Market Snapshot

Equity Snapshot

United States

US equities started the quarter on strong footing, boosted by speculation that slowing economic growth might mean the Federal Reserve (Fed) would likely rein in the pace of interest rate hikes later this year. By mid-August, the S&P 500 Index had rallied around 15% from its June lows, while the Nasdaq Index had rebounded more than 20%. However, shares subsequently slumped as signs that US inflation might be easing proved to be premature and US policymakers issued a series of hawkish statements. US shares lost ground over the quarter, falling into a bear market as they retreated back to levels last seen in mid-June. In late-August, the US passed the Inflation Reduction Act. The USD 740 billion bill contained plans to invest nearly $375 billion over the next decade to fight climate-change issues.

The Fed raised interest rates by 75 basis points (bps) in July and followed this with another 75-bps hike in September. This was the third successive increase of that magnitude and marked a run of the most aggressive tightening of monetary policy since 1981. US policymakers' "dot plot" of future interest rate projections indicated that US rates were expected to rise to 4.4% by the end of 2022 with a peak of 4.6% forecasted in 2023. Currently, the range for the Fed funds rate is 3.00-3.25%.

Europe

After starting the quarter with the strongest monthly returns since November 2020, European equities retreated sharply from mid-August onwards. The sell-off meant European equities entered an official bear market, having fallen at least 20% from their peak in early-January 2022, with major indices closing the quarter around two-year lows (in EUR terms). As the economic outlook for Europe darkened, governments introduced measures to help households hit by a cost-of-living crisis. The EU proposed a windfall tax on energy companies to help pay for lower-income household bills, even though the proposals were met with severe reservations from some member states. In political developments, Italy's prime minister, Mario Draghi, resigned, triggering a general election that was won by a coalition of right-wing parties.

After expanding by a stronger-than-expected 0.8% in the second quarter, the eurozone economy weakened in the third quarter. The flash estimate of the S&P Global eurozone composite purchasing managers' index fell to 48.2 in September, the lowest reading since January 2021, with both services and manufacturing activities well into contraction territory. Eurozone inflation continued to accelerate, reaching a fresh high of 10.0% in September.

In July, the European Central Bank (ECB) raised rates for the first time since 2011. The 50-basis-point (bps) increase, which ended eight years of negative borrowing costs, was followed by a 75-bps hike in September, with the ECB signalling that interest rates will likely be raised further in subsequent meetings. Elsewhere, Switzerland raised rates by 75 bps to 0.25%, ending the era of negative interest rates in Europe, while Norway and Sweden both increased rates by 100 bps.

Allianz Global Investors

Asia

Asia equity markets delivered mixed performances in the third quarter. Fears over the outlook for the global economy grew after major central banks indicated they would continue to aggressively tighten monetary policy to tame rampant inflation. While inflation in Asia Pacific is generally lower than in most G7 economies, several central banks in the region continued to hike rates. At a country level, China and Hong Kong equities closed the quarter with double-digit declines amid concerns over China's economy and the housing market. Equity markets in South Korea and Taiwan also lost ground as tech companies were hit by fears of weaker demand. On the contrary, Australian stocks held up relatively well, supported by a better-than-expected second-quarter earnings season. Indian stocks also remained relatively resilient with more robust domestic economic activity. Overall ASEAN markets outperformed the broader region.

China/Hong Kong

It was a challenging quarter for China equities with a double-digit decline recorded over the last quarter. China A shares slightly outperformed offshore indices that are more exposed to higher global rates and tightening global liquidity. Returns to global investors were further impacted by the strength of the US dollar. The two biggest factors weighing on economic activity have shifted from the strength and sustainability of economic recovery to the declining housing market and Covid policies. Economic data showed that, while activity had recovered after the lockdown-induced slowdown in April and May, sporadic Covid-19 curbs and power shortages were continuing to affect momentum. Meanwhile, the Chinese authorities announced further fiscal support, mainly targeted at infrastructure and the housing market.

It was a challenging quarter for Hong Kong equities, with a double-digit decline recorded amid fears over higher global rates and tightening global liquidity. Rates in Hong Kong were increased to 3.5% to maintain Hong Kong's currency peg with the US dollar. The two biggest factors weighing on the market have been the concern over the declining housing market and Covid policies in China. While mainland China continues its strict zero-Covid policy, a positive development announced in Hong Kong was to ease mandatory hotel quarantine for international travellers.

Japan

Japanese equities declined slightly over 3Q 2022. The TOPIX index (total return) ended the quarter down 0.79% in local terms.

The equity market rose until mid-September as slowing global economic growth raised hopes that inflation would moderate, meaning interest rate hikes would be less aggressive than had been feared. The Bank of Japan's supportive stance also helped market sentiment. Since then, however, Japanese equities plunged amid growing worries over the outlook for the global economy on the back of the FED's hawkish stance, which stemmed from the current increase in US CPI with acceleration of stickier inflation.

The BOJ and the Japanese government intervened in the currency markets for the first time since 1998 as the Japanese yen fell to a 24-year low against the US dollar.

In terms of sector, some defensive sectors such as Consumer Staples and Healthcare outperformed amid global economic concerns. On the contrary, cyclical sectors such as Energy, Consumer Discretionary and Materials sector underperformed.

Bond

After positive returns in July, global bonds tumbled over August and September as central banks dispelled hopes that weak economic data would mean they would be less aggressive in raising rates. The Fed raised interest rates by 75 basis points (bps) in July and followed this with another 75-bps hike in September. This was the third successive increase of that magnitude and marked a run of the most aggressive tightening in monetary policy since 1981. Accordingly, the 10-year Treasury yield touched a 12½ year high of 4.0% in late-September. Shorter dated yields rose even more, with the yield on the 2-year note trading above 4.2% for the first time in 15 years. The yield curve is now inverted two years and out, with such an eventuality usually predicting a US recession.

European bonds sold off sharply. Positive returns in July were more than reversed by steep declines in August and September as the European Central Bank (ECB) indicated it was committed to taming inflation, even in the face of slowing economic growth. The ECB raised rates by 50 bps for the first time since 2011, which was followed by a 75-bps hike in September. Furthermore, the ECB signalled that interest rates would likely rise further in subsequent meetings. Accordingly, the yield on the 10-year German Bund rose around 75 bps over the quarter, trading above 2.2% for the first time since late-2011.

UK bonds plummeted. Boris Johnson resigned as prime minister, triggering a leadership battle that was won by former Foreign Secretary Liz Truss. In an attempt to kick start growth, the new UK government implemented the largest package of tax cuts in 50 years and took steps to cap energy costs for households and businesses. The measures ramped up government borrowing, spooking financial markets and leading to a sharp sell-off in the British pound and a surge in Gilt yields. The yield on the 10-year Gilt topped 4.5%, its highest level since late-2008, and a rise of around 240 bps over the quarter, before falling back to just above 4.0% after the Bank of England was forced to intervene to prevent financial instability.

In Asia, the yield on the 10-year Chinese bond touched a 26-month low of just above 2.6% in mid-August. The People's Bank of China cut loan and mortgage reference rates as an already slowing economy was further challenged by renewed COVID-19 curbs and an ongoing property crisis. Yields backed up as developed market bond yields rose in September, closing the quarter little changed around 2.75%.

Outlook

The inflation narrative continues to wrongfoot global equity markets. The first full week of October saw softer than expected US manufacturing data swiftly followed by a stronger than expected jobs report. Stocks whipsawed as a result, surging with hopes of a Fed pivot and falling as these were soon dashed.

This pattern is becoming all too familiar. With valuations having pulled back so much, skittish equity investors are searching for signs of relenting central banks. Yet there are signs that not only is inflation dropping slower than expected, but that underneath the headline decline some prices continue to rise.

Energy, the biggest driver of inflation this year, has softened with a barrel of Brent crude now 25% cheaper than its March peak. Yet with unemployment at historic lows, service costs continue to grow, and the effect of hedging means many other price increases have yet to be felt by consumers. Similarly, longer-term inflationary forces, such as demographic change and long-standing underinvestment in infrastructure, not only precede Russia's invasion of Ukraine but may also outlast it.

Equity investors are thus grappling with a world in which central banks remain fully committed to monetary tightening even as economic indicators sour. At a fundamental level, many companies are now facing a decline in revenues and earnings expectations. The question is to what extent analysts and management have correctly priced this in?

At the same time, markets continue to be highly sentimental and short term in focus. Russia's invasion prompted a risk off move that has been prolonged by a European energy crisis, broader geopolitical tensions and the prospect of global recession. Equally, when inflation is high it has historically also tended to be volatile. Markets as a discounting mechanism are increasingly likely to misprice securities on the basis of extrapolating short-term data.

As active equity investors, it behoves us to take a longer-term view. In a lower growth environment, many stocks with strong balance sheets and sticky revenues have seen an excessive collapse in their valuations, relative to peers. Similarly, companies with exposure to structural drivers that are not

correlated with the broader economy – such as digitalisation, electrification and ageing populations – offer greater growth visibility for investors. We believe that opportunistically adding to such high conviction names will lay the necessary foundation for performance when fundamentals are once again in focus.