HYMANS ROBERTSON

Capital Markets Update

Autumn 2022

High inflation, tighter monetary policy, and further increases in interest rate expectations weighed heavily on bond markets in the third quarter (Q3).

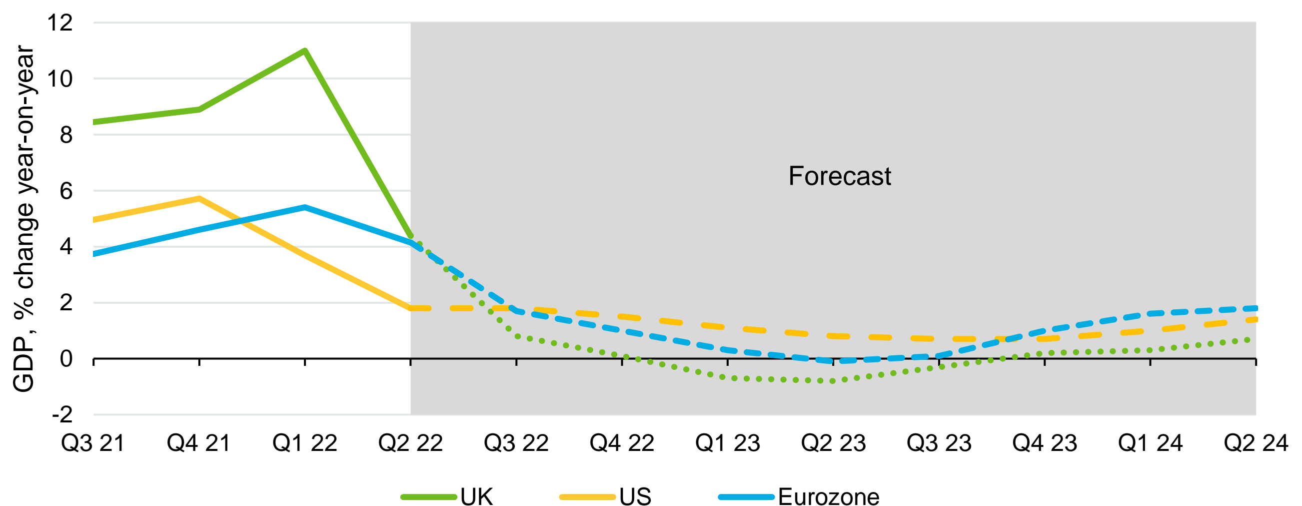
Simultaneous growth concerns offered little shelter elsewhere, as equity, property, credit, and commodity prices all fell.

Global themes

As high inflation and rising interest rates weigh heavily on consumers and businesses, consensus forecasts suggest growth in the major advanced economies will slow considerably in 2023 (Chart 1). The global manufacturing purchasing managers' index (PMI) suggests industrial activity is already slipping into recession, after weakening further in September as output contracted and new orders slowed. Energy independence and a resilient jobs market lend relative support to the US economy, but US growth is also forecast to slow, elevating the risk of a global recession.

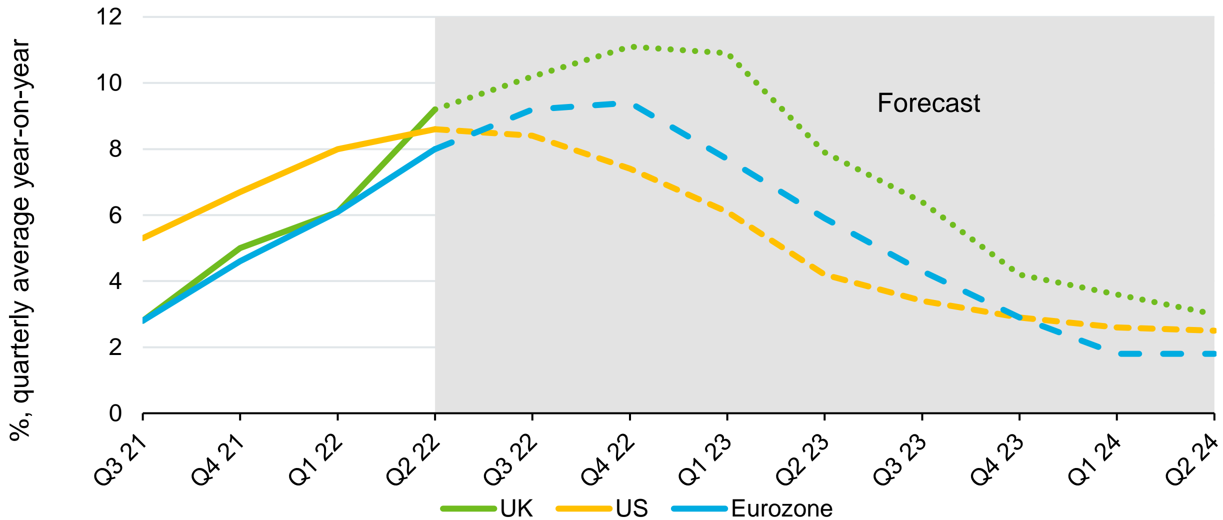
The slowdown in advanced economies is likely to weigh on emerging economies too, although they have proven more resilient in the face of current global shocks. Chinese growth is likely to remain subdued amid its zero-COVID policy and real estate market weakness, but lower inflation is allowing policymakers to adopt an easing bias, in contrast to their advanced economy counterparts.

Chart 1: Consensus forecasts suggest a recession in the UK and eurozone and a near miss for the US



Year-on-year headline Consumer Price Index (CPI) inflation remains very high in the major advanced economies, but is expected to moderate in 2023 and fall back towards its target in 2024 (Chart 2), as commodity prices fall and supply chain pressures ease. While the energy price interventions by UK and European governments will limit the near-term peak in headline inflation, they may also support aggregate demand, by preserving consumers' disposable incomes. This potentially increases the risk of ingraining core inflation (currently running at 6.5%, 6.6%, and 4.8% in the UK, US, and eurozone, respectively), which is a much bigger concern to central bankers than the height of a headline spike.

Chart 2: Headline CPI inflation is still expected to return towards its target in 2024

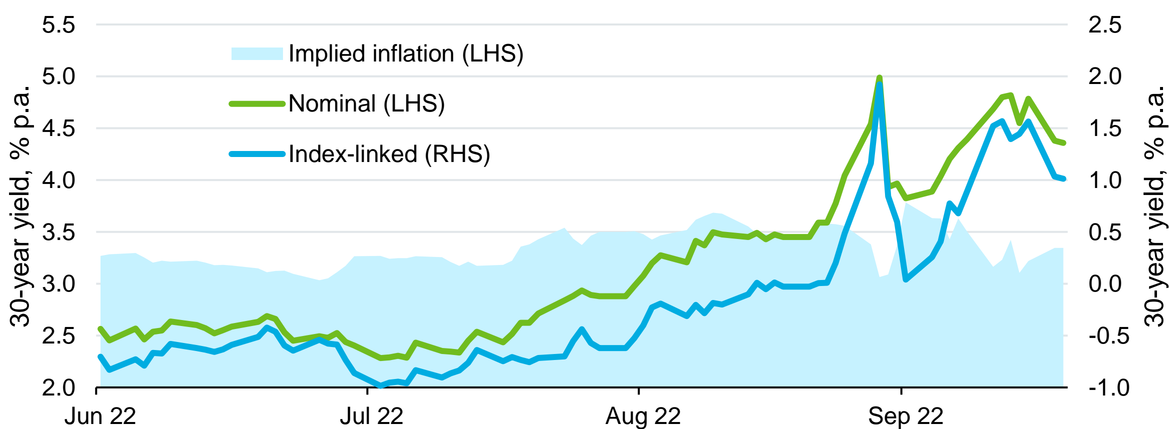


Amid this growing concern about sustained high inflation, central banks appear unlikely to stop raising interest rates until slowing demand brings about sustained declines in inflation. As a consequence, markets are now pricing in a greater degree of monetary tightening, with rates now expected to reach 4.5% p.a., 3.5% p.a. and 5.3% p.a. by next year in the US, Europe, and UK, respectively.

Government bonds

UK government bonds significantly underperformed global comparators in Q3 as the government proposed a significant loosening of fiscal policy in September. Selling threatened to get out of control as cash calls on pension funds' leveraged interest rate and inflation hedging programmes saw them sell collateral, often gilts, or reduce hedging, equivalent to selling gilt exposure into the market. Yields fell back once the Bank of England (BoE) intervened with temporary purchases of long-dated bonds amid material risks to financial stability. The market recovered further when the replacement Chancellor unwound most of the proposed fiscal loosening. Even so, real and nominal yields remain well above the levels seen immediately prior to the 'mini' budget (Chart 3) and look reasonably attractive relative to our assessment of longer-term fair value.

Chart 3: Nominal and real yields have risen sharply, and inflation expectations remain reasonable



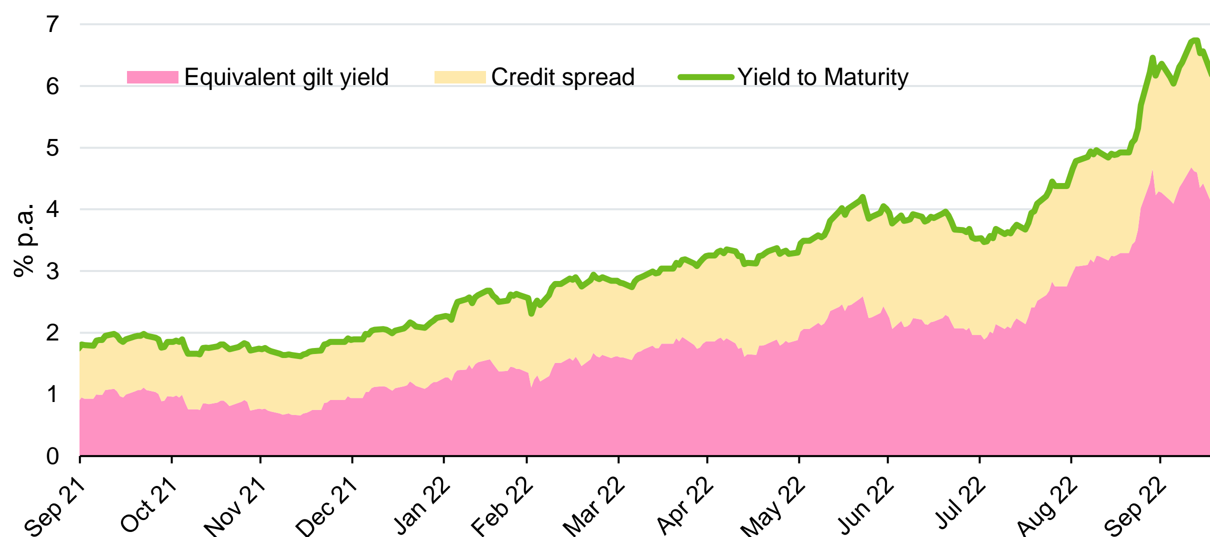
Implied inflation cannot be compared directly to the official inflation CPI target of 2% p.a. Index-linked gilts will receive higher inflation protection – typically 1% p.a. over the longer term – until RPI is aligned with CPIH in February 2030. CPI is also expected to overshoot the target by a cumulative 13% over the next two years. Even adjusting for these factors, long-dated implied inflation looks a little expensive. The front end of the curve, where distortions have more effect, looks to offer better value.

Despite recent fiscal developments, near-term technical headwinds remain. The UK's energy support package, even in its reduced form, will require an increase in gilt issuance, and the BoE now intends to begin the delayed selling programme of its £838bn gilt portfolio in November. Meanwhile, the de-leveraging of UK defined benefit (DB) pension schemes' interest-rate and inflation-hedging programmes is likely to continue as schemes, and their liability-driven investment managers, adopt more prudent target leverage levels.

Credit

Investment-grade credit spreads have increased, rising well above long-term median levels. On top of higher risk-free rates, this makes credit yields far more enticing (Chart 4). Speculative-grade credit spreads are also above long-term medians but are less attractive relative to their own history than investment-grade markets. Corporate balance sheets are in reasonable shape relative to history, but will likely come under pressure as the economic outlook deteriorates. This is likely to be more troubling for the speculative-grade market, where borrowers are typically more highly levered and more sensitive to an economic slowdown. As a result, we would prefer investment- to speculative-grade credit at the current time, focusing particularly on short-duration, high-quality assets.

Chart 4: Sterling A-rated corporate credit spreads and yields are at attractive levels



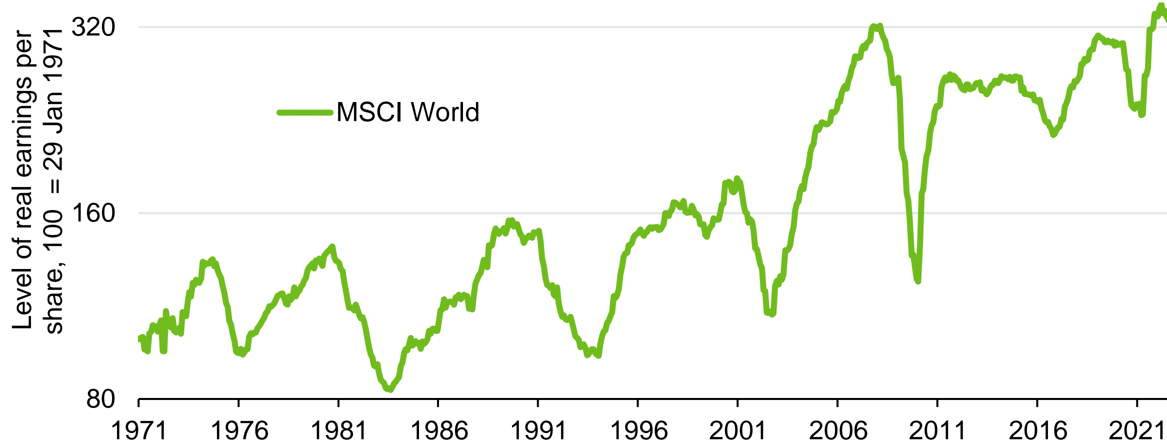
As a mainstay of the collateral waterfalls employed by UK DB pension schemes, asset-backed securities (ABS) have come under intense selling pressure, pushing ABS spreads even further above longer-term median levels. While higher-quality ABS remain well insulated from potential defaults, the deteriorating outlook for consumers may also continue to weigh on sentiment.

In both investment- and speculative-grade markets, investors may want to consider shifting from floating- to fixed-rate markets, given the extent of rate-driven outperformance in the floating-rate ABS and loan markets in the year to date. Additionally, relative to high-yield bonds, leverage is higher and interest coverage lower in the loan markets and, due to their floating-rate nature, rising interest rates hit servicing costs more quickly.

Equities

Global equities rallied in July but fell sharply in the second half of Q3 as inflation and higher interest-rate expectations weighed on both valuations and the fundamental outlook. The FTSE All World total return index ended the quarter 4.8% below end-June levels, taking year-to-date declines to 21.2%, though sterling weakness led to a 1.4% gain in Q3 and has limited year-to-date declines to 9.2% for unhedged sterling investors. Full-year earnings forecasts for 2022 and 2023 still point to reasonable real earnings growth, but average earnings momentum (upwards versus downwards earnings revisions) is poor and the level of real earnings has started to roll over – declines can often be extended in time and extent (Chart 5).

Chart 5: History suggests declines in the level of real earnings are rarely short-lived episodes

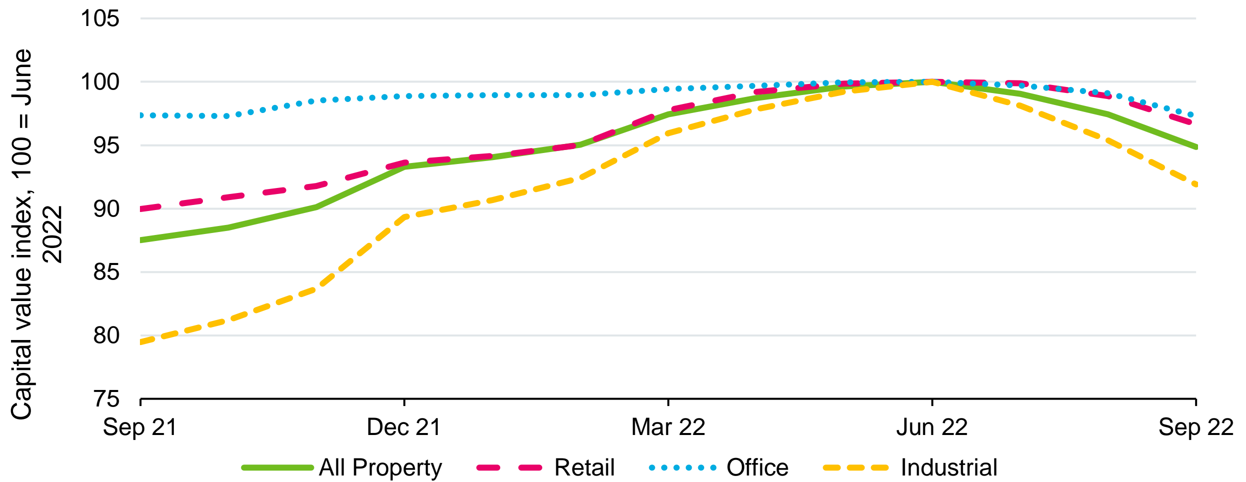


Cyclically adjusted price-to-earnings ratios are now modestly below long-term median levels, having fallen sharply from their peak at the beginning of the year. However, we might expect to see more compelling cheapness if the news flow remains negative. Additionally, although absolute valuations have improved, relative valuations look much less exciting as real yields move closer to long-term fair value. As a result, investors might want to wait before adding to existing equity exposures.

Property

The UK commercial property market retains a degree of fundamental support – rising nominal rents, though lagging inflation, and a still-healthy occupational market, even if the most recent Royal Institution of Chartered Surveyors survey shows hints of a downturn. However, technical conditions in investment markets are deteriorating. Transaction volumes have declined in the primary market and redemptions from property funds have increased dramatically, with several UK commercial property funds now limiting withdrawals. Existing selling pressure from institutions rebalancing portfolios, given the scale of property's outperformance year to date, has latterly been exacerbated by pension funds' attempts to sell assets to meet collateral demands.

Chart 6: UK commercial property values are declining, with more dramatic falls in the industrial sector



Against this backdrop, capital values have been falling since June (Chart 6). Of the major sectors, industrials have been hardest hit. The industrial sector had benefited most from capital appreciation over the last 12 months and yields reached record lows. Despite recent rental growth and capital value declines, initial and reversionary yields are low versus long-term history, both for industrials and the market as a whole. This is increasingly true relative to other asset classes, given the rise in yields in equity and bond markets. Property markets look vulnerable to further pressure, given expensive valuations and a rapidly weakening economic outlook.

Conclusion

Major central banks have increasingly shifted to the view that the recent rise in inflation is persistent and are setting policy to achieve a sustained return to target. While market forecasts suggest this will be achieved over the next year or so, they also suggest this will require higher interest rates than previously expected. The rebalancing of global economic supply and demand is likely to require a period of sub-trend economic growth.

Despite improving valuations across risk assets, we would still hold more cash than strategic requirements dictate due to the deteriorating fundamental outlook. In fact, we would look to trim property exposures, where possible, as the asset class still looks expensive against a particularly weak UK economic backdrop. Despite near-term difficulties, bonds look reasonably attractive given rises in sovereign bond yields and credit spreads. However, we would prefer to hold investment-grade credit and sovereign bonds over speculative-grade credit, which is more susceptible to a weaker economic backdrop. In equity markets, further pressure on earnings is likely to offer better buying opportunities.

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