Henry James International Management

Market Outlook

July 2022 Market Report

Market Overview

As the second quarter ends, markets wearily amble back into the locker room. It is half time. The first 6 months of the fiscal year are in the books. Time to lick wounds, grab a sports drink and forget about the dismal performance, thus far. Year-to-date the MSCI Emerging Markets index is down -17.47%, the MSCI ACWX by -18.15%, the MSCI EAFE -19.23% and, worst of all, the MSCI ACWI is down by -19.26%. Can anything rally markets back to profit, or are current geo-politics too much for 2022 to be anything but a dismal year for investors?

The global market's main villain is Russian President Vladimir Putin whose February invasion of Ukraine turned 2022 from what was meant to be a year of modest growth into one that has seen chunks of value slashed off equities. Even now, after so much bloodshed and economic damage, there is no end to the conflict in sight. After Russia's failure to take Kiev through *blitzkrieg*, Putin's forces refocused their efforts to save face and take control of East Ukraine. A slow and bloody battle saw Russia capture cities Luhansk and Lysychansk, but for Putin to satisfy his primary objective of overrunning the entire Donbas region, home to Russian-backed separatist since 2014, the city of Donetsk is anticipated to be next. These little wins give Putin and his propaganda machine the red meat to claim glorious victories back home, but as long as the war wages, Western sanctions mean that the Russian economy, its markets and currency will continue to erode and be uninvestable. Of course, while this is extremely painful to the Russian people, including to its wealthy elite, a hemorrhaging Russia, is also bad news for global markets; and Putin's countersanctions, especially those leveraged through oil, have significantly contributed to gas-prices rising, the cost-of-living crisis and global inflation. Moreover, the Ukraine's suffering will continue until the bullets stop flying, and its interrupted wheat production poses serious consequences for world food, particularly to emerging market nations.

Part and parcel of the West's sanctions against Russia is moving on from its reliance on Russian fossil fuels. The European Union has threatened that it will reduce the quantity it purchases from Russia by 90% by the end of 2022. The USA and UK have already banned all Russian fossil fuels, despite what political hostilities towards the Kremlin have done and are doing to the price of gas for their own citizens. But it is feared that Putin may respond in the fashion that perhaps he alone has the recklessness to implement. Presently Russian natural gas shipments to Europe have stopped via the Nord Stream pipeline due to planned maintenance works, but it is unclear whether the Russian-state-owned Gazprom will turn the gas back on after completion. Germany is pretty much completely dependent on Russian oil as things stand and if Putin turns off their supply it is feared that they and other European nations will not have enough fossil fuels to heat their homes and drive their cars this winter. The war in the Ukraine has already ravaged the Sri Lankan economy; i.e. spiking food and fuel prices, and having started a major social uprising that saw its people oust their government. One wonders if Putin is playing a game to achieve a similar outcome for Western countries and their governments?

Recession is anticipated early in 2023 at home and in Europe, which will have a major effect globally. We are hopeful that the US Federal Reserve will continue to stave off inflation with interest rate rises, with another 75 basis point (bps) rise expected in July and an additional 50bps rise in September. While this may well stabilize inflation and the economy back home in the USA, it is bad news for the rest of the world as it will result in the deprecation of the Euro and other currencies, thus making the price of energy even more expensive than it already is. Further, rising interest rates punish emerging market economies with USD denominated debt. It is our hope and expectation that the recession will be short and will lead to a longer recovery cycle that will affect the role of a tide rising all ships. In short, 2022 may well be one for the loss column, but such a dip should provide for opportunities for plenty of wins in 2023 and beyond.

Investment Overview

The United Kingdom (UK) is in a bit of a mess: cost of living crisis, gas prices out of control, sputtering economy and now disgraced Prime Minister Boris Johnson having resigned. Johnson, whose legacy is marked by achieving what his predecessor Theresa May could not in 'getting Brexit done' – as the campaign slogan went – had a premiership marred by the Covid pandemic and his incessant scandals involving his own and his closest allies' breaking of Covid lockdown rules. What got Boris Johnson in the end was having appointed Chris Pincher to the position of Deputy Chief Whip despite knowing that there were sexual misconduct complaints made about Pincher prior to his appointment. Now the Conservative Party is in the midst of selecting the new British Prime Minister, and this person will have the unenviable task of having to rebuild public trust and putting Britain back on a path of success. While some believe Johnson did a decent job in supporting Ukraine and being firm with Russia, the UK economy is insipid with an average annual growth rate of 1.7%. This reduction along with increased government spending has put the UK at a disadvantage versus Germany and the US in terms of purchasing power parity. Looking forward we hope that the new Prime Minister will pay more attention to detail and implement a long-term strategy to revive the UK economy. That said the UK is home to many well-run global companies, some of which we include in our portfolios. Regarding the UK's stock market performance YTD 6/30/2022, the UK's MSCI market is down only -8.83%, just below MSCI Norway at -5.3%, and is the second highest in Europe.

China still cannot shake its Covid problem, its 'zero Covid' policy, notwithstanding. China is in the midst of a serious heat wave which is bringing many of its cities to breaking point as they deal with serious outbreaks, including Shanghai, Beijing, Dalian in the northeast and the central city of Xi'an. Presently only about 50% of Chinese octogenarians are fully vaccinated, with this number less than 20% in Hong Kong, meaning the most vulnerable remain very exposed to the worst the Covid has to offer. Furthermore, with many families living in multigenerational households, Covid transmission is seamless. Until China can get out of its seemingly constant cycle of lockdowns and other restrictions, its economy will suffer, which in turn disrupts supply chains. Moreover, if the US and the West go into recession which may be likely, China's economy will suffer further with lower demand for its products.

Canada has the third best MSCI Developed Country YTD 6/30/2022 return of -11.58%, which is a sufficient indicator of how well markets are performing in 2022. Canada's relative success, notwithstanding, inflation has not abated with a continued high annualized inflation year-on-year in May of 6.1%. According to the Canadian Press, economists are predicting an interest rate raise of an additional 75bps in July pushing up the rate to 2.25% from 1.5% to help check the increase in inflation. Despite these difficulties, we believe Canada will recover nicely in 2023, for which reason we will continue to be overweight in equities from north of the border.

With the first half of 2022 complete, we can now say with certainty that it has not been a good year for investors; indeed, we also can safely assume that the rest of the year may well be a difficult period. However, markets are intelligent and dynamic and they will adjust to a world in which there is a major war in Europe; inflation will eventually temper, gas prices will moderate and economies will get back on track. We expect this process to see the green shoots of success in 2023. In the meantime, it is question of being patient and trying to find the opportunities and position our portfolios for better economic conditions in the future.

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