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"TINA" is no more, welcome to "TARA"

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The acronym 'TINA' has been much cited in financial markets to reflect "there is no alternative' to equities, a reflection of the paltry returns on offer from other assets classes – especially from bonds. In September, we saw losses mount in global stock markets and bond markets. It has also marked a very significant increase in the yields on offer from bonds[1]. A new acronym is now in use as a result "there are real alternatives" ("TARA"). For many more conservative investors, for whom bonds can make up a significant element of their funds, this will come as welcome news.

Asset class performances	September	YTD
Global equities	-7.2%	-13.7%
European government bonds	-3.9%	-16.8%
Global commodities	-5.9%	+30.7%

September has a historic track record of being the worst of months for the stock market[2] and 2022 hasn't proven the exception. After a strong summer, we've seen markets retrench back to early June levels.

Figure 1: Asset class performance to end September 2022

Source: Bloomberg 01.10.22

What's behind this?

What's behind this is the more aggressive inflation fighting from the developed world's main central banks, led by the US Federal Reserve (Fed) and a belief in markets that central banks are no longer in supportive mode when it comes to markets. They are instead focused on reducing inflation by rising interest rates and if needed, significantly.

The acronym 'TINA' has been much cited in financial markets to reflect "there is no alternative' to equities, a reflection of the paltry returns on offer from other assets classes – especially from bonds.

[1] Yields reflect the return you get on a bond, when the price of a bond falls, the yield rises and vice versa
[2] Source: Bloomberg: J. Menton "Stock markets worst month gets even more dicey with hawkish Fed" 01.09.22

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US Federal Reserve & ECB

- In late August at the annual Jackson Hole symposium of the main global central banks, Fed Chairman Powell outlined what was in store for US interest rate policy. He indicated very clearly that the Fed was going all out to quell inflation and acknowledged that a slowdown/ recession in the US economy was going to be necessary to achieve this.
- A 0.75% rate increase followed.The European Central Bank (ECB) has since delivered the same level of rate increase.

Market reaction

- As is expected with this type of announcement, we have seen a fall in equities and bond markets in September.
- The US S&P 500 registered six down weeks in the past seven, and in US dollar terms, the S&P 500 has had its third worst opening 9 month period since 1931.
- Fortunately the US dollar has risen over the same period, protecting euro based investors, with gains of 16%. However, for European investors the movements in local bond and equity markets have also proven damaging this month.

Is a market rebound likely?

With such elevated pessimism, oversold markets and a quite clear path in interest rate policy (upwards), many of the conditions for a market rebound are now in place. However, it will take more time to sound the 'all clear'. Markets are looking to see when central banks begin to change their tone and the impact of reduced growth on company earnings is yet to be seen.

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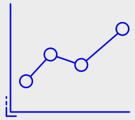

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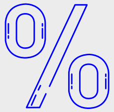

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5 drivers of returns in September 2022

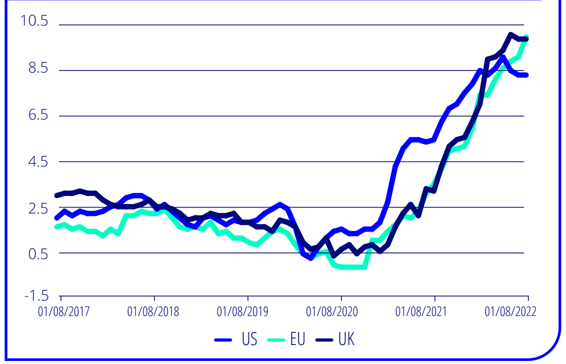
1 Sticky inflation

The most recent European inflation data saw it reach 10%, higher than the 9.7% which was anticipated[3].

At the heart of this rise, once again, was energy prices. While energy currently makes up just under 11% of what Europeans spend their money on, prices have moved up by approximately 40% per annum (p.a.)[4]. Driving this is that Russia has ceased gas supplies and is rumoured to have damaged the Nordstream 1 and 2 pipelines, moves that would have been thought worst case scenarios only weeks ago.

While Europe has made substantive gains in securing new supplies it has come at a hefty price, especially given the drop in the euro against many of its new suppliers.

Figure 2: Inflation in the past 5 years



Source: Bloomberg 01.10.22

In the US, the inflation news has also been challenging. While it is more clearly on the decline, with the latest reading at 8.3% p.a.[5], US inflation is falling at a slower pace than had been expected. On a more positive note, the US economy continues to perform well with consumer spending up, personal incomes up and savings up and a robust jobs market[6].

2 Central banks take charge

With parallels being drawn to the actions of former Federal Reserve Chairman Volcker from 1979 to 1981, the Fed made a very clear statement to the market on August 26th at the Jackson Hole meeting – one which has reverberated through markets ever since.

In this speech Chairman Powell indicated that reducing inflation to 2% (the current target) "requires using our tools forcefully" (aka through the use aggressive interest rate hikes) and "require(s) a sustained period of below-trend growth" (aka US recession). This was followed in September with a 0.75% rate increase and it remains likely that we will see this again in the next increase.

The ECB followed in a similar fashion with President Lagarde indicating that inflation "is likely to stay above our target for an extended period" (aka it will be 2024 before inflation will be under control). The ECB also increased interest rates by 0.75% in September with market expectations that this may be repeated in Q4.

Interest rate rises were put in place by central banks all over the globe in Q4. When you add up the rate rises from the developed/larger economies in September it totals to 3.5%[7] in rate rises with the notable exceptions being Japan and China (which has been cutting rates).

3 Company earnings' estimates 'wobble'

Over the past couple of years, company earnings growth has been a very significant factor in supporting equity markets. Even the most recent quarter showed a decent level of earnings growth which had led valuations levels to below average, when judged by the past couple of decades.

While analyst estimates continue to point to an increase in earnings amongst large companies in the year ahead, there is a growing scepticism about. This is being fuelled by profit warnings from a number of 'bell-weather' companies (companies that are seen as a barometer for the market direction), including the likes of Fedex, Ford and GM (General Motors) most of whom are citing inflation pressures.

[3] Source: Eurostat 30.09.22 [4] Source: Eurostat 30.09.22 [5] Source: Bureau of Labor Statistics 13.09.22 [6] Source: Reuters 30.09.22 "U.S. consumer spending rebounds, but high inflation cooling demand" L. Mutikani [7] Source: Reuters 22.09.22 "Central banks unleash 350 basis points more of rate hikes in inflation fight"

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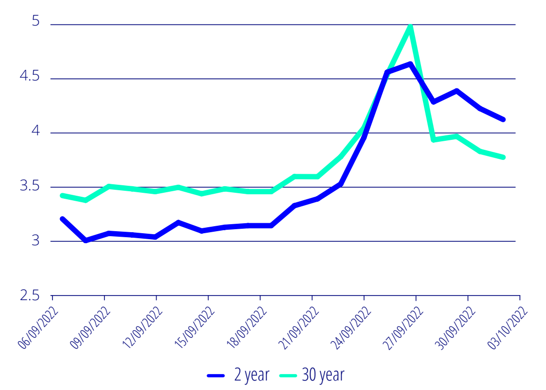
4 The UK steps into currency crisis

Figure 3: UK gilt yields since the election of Prime Minister Truss



Source: Bloomberg 03.10.22

Late September saw the UK government announce significant tax cuts and an energy focussed support package for households and business.

In an economy with an 8.3% current account deficit and concerns that its inflation rate was already likely to rise well into double digits, the market reacted badly, doubting the ability of the UK government to pay for this support. As a result, Sterling fell to a low of $1.03 to the US dollar and bond yields rose dramatically (See: Figure 3) (as prices and demand fell). The consequence was felt most acutely in some UK pension funds which were faced with liquidity problems as a consequence. As a result of this, the Bank of England was forced to intervene in a targeted manner to relieve pressure off pension funds, which they did successfully.

Sterling recovered in the last trading day of the month, largely as markets now expect a very significant rate increase will shortly follow to manage the impact of the government measures. The UK government subsequently withdrew the top rate of tax proposal (to remove this rate) but markets continue to be concerned about UK policy.

5 The bond 'comeback'

At the start of this year, the yield on most high quality bonds was either negative or meagre. This has been changing all year as interest rates have moved upwards, and never more so through the month of September (See Tables 1 and 2).

We have seen some dramatic changes in the yields available globally and while bonds continue to be a challenging area in which to generate a return, it is likely that over the coming months, they will regain a more significant role in generating returns for investors.

- For US bonds, using the 2 year bond as a proxy for the market, yield levels haven't been as high since 2007.
- For the Eurozone, using the German 2 year bond as a proxy for the market, we have to look back to 2011 to find when bonds looked this rewarding.

Table 1: Bond yields on 01.01.22

	German	Irish	US	UK
1 year	-0.66%	-0.50%	0.38%	3.05%
3 year	-0.66%	-0.55%	0.95%	3.19%
5 year	-0.45%	-0.34%	1.26%	3.28%
10 year	-0.18%	0.25%	1.50%	3.27%

Source: Bloomberg 01.10.22

Table 2: Bond yields on 30.09.22

	German	Irish	US	UK
1 year	1.72%	1.09%	3.99%	3.77%
3 year	1.76%	1.92%	4.29%	4.26%
5 year	1.96%	2.24%	4.09%	4.29%
10 year	2.11%	2.69%	3.82%	4.05%

Source: Bloomberg 01.10.22

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Outlook for the remainder of 2022

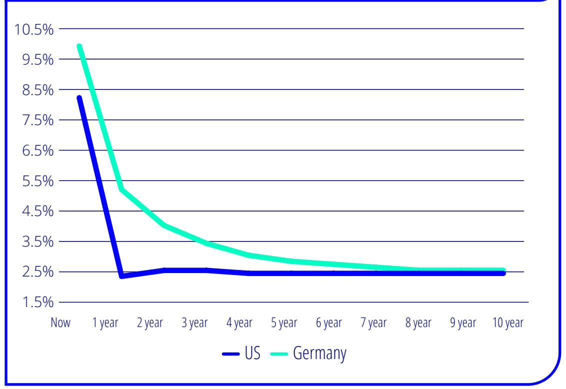
Inflation, inflation, inflation

The most important factor influencing returns for investors for the foreseeable future is inflation.

- At present the market believes that US inflation is going to be well-controlled within the next 12 months.
- In contrast, Eurozone and indeed UK inflation is likely to take longer to be brought back to central banks' target of 2%.

Set against this backdrop, we can then begin to gauge how high the market thinks interest rates will reach in order to squeeze out the high levels of inflation.

Figure 4: Inflation expectations in the US and Germany for next 10 years[8]



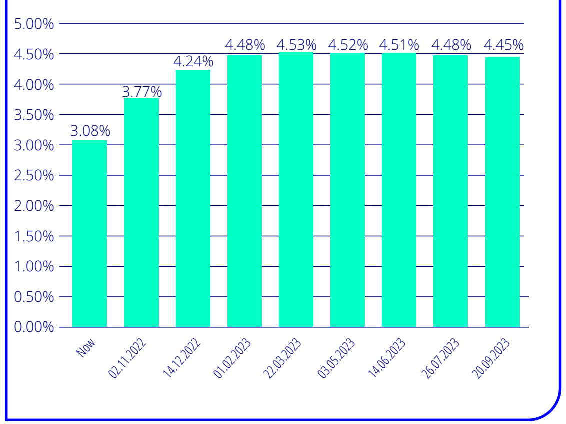
Source: Bloomberg 01.10.2020

[8] Source: Bloomberg 01.10.22 using inflation swaps over relevant time frames

At time of writing, the market believes that interest rates are likely to reach a plateau from the middle of next year in the US and into the second half of next year in the Eurozone (see Figure 5 and 6).

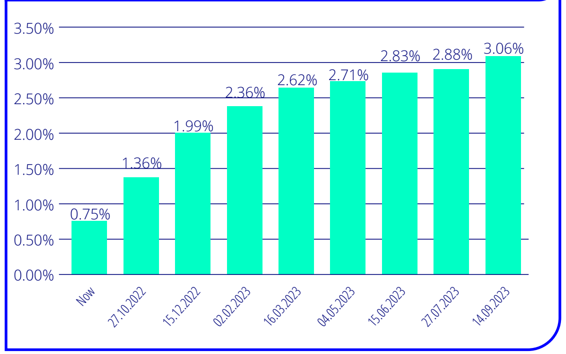
It also seems likely that it will be out as far as 2024 before we start to see interest rates falling. Its likely, in the mean time, that the world economy will need to adapt to a higher interest rate regime for some time.

Figure 5: US Interest rate expectations



Source: Bloomberg 01.10.2020

Figure 6: Eurozone interest rate expectations



Source: Bloomberg 01.10.2020

And for investors.....

For investors, it's hard not to expect further market volatility during this period of transition. However, the lesson of the summer months is that once better news in the form of falling inflation starts to come into the system, markets will react positively and at quite a pace. We will most likely need to see a change in central bank policy coming into play before we see a sustained rally in equity markets of this kind.

Importantly, the change we are seeing coming through in the bond market is making investing in bonds a more attractive place to invest, meaning there are now real alternative sources of return available. As always, and particularly during difficult times, we recommend that you talk to your Advisor before making any change to your investment portfolio.

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Performance table

Table 3: 5 year historic performances

	2017	2018	2019	2020	2021
Global equities	7.5%	-4.9%	28.9%	6.6%	27.5%
US equities	6.9%	-0.5%	33.9%	8.6%	39.3%
European equities	11.4%	-12.0%	29.8%	-2.3%	23.8%
Emerging markets equities	21.2%	-10.0%	21.8%	8.7%	4.2%
Global bonds	1.0%	-1.1%	5.3%	4.9%	-2.63%
US government bonds	-10.6%	5.9%	8.8%	-2.2%	5.4%
European government bonds	0.1%	0.9%	6.8%	5.0%	-3.5%
Emerging market debt	-3.7%	0.6%	17.1%	-3.2%	4.3%
UK gilts	-2.10%	-0.50%	13.45%	2.36%	0.97%
Broad commodities	-12.4%	-6.8%	9.8%	-11.0%	36.5%
Oil	3.2%	-15.5%	25.1%	-27.9%	61.2%
Gas	-30.4%	4.5%	-24.1%	6.5%	57.7%
Copper	31.7%	-20.3%	6.3%	25.8%	38.4%
Wheat	4.7%	17.9%	11.0%	14.6%	24.8%
Gold	13.5%	-1.6%	18.3%	25.1%	3.6%
US corporate bonds	-6.60%	2.45%	16.46%	1.28%	6.28%
European corporate bonds	1.75%	-0.87%	6.15%	2.82%	-0.96%
Aluminium	-6.62%	5.39%	-32.24%	9.22%	126.21%
Coal	16.95%	-15.27%	0.11%	1.59%	52.07%
Global hedge funds	-3.7%	0.9%	12.6%	2.7%	18.3%
Liquid absolute return	+4.0%	-8.2%	5.1%	0.4%	4.3%

Source: Bloomberg 01.10.22

For more information:

Fund Centre

boi.com/marketwatchupdates

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Warning: If you invest in these funds you may lose some or all of your investment.
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October 2022

Bank of Ireland