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A Quarter in the Markets

Q3 2022

We are pleased to introduce our latest edition of 'A Quarter in the Markets', which provides an insight into financial markets from the Multi-Asset Solutions team at Santander Asset Management UK.

What were the key factors influencing markets in the third quarter of 2022?

The third quarter began with a market rally in July[1], driven by investor hopes that inflation had peaked and a recession had been averted. However, this optimism began to falter by the middle of August as it became clear that stubborn inflation and large interest rate hikes may continue. Subsequently, stock and bond markets remained on the decline for the rest of the quarter.[2]

Further disruption was created by Russia's threats of nuclear war[3], as well as the deepening of Europe's energy crisis following damage to a major gas pipeline.[4]

Major central banks, including the US Federal Reserve (Fed), Bank of England (BoE) and European Central Bank (ECB), raised interest rates over the course of the quarter in an attempt to control inflation[5]. In Asia, China's continued efforts to eradicate COVID-19 through strict lockdowns hampered domestic supply chains and economic growth[6],

[1] CNBC, 9 August 2022
[2] Business Insider, 26 September 2022
[3] The Guardian, 21 September 2022
[4] CNN Business, 30 September 2022
[5] Federal Reserve, 30 September 2022
[6] Bank of England, 22 September 2022

while slowing growth throughout the rest of the East Asia and Pacific region.[7]

Towards the end of the quarter, the new UK Government introduced a plan that included tax cuts for the highest earners, to be paid for by borrowing more money.[8] Although since the quarter ended much of their plan has been reversed, the announcement rattled investors, prompting an intervention from the BoE designed to restore calm.[9]

What happened in markets during the quarter?

It was a difficult period for investors as global stock markets fell for the third quarter in a row. This was the first time this had occurred since the global financial crisis of 2008.[10] Inflation also remained close to 40-year highs in both the US[11] and UK[12], while reaching double digits in Europe.[13]

The subsequent reactions of central banks were keenly watched. The Fed sought to control inflation by raising interest rates twice during the quarter, to their highest level since 2008.[14] The BoE raised rates twice in the quarter, marking seven consecutive rate increases.[15] The ECB began its rate-hiking cycle with a 0.25% hike in July, followed by a record 0.75% increase a month later.[16]

All of this meant that investors had little place to hide. US stocks fell for a third consecutive quarter[17], with European stocks[18] and the UK's domestically focused FTSE 250 index following suit.[19]

Stocks based in emerging markets, China and the Asia Pacific region also slipped lower. Japanese stocks recorded the smallest decline among major global markets.[20]

Historically bonds have been viewed as a safe haven for investors when stock markets are in decline, but the bond market also performed negatively this quarter.[21] Rising inflation and interest rate hikes drove bond yields higher [22], as investors demanded higher returns on their investments. Bond prices and yields move in opposite directions, meaning that bond prices fell as yields rose.

How did different economies react?

Most central banks have focused on the fight against inflation by raising interest rates. The inability of wages to keep pace with soaring inflation has resulted in a fall in real wages[23], leading to a cost-of-living crisis in countries around the world.[24] Other factors are also causing difficulties for global economies. Europe faces winter with an energy shortage, Russia has threatened the use of nuclear weapons in its war with Ukraine, global economic growth is slowing and COVID-19 is still causing shutdowns in parts of China.[25]

In the UK, revised growth figures revealed that the economy expanded by 0.2% from the first to the second quarter of 2022, rather than having contracted as had been previously predicted.[26] This seemed to sooth fears of a recession somewhat. However, the UK economy remains smaller than it had been prior to the COVID-19 pandemic.[27] Consumer confidence hit a record low in September[28] amid deep concerns over personal finances and the economy.

The economic outlook for Europe worsened during the quarter, with the International Monetary Fund (IMF) downgrading its expected growth for the region.[29] This is largely due to the ongoing regional disruption caused by the war in Ukraine and the subsequent risk of gas shortages.

The highest US interest rates since 2008 encouraged investors to purchase dollar-based assets, strengthening this currency.[30] The belief that the Fed will continue to raise interest rates, along with the decline of US employment to a 53-year low of 3.5% in July[31], further bolstered the dollar. Additionally, consumer spending has remained strong, although this has made controlling inflation difficult.[32]

In Asia much of the attention was focused on China, where COVID-19 lockdowns continued to hamper manufacturing. Chinese consumer confidence is tracking near its lowest levels since at least 1992[33], although the manufacturing outlook in China expanded for the first time in three months in September. This was thanks to support packages from the government and the easing of COVID-19 restrictions in some cities.

What is the outlook for markets?

The first nine months of 2022 were tough for investors, and many of the causes of this will remain in place for the rest of the year. However, we believe the most likely outcome for the global economy is a slowdown rather than a recession. Central banks will likely continue to hike rates until mid-2023, by which time inflation may be under control.

Looking ahead to the fourth quarter, the same factors look set to continue shaping markets: higher inflation across many regions, rising interest rates, aftershocks of the pandemic, supply constraints, the war in Ukraine and highly volatile stock and bond markets.

While markets have already fallen a long way this year[34], there may be room for them to decline further if the outlook deteriorates. The environment remains negative for shares and bonds, and as a result this is no time to take unnecessary risks.

How are we positioned for the major risks to our outlook?

We have retained a cautious stance in both shares and bonds and remain underweight risky assets, meaning that the funds contain less of them than the market benchmark. However, where a fund permits us to, we've purchased contracts that will allow us to buy some of these assets back if market fortunes improve.

While our positioning is cautious, we are also aware that markets may rebound sooner than expected and have anticipated this by buying US shares, marginally reducing our underweight position relative to the benchmark, where applicable.

For the first time this year, we've repositioned our funds with the expectation of a weaker pound sterling relative to the US dollar. We believe that the UK currency may decline relative to the value of the US dollar, just as the euro did in July of this year.

Outlook by asset class

Shares

Our stance on shares and other riskier assets remains cautious, given that we see further potential for downward movement in a high-inflation environment where interest rates are rising.

Bonds

As central banks continue to raise interest rates, we expect to see further volatility in the bond market. We have shifted a lot of our exposure from long-duration bonds to short-duration bonds as these are less sensitive to interest rate movements, across both government and corporate bonds. Whilst we are monitoring for an attractive entry point in anticipation of a potential recovery, our stance remains cautious for the time being.

Find out more

Learn more, visit our website here for more insights into financial markets.

[7] European Central Bank, 8 September 2022
[8] The Guardian, 31 August 2022
[9] World Bank Group, 30 September 2022
[10] The Guardian, 23 September 2022
[11] The Guardian, 28 September 2022
[12] Bloomberg, 2 October 2022
[13] U.S. Bureau of Labor Statistics, 30 September 2022
[14] Office for National Statistics, 14 September 2022
[15] Eurostat, 30 September 2022
[16] BBC News, 21 September 2022
[17] Bank of England, 30 September 2022
[18] European Central Bank, 13 September 2022
[19] Morningstar, 3 October 2022
[20] Reuters, 30 September 2022
[21] New York Times, 3 October 2022
[22] Reuters, 29 September 2022
[23] Statista, 13 October 2022
[24] The Guardian, 7 September 2022
[25] OECD, 26 September 2022
[26] Financial News, 30 September 2022
[27] The Guardian, 30 September 2022
[28] GFK, 30 September 2022
[29] International Monetary Fund, 31 July 2022
[30] Forbes, 30 September 2022
[31] U.S. Bureau of Labor Statistics, 7 October 2022
[32] Deloitte, 26 September 2022
[33] Trading Economics, 30 September 2022
[34] Next Advisor, 26 September 2022