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Portfolio Review — June 2022

"I think we now understand better how little we understand about inflation"

– Federal Reserve Chair Jerome Powell, 29 June 2022

It seems hard to believe that as little as twelve months ago we were repeatedly being told by central bankers that the building inflationary pressures were transitory and that inflation was expected to return to normal levels (around 2%) by the end of the year. It also seems hard to remember the new all-time highs stock markets soared to from one month to the next during 2021 and the relative optimism investors felt as we entered the start of this year. The positive outlook was supported by pent-up consumer demand as the pandemic headwinds started to fade, a robust labour market and solid corporate and household finances.

Fast forward six months and the picture could not feel more different. 2022 has so far been defined by a prolonged selloff. Indeed, it has been a painful first half for investors with many stock market indices having their worst starts in 50 years as inflation reached levels not seen since the 1970s. Steep selling was initially led by the expensive growth stocks but has since rotated into the value, defensive and commodity sectors. Most major equity indices posted declines for five out of six months in the first half of the year.

What has felt equally painful for investors, and a key reason why balanced portfolios have suffered so much this year, is that bonds have not provided their typical diversification benefit (bond prices tend to rise when stocks decline, and vice versa). Instead, bonds sold off along with equities as central banks signalled aggressive tightening policies which triggered a major reset in bond yields. At the start of the year markets were pricing in around three 25 basis points interest rate hikes in the US, but this has recently risen to 12, sending bond yields soaring and global bond indices falling. And it's a similar picture elsewhere in the world.

By now, we are all well versed in the myriad of factors behind the widespread rout in markets – soaring inflation, increasingly hawkish central banks, the war in Ukraine, lockdowns in China, food and energy shortages and, more recently, growing recessionary fears. These persistent headwinds have provided a dizzying amount of uncertainty and volatility to markets and, in the short term at least, these factors look set to continue. So, while the risks remain, what can investors expect from the second half of 2022 and beyond?

Firstly, there's no escaping that economic growth will need to moderate in order for inflation to come down. However, whilst economies are starting to show signs of slowing, it is not inevitable this will result in recession. Central banks are hopeful that growth will remain positive, although as inflation proves stickier than initially feared, many central banks are now behind the curve and being forced to catch up with rapid tightening which reduces the likelihood of a soft landing or avoiding the possibility of recession.

If we do find ourselves in a recessionary environment, the key question becomes how bad will it be? With the labour market still strong, perhaps the silver lining here is that there doesn't seem the scope as yet for a deep and prolonged downturn. Indeed, recession may be avoided, limited or short-lived as the demand for employment remains high. However, while the labour market and unemployment are still positive, consumer sentiment reached a record low in June due to the squeeze on living standards, the likes of which we haven't seen for some time. Real incomes are falling in a way they haven't done since the second half of the 1970s, when inflation topped out at 22%. The rise in food and energy prices are major contributors to the current cost of living crisis but we are already seeing this broaden out into other parts of the economy. Retailers are also making adjustments – introducing cheaper lines of products so that people can continue to spend, but they don't have to spend so much.

As we move forward, the hit to living standards will cause people to adjust their spending behaviours. We will likely start to see much more evidence of weaker consumer spending coming though, particularly on retail sales. To this end, Q2 earnings season is on the horizon and should provide some clarity on how resilient the outlook for corporate profits is. The earnings growth rate is expected to be 4.3% which would mark the lowest since Q4 2020 (3.8%) but market participants will be looking for the accompanying management guidance which is likely to have a significant impact on the direction of stock prices. While stock prices have already corrected, the process of revising earnings expectations could weigh on sentiment in the months ahead however it is generally expected that earnings will still rise from last year.

Secondly, it is important to remember that markets are forward looking. Stock prices have already fallen a long way this year and at current levels are undoubtedly pricing in a shallow recession or economic slowdown. Historically, equity markets fall around 30% on average in periods of shallow downturns. With the S&P 500 already down 20% year-to-date, we could start to see a gradual bottoming process in the months ahead, giving investors opportunity to add quality investments at attractive valuations. Keep in mind that economic downturns are a natural part of the business cycle and over time, bear markets have led to bull markets, which tend to be longer and stronger than the downturns that preceded them. Ultimately, while markets may be sending warning signals about slowing growth ahead, this may be the first step in a U-shaped bottoming process and while bear markets are never comfortable, they often offer opportunities for long-term investors.

Finally, a note on fixed interest; bonds are down, but perhaps not out. With interest rates having reset higher, we could see better returns in the second half. Investors can now find attractive yields in higher credit quality bonds with income earned better able to compensate for the higher interest-rate risk relative to cash. If inflation pressures do start to ease in the second half, investors are now getting paid an adequate return, suggesting bonds will be better able to help provide portfolio protection. The key will be to focus on the right quality bonds as the credit environment becomes more difficult as borrowing costs rise and the economy slows.

Portfolios

Once again the Beckford James portfolios followed the gyrations of global financial markets and fell for the majority of the month but did claw back some gains in the final week. Overall, portfolios delivered negative returns. The fall back in bond yields over the course of the month meant fixed interest stocks outperformed equities, resulting in the lower risk Growth portfolios delivering the best returns, albeit still negative, while the higher risk Growth portfolios fared the worst over the course of the month. June also saw value stocks, which had been the better performing areas of the market year-to-date, capitulate and the Income portfolio fell in line with Growth 10.

In the Growth portfolio the two property funds (L&G and Columbia Threadneedle) once again delivered positive returns and were joined by the JP Morgan Global Macro Opportunities fund which rose 0.80%. Aside from these, all other funds delivered negative returns. Returns ranged from -3.14% for Growth 3 to -5.14% for Growth 10 which were all in line with their respective benchmarks. Year to date performances follow a similar pattern to that observed in June, with Growth 3 being the best performing portfolio over the first half of 2022 and Growth 10 the worst, again in line with global markets and benchmarks.

In the Income portfolio the only fund to deliver a positive return was the L&G UK Property fund which was up 1.03%. Some of the previous months' winners could not repeat their gains last month with the likes of Artemis Global Income and JO Hambro UK Equity Income echoing market returns and falling heavily. The portfolio delivered a return of -5.12% in June, although remains the best performing portfolio year-to-date, down 4.82%.

Finally, it is pleasing to note that the changes made to the Ethical portfolio at the end of May saw the greater diversified portfolio avoid the bottom spot in portfolio rankings and performed better than it would have without making the changes. Two of the newly added funds, the L&G UK Property and JP Morgan Global Macro Sustainable funds both delivered positive returns in an otherwise negative market although these were not enough to offset some of the heavier falls elsewhere, such as the Liontrust Sustainable Future UK Growth fund. The portfolio delivered a return of -4.5% for the month as a whole.