

# OUR MONTHLY INVESTMENT REVIEW: JULY 2022

10/08/2022 | KEVIN THOZET

## A HOT SUMMER

Despite being a summer vacation month, July was eventful, to say the least. Central banks in the western world seemed increasingly willing to rapidly tighten monetary policy. The US Federal Reserve raised interest rates by 75 basis points for the second month in a row, the Bank of Canada implemented a full 1% hike and the Bank of Australia is to proceed with a third consecutive 50 basis point hike. The European Central Bank surprised markets with a 50 basis point hike (vs 25 anticipated). This unexpected move happened at a delicate time for Europe's economy. During the month, Russia drastically reduced its distribution of gas to European countries, sending the commodity's price much higher. In Italy, prime minister Mario Draghi resigned, following dissension in his government's majority, further fueling political uncertainty in the region. Furthermore, the continent's growth is showing signs of weakness, illustrated by a below 50 composite PMI reading, hinting towards a contraction of economic activity. In the US, month-end GDP prints confirmed the country was in a technical recession during the first half of the year. The main signs of apparent hope come from a resilient jobs market and somewhat resilient consumption (notably on the services side). Yet these "positives" tend to also point towards some ongoing persistence of inflation and, despite economic contraction, to further tightening into restrictive territory despite the US economy's weaker footing.

## BAD NEWS IS GOOD NEWS

Despite a volatile set of news and data, risk assets recorded an overall positive performance over the month of July. It has taken half a year for markets to digest the shift in monetary policy, as illustrated by the market chaos of the first semester, in particular in fixed income markets. However, in July, investors seemed to have bought into the idea that central banks are effectively frontloading their monetary tightening, in line with the "whatever it takes" approach raised throughout the year. As a result, markets looked past current multi-decades high inflation figures to an environment where prices will most likely continue to grind higher (albeit at a slower pace), but where growth will trend much lower. Seemingly, markets are anticipating that central banks won't have to tighten as much as initially expected and will eventually lower interest rates during 2023 as the downturn becomes more pregnant and inflation is eventually tamed. This might explain the slightly odd bad-news-is-good-news phenomenon seen during July, as negative publications mean we're one step closer to a central bank "pivot", supporting the performance of risky assets. Extremely bearish investor sentiment and positioning certainly helped as well.

## WHY WE REMAIN CAUTIOUS

Our view is that markets are underestimating the persistence of ongoing inflationary forces and its impact on the length of the tightening cycle. In the US, the slowdown in the real estate market, induced by falling affordability (due to both the rising prices of both homes and mortgages) is putting upward pressure on rents, which are contributing increasingly to higher consumer prices. In Europe, a lack of investments in the previous commodity cycle, gas shortage, fiscal populism and a potential wage-price spiral will also keep pressure on prices going forward. Meanwhile, a strong dollar continues to fuel inflation in both the old continent and emerging countries. As a result, we maintain an overall cautious positioning, characterized by low equity exposure, credit protections and a high allocation to cash.

When it comes to investing, there are however plenty of reasons for active managers to feel positive about the current environment. Indeed, equity markets, which have derated on the back of higher rates, will now likely be driven by earnings, boding well for fundamental bottom-up stock selection. Credit markets are bound to stay volatile, but some idiosyncratic opportunities offer a high enough carry to compensate for volatility, even in case of a pessimistic outlook.

Our equity allocation balances out quality investments in defensive sectors such as consumer staples and healthcare - recently enriched by a new position in Centene (US-managed care company). Investments in energy companies, which, to quote Schlumberger's CEO Olivier Le Peuch "marked a significant inflection point" amid a sharp increase in exploration activity across the world. We significantly stepped up our China exposure as the country is in a relatively better position than its emerging and developed peers, with inflation contained and a supportive policy mix going forward. Our fixed income allocation is diversified in terms of segments and countries. We are combining high-yield and investment-grade corporate bonds, mainly within the financial and energy sector, emerging market debt within countries that export commodities or benefit from positive onshoring dynamics, as well as sovereign debt of core countries to reflect prospects of lower growth. Although C. Lagarde announced a mechanism to control volatility in peripheral sovereign interest rates - the Transmission Protection Instrument - the lack of details and the ongoing tightening leads us to keep hedging positions on Italian debt.

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