



Investment review – EUR

Third quarter 2022

Global equities fell by 0.6% in EUR terms, somewhat helped by a decline in the euro against the dollar. In US dollar terms, equities fell by 6.8% to a fresh year-to-date low. Meanwhile, German 10-year bunds declined by 5.4% (unhedged, EUR terms).

Central banks became more determined in their attempts to restrain inflation and normalise monetary policy as underlying inflation rates remained sticky. As a result, market-implied policy rate expectations – along with global government bond yields – moved significantly higher, particularly in the UK, where the new government's tax-cutting 'Growth Plan' amplified the process towards quarter-end, contributing to an almost 2-percentage point (ppt) surge in 10-year nominal gilt yields over the quarter.

The challenging geopolitical landscape persisted. Ukraine's counter-offensive in the Kharkiv region prompted Russia to announce a 'partial mobilisation' of some 300,000 additional troops. On the other side of the globe, and potentially even more significantly, tensions over Taiwan mounted. After US Speaker of the House, Nancy Pelosi's visit, China ramped up its military exercises near the island, as the Biden administration stated it would defend Taiwan in the event of an attack.

Global economic data pointed towards an ongoing slowdown. Many commentators continued to talk of a significant recession ahead, but there were few signs of that yet in the numbers. The US entered a technical recession with Europe expected to follow suit over the coming quarters. Central banks continued to increase interest rates given ongoing inflationary pressures. Although headline measures have decelerated in line with easing oil and food prices, price rises within the "core" inflation basket have necessitated tighter monetary policy.

Technically, the US had already entered a recession during the second quarter of this year, albeit a very modest one, after contracting by 0.1%, a second consecutive decline. On the other hand, euro area real GDP expanded by a stronger-than-expected 0.8%, notwithstanding the disruption associated with Russia's ongoing invasion of Ukraine. The timelier PMI data were mixed between July and September, offering few signs of a major downturn starting in the third quarter. Indeed, the closely watched US ISM Manufacturing PMI remained in expansion territory in August, with the forward-looking New Orders sub-index rebounding.

Headline inflation rates remained elevated in the US (8.3% year-over-year), eurozone (10%) and UK (9.9%). Promisingly, the likely peak in the UK's headline inflation rate fell markedly as the new government announced a two-year freeze in the energy price cap from October onwards: the Bank of England now expects it to peak at almost 11% in October. Several European countries also introduced fiscal measures to limit the impact of rising energy prices on households and businesses. Despite Russia reducing – and even turning off – gas flows on major pipelines, wholesale natural gas benchmarks ended the quarter lower in the UK and only slightly higher in the euro area.

Core inflation rates were also stubborn – above 6% in the US and UK, and at a record high in the eurozone (4.8%). However, there were still few signs of a wage-price spiral developing: real wage growth remained firmly negative across all regions. But labour markets remained very tight with unemployment rates touching multi-decade lows in several of the major economies.

Amid these testing inflation and labour market dynamics, the Fed raised its target interest rate by 0.75ppts at both of this quarter's meetings, taking the rate to 3%-3.25%. There were no signals of an early change in approach, with the FOMC's latest projections indicating rates would likely remain above 4% through all next year, and for most of 2024. There were significant rate hikes over the quarter from the Federal Reserve, the Bank of England, and the European Central Bank. The messaging from the Federal Reserve following August's Jackson Hole summit put the expected "pivot" narrative to bed and led markets to price in a steeper path for future interest rates. The US 2-year yield moved from 2.93% to 4.23%, whilst the 10-year went from 2.97% to 3.83%.

In Europe, the European Central Bank (ECB) began its tightening cycle: the deposit rate increased by 1.25% over the quarter, from -0.50% to 0.75%. In addition, a Transmission Protection Instrument – designed to alleviate any excessive widening in peripheral countries' government bond spreads – was officially unveiled. The Bank of England (BoE) also tightened its policy rate to 2.25%, but by a smaller magnitude than both the Fed and even the ECB despite its arguably more troubling inflation backdrop. What's more, the BoE announced temporary purchases of long-dated UK government bonds, after a sharp sell-off at the end of September. Separately, the Swiss National Bank (SNB) also continued to raise its base rate, now at 0.50%.

Elsewhere, the Bank of Japan (BoJ) remained the major outlier in developed markets, leaving its policy rate unchanged and still in negative territory. This contributed to a further weakening of the

Japanese Yen, prompting an intervention in the foreign exchange market for the first time since 1998.

Localised lockdowns continued to dampen China's growth outlook, with few signs of a shift in Xi's zero-COVID policy. Nonetheless, lockdowns of a similar economic magnitude to Shanghai's were avoided: manufacturing and services activity expanded, albeit very modestly, by the end of the quarter, according to the National Bureau of Statistics PMI data. Problems in the housing market also persisted, though Beijing announced a bailout fund and the People's Bank of China (PBoC) continued to trim some of its lending rates.

Finally, Europe's political landscape experienced some changes. In the UK, Liz Truss won the Tory Party leadership race to succeed Boris Johnson as the new prime minister. Fiscal measures were quickly announced: contentious tax cuts were introduced alongside the energy price cap freeze. The reaction to the new government's fiscal package, which included a swathe of unfunded tax cuts, pushed sterling to record lows versus the dollar. It also forced the Bank of England to purchase longer dated UK Gilts, which had registered historic one-day moves, to protect pension funds.

In Italy, a far-right coalition led by Giorgia Meloni, Italy's first female prime minister, claimed victory at the general election. Elsewhere, Biden's approval ratings have somewhat increased ahead of November's midterm elections, though are still low by historical standards. Xi Jinping is also set to secure his third term at China's National People's Congress in October.

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MARKET REVIEW

As we have highlighted, both global equities and bonds fell in the third quarter of this year.

Developed market stocks fell by 4.4% last quarter, whilst emerging markets were down by 8.2% (in local currency terms). The former's more modest decline was broad-based across the major economies: North America fell by 4.7%, the euro area by 4.8%, and the UK by 2.9%. Performance within emerging markets was more mixed: EM Asia equities were down by 10.6%, while Latam was up by 6.1%.

Sector-level performance was also varied, though most were down on the quarter. Consumer Discretionary outperformed (+2.1%) despite market-implied policy rate expectations sharply rising, while Energy was the only other sector to experience a modest gain (+1.4%). Communication Services (-11.9%) and Real Estate (-10.6%) were the worst performers.

In fixed income, global government bonds fell by 7.6% over the quarter (unhedged, USD terms). The US benchmark 10-year bond yield briefly breached 4%, before moderating to 3.8%. Real yields also surged: the US 10-year TIPS yield ended the quarter at 1.7%, a 1% quarterly increase. It was a similar story elsewhere: UK 10-year gilt yields breached 4.5% – before moderating in the quarter to 4.1% – and real yields turned positive for the first time since 2011. Moreover, following the tax cut announcements, UK 30-year gilt yields broke above 5%, though intervention from the Bank of England helped ease the long-dated yield to 3.8%. In the eurozone, the 10-year Italian BTP to German Bund spread crept higher, ending the quarter at 2.4%.

Broader commodity prices edged lower over the quarter. Both Brent Crude (-23% to \$88 p/b) and WTI (-25% to \$79p/b) returned to levels last seen before Russia began its invasion of Ukraine. Natural gas futures continued to be more volatile: Index TTF futures – a proxy for eurozone prices – were up 26% over the past three months, at one point they more than doubled. Most precious and industrial metal prices declined, including gold (-8.1%), copper (-8.5%) and iron ore (-2.1%). On the other hand, agricultural product prices rose modestly: wheat, for instance, increased by 2.3%.

In currencies, US dollar strength continued, up 5.6% on the quarter (on a trade-weighted basis), along with the Swiss Franc (+3.5%). Sterling underperformed, falling by 3.3% over the quarter.

All investment returns quoted are in local currency terms and sourced from Avaloq.

Index returns are sourced from Bloomberg.

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