The Central Bank Conundrum – Self-Inflicted?

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Major Developed Markets were down over the month, with the S&P 500 (TR) (USD) once more faring the worst -8.3%, the MSCI Europe (TR) (EUR) next at -7.7% and MSCI Japan (TR) (JPY) -2.7%[1]. Whilst the MSCI EM (USD) was -6.6%, a notable exception was the MSCI China (HKD), up 6.7%[1]. Despite being the strongest performer in previous months, at -14.2%, the MSCI Energy (USD) represented one of the worst performing sectors this month[1]. Though the US 10-Year Treasury yield moved above 3% during June, peaking at 3.5%[2], it was back to 3.01%[1] by month end, on the back of deteriorating consumer data and growth indicators.

We expect inflation to moderate slowly in the coming 12 months. Even if demand slows in response to high prices as we expect, some components of the CPI such as housing, may prove much stickier because of the lag between the index and rental prices. We expect food CPI to peak during Q3 2022.

We remain concerned that a recession is becoming increasingly likely, given high inflation could force a quick pace of hikes in the US and Europe, meaning potentially excessive tightening, especially by the Federal Reserve, just as growth weakens. The end of June saw a number of data releases indicating US consumption is already in sharp decline. Consumer durables dropped in May -3.2% month-on-month[3], real disposable income growth was down 0.1% month-on-month[4], and real spending growth at -0.4% month-on-month, was the first

Notes:
[1] Bloomberg, as of 30 June 2022.
[2] Bloomberg, as of 14 June 2022.
[3] Morgan Stanley Research. Bureau of Economic Analysis. Personal Consumption Expenditure by Major Type of Product and by Major Function. Last revised on 30 June 2022.
[4] Morgan Stanley Research. Bureau of Economic Analysis. Personal Income and Outlays, May 2022. New Release 30 June 2022. www.bea.gov/news/2022/personal-income-and-outlays-may-2022 May 2022, Personal Consumption Expenditure (PCE) percentage change over the month.

decline in real personal consumption expenditure since November 2021[4]. So far, US forward sales and earnings estimates appear to have held up well, but this could turn. Ultimately central banks could end up shifting to a more benign stance in the latter part of 2022.

Investment Implications

We have kept our broad asset allocation stable, with low equities, having deployed our high cash position last month into fixed income. We made a number of tactical changes over the month, which we have outlined below:

China A Equities

We moved positive China A equities and are constructive, as the country comes out of lockdowns. The pace of recovery in consumption and private investment still appears muted. However, the economy is supported through increased public infrastructure spending, and easing measures for the residential property market. We expect fiscal stimulus to continue, combined with further cuts to rates and the bank's reserve requirement ratio (RRR), but at a controlled pace compared with past cycles, to avert fuelling asset bubbles. Valuations appear fair, with forward P/E ratios around 10Y median levels[5]. We believe Chinese equities should outperform relative to other regions. Indeed, sentiment is picking up, as YTD northbound flows have turned positive[6].

Global Energy Equities

We increased our positive tilt to global energy. As mentioned, supply disruptions due to the Russia-Ukraine war should keep energy elevated and structural trends, such as energy companies' underinvestment in production and refining capacity, should further support. Based on past recessions, if we move towards a recessionary environment, we expect any hit to demand to be counterbalanced by supply disruptions in Russia and residual pent-up demand as the global economy concludes its reopening phase over the summer. Oil prices have generally been rising despite China lockdowns. However, with China now reopening, we believe that this and residual pent-up demand should offset any hit from slowing growth.

Government Bonds

Italian Government Bonds

We moved underweight Italian government bonds (BTPs) and bought German Bunds and French government bonds (OATs), remaining neutral on the latter two. We view risks to BTP spreads skewed to the downside. The announcement that the European Central Bank (ECB) is designing an anti-fragmentation tool caused a significant tightening in spreads and should allow the ECB to hike rates quicker if needed, with less worry of causing another pickup in peripheral spread volatility. However, as the structure of the anti-fragmentation tool is worked out, we are likely to see some volatility in news flow just as the ECB is set to hike rates. This is still likely to put upward pressure on spreads, and we believe the ECB would allow for a gradual spread widening as a reflection of a tighter monetary stance, if this does not threaten the monetary policy transmission mechanism.

Notes:

[5] Datastream, MSIM. MSCI CA – 12month forward P/E ratio, as of 30 June 2022.
[6] Hong Kong Exchanges and Clearing Limited, MSIM. Total Northbound net buying is CNY 71.8 billion YTD as of 30 June 2022, based on flows from Shanghai Stock Connect Net Buy and Shenzhen Stock Connect Net Buy.

Japanese Government Bonds

We also moved negative Japanese government bonds (JGBs), adding instead to US Treasuries, as we expect JGBs to underperform relative to cash in the short term and the broader bond universe in the medium term. The Bank of Japan may be forced to relax its Yield Curve Control (YCC) and ultra-loose monetary policy, if inflation expectations and wage growth picks up.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results. See Disclosure section for index definitions.**

Tactical Positioning

We have provided our tactical views below:

Asset Class	--	-	=	+	++
Equity					
US			■		
US Energy				■	
US High Dividend				■	
US Value				■	
Eurozone		■			
UK				■	
European Energy				■	
Japan			■		
Asia ex Japan			■		
Chinese Equities			□	■	
Emerging Markets			■		
Brazil			■		
Global Growth		■			
Global Infrastructure			■		
Global Property			■		

Asset Class	--	-	=	+	++
Fixed Income					
US IG Credit			■		
EU IG Credit		■			
High Yield			■		
EM Sovereign Debt HC			■		
EM Sovereign Debt LC			■		
US Treasuries			■		
German Bunds			■		
EU Peripheral Bonds		■	□		
JGBs		■	□		
Commodities					
Energy				■	
Agricultural				■	
Gold				■	
Currencies					
Euro		■			
JPY		■			

Source: MSIM GBaR team, as of 30 June 2022. For informational purposes and does not constitute an offer or a recommendation to buy or sell any particular security or to adopt any specific investment strategy. The tactical views expressed above are a broad reflection of our team's views and implementations, expressed for client communication purposes. The information herein does not contend to address the financial objectives, situation or specific needs of any individual investor. The signals represent the GBaR team's view on each asset class. A negative signal indicates a negative or underweight relative view, a positive signal indicates a positive or overweight relative view. Light blue indicates the tactical view before the change, with dark blue indicating the view as of 30 June 2022.

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China A Shares: These are shares of companies based in mainland China denominated in Renminbi and traded in the Shanghai and Shenzhen stock exchanges. They are available to purchase by qualified foreign institutions, where historically they were only available to investors in mainland China.

Consumer Price Index: The Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food and medical care. The CPI is calculated by taking price changes for each item in the predetermined basket of goods and averaging them; the goods are weighted according to their importance. Changes in CPI are used to assess price changes associated with the cost of living.

Forward P/E: Price-Earnings (P/E) is the price of a stock divided by its earnings per share for the past 12 months. Sometimes called the multiple, P/E gives investors an idea of how much they are paying for a company's earning power. The higher the P/E, the more investors are paying, and therefore the more earnings growth they are expecting. Forward to price earnings (P/E) is a measure of the price-to-earnings ratio (P/E) using forecasted earnings for the P/E calculation.

MSCI China (HKD) measures large and mid-cap representation across China securities listed on the Shanghai and Shenzhen exchanges. The index covers only those securities that are accessible through "Stock Connect".

MSCI ACWI Energy Index includes large and mid cap securities across 23 Developed Markets (DM) and 27 Emerging Markets (EM) countries*. All securities in the index are classified in the Energy as per the Global Industry Classification Standard (GICS®).

MSCI Emerging Markets Index: The MSCI Emerging Markets Index (MSCI EM) is a free float-adjusted market capitalization weighted index that is designed to measure equity market performance of emerging markets.

MSCI Europe Index: The MSCI Europe Index captures large and mid-cap representation across 15 Developed Markets (DM) countries in Europe.

MSCI Japan Index: The MSCI Japan Index is designed to measure the performance of the large and mid-cap segments of the Japanese market.

S&P 500 Index: The Standard & Poor's (S&P) 500 Index tracks the performance of 500 widely held, large-capitalization US stocks.

VIX©: This is a trademarked ticker symbol for the Chicago Board Options Exchange Market Volatility Index, a popular measure of the implied volatility of S&P 500 Index options. Often referred to as the fear ndex or the fear gauge, it represents one measure of the market's expectation of stock market volatility over the next 30-day period.

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