and 1.19 in early July. With over 70% of FTSE 100 Index earnings generated in overseas markets, investors have traditionally regarded weakness in the pound as a reason to switch away UK-focused mid-capitalisation stocks in favour of larger ones with an international presence. In June, however, a 9% fall in the FTSE 250 Index was accompanied by a fresh wave of concerns about the health of the global economy and a 6% drop in the FTSE 100 Index. This was the largest monthly decline in the FTSE 100 Index since March 2020, when the onset of coronavirus triggered a major bout of risk aversion.

Data has shown that confidence in the economy has deteriorated. Prices have spiked across broad swathes of the global economy and disposable incomes are being squeezed, forcing consumers to reappraise their spending. Interest rates are rising, business confidence appears to be ebbing away at a rapid rate, and investors are unnerved by the thought that weak data will inevitably be followed by profit warnings and further weakness in share prices.

#### The data shows that confidence in the economy has deteriorated



Source: Bloomberg, LGT Wealth Management

Note: The GfK UK Consumer Confidence survey is conducted using a random sample of around 2,000 UK individuals above the age of 16

While the challenges to the economy and wider business community are numerous, the valuations of some of the businesses are attracting international bidding interest. This underscores how poor market sentiment can sometimes create opportunities. According to our calculations, more than 1 in 10 of the UK's top 350 stocks have been bid for since the start of the year. The bidders have come from a variety of geographies, but it is safe to assume that they are all focused on the longer-term earnings potential of the companies that they have targeted, and the opportunity presented by the combination of the fall in the pound and the sharp sell-off in share

prices. Some companies that have been floated as targets include DS Smith plc, Coats Group plc, Whitbread plc (the parent company of Premier Inn), and Entain plc. All four companies are leaders in their industries (in sustainable packaging, threads, branded budget hotels and online gambling respectively), and we believe are relatively resilient to current pressures.

“While the challenges to the economy and wider business community are numerous, the valuations of some of the businesses are attracting international bidding interest.”

James Follows, Head of UK Equities

We appreciate that the news flow surrounding the UK economy of late has deteriorated. However, the UK equity market consists of a wide array of businesses, most of which have a global reach. The valuation opportunities available within the UK stock market have attracted international interest and this could provide support for selective stocks despite the economic backdrop.



# Key market data

## Key market data (as at 30 June 2022)

Asset class	Level	1m %	3m %	6m %	1y %	3y %	5y %	YTD %
<b>Equity indices (total return) *</b>								
FTSE All-Share (GBP)	3941	-6.0	-5.0	-4.6	1.6	7.4	17.8	-4.6
S&P 500 (USD)	3785	-8.3	-16.1	-20.0	-10.6	35.3	70.9	-20.0
Euro Stoxx 50 (EUR)	3455	-8.8	-9.9	-17.9	-12.8	6.1	13.0	-17.9
Nikkei 225 (JPY)	26393	-3.1	-4.9	-7.3	-6.5	31.3	45.2	-7.3
MSCI World (USD)	2546	-8.7	-16.2	-20.5	-14.3	22.5	44.7	-20.5
MSCI AC Asia Pacific ex Japan (USD)	524	-5.7	-10.6	-15.7	-23.3	6.5	17.6	-15.7
MSCI Emerging Markets (USD)	1001	-6.6	-11.5	-17.6	-25.3	1.7	11.4	-17.6
<b>10 year bond yields **</b>								
UK	2.23	0.1	0.6	1.3	1.5	1.4	1.0	1.3
US	3.01	0.2	0.7	1.5	1.5	1.0	0.7	1.5
Germany	1.34	0.2	0.8	1.5	1.5	1.7	0.9	1.5
Japan	0.23	0.0	0.0	0.2	0.2	0.4	0.1	0.2
<b>Commodities (USD)</b>								
Gold	1807	-1.6	-6.7	-1.2	2.1	28.2	45.6	-1.2
Oil	115	-6.5	6.4	47.6	52.8	72.5	139.6	47.6
<b>Currency</b>								
GBP-USD	1.22	-3.4	-7.3	-10.0	-12.0	-4.1	-6.5	-10.0
GBP-EUR	1.16	-1.0	-2.2	-2.3	-0.4	4.0	1.9	-2.3
EUR-USD	1.05	-2.3	-5.3	-7.8	-11.6	-7.8	-8.2	-7.8
USD-JPY	135.72	5.5	11.5	17.9	22.1	25.8	20.8	17.9

Source: Bloomberg, ICE, London Stock Exchange, MSCI, Standard & Poor's, Stoxx Tokyo Stock Exchange

\* Performance is given on total return indices, but the levels are for the main indices.

\*\* Displayed as absolute changes in yields, rather than percentages.

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Jonathan Marriott, Chief Investment Officer

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