Week in Review

Friday, July 22nd, 2022

1. Investor Sentiment at Trough Levels

According to Bank of America's latest fund manager survey, institutional investor sentiment is at a trough level and eclipsing levels seen following the bankruptcy of Lehman Brothers during the financial crisis in the fall of 2008. The current negative sentiment has resulted in investors indicating they have slashed exposure to risk assets resulting in lower allocation to stocks and surging allocations to cash.

Investor Risk Asset Exposure

Driving the pessimism of investors is a dire economic outlook. Global growth and profit expectations sank to an all-time low in the survey. Additionally, recession expectations rose to their highest level since the COVID pandemic spiked unemployment and business closures in the spring of 2020.

Global Profit Optimism

Source: BofA Global Fund Manager Survey

The survey found that the greatest concerns were high inflation followed by a global recession, hawkish central bank policy, and a systemic credit risk event. However, the survey also found that most investors believe that inflation will be lower next year and be accompanied by lower interest rates. The combination of maximum pessimism, yet belief rates could prospectively be lower, has set the basis for a contrarian relief rally, demonstrating optimism that peak inflation and peak rate increases may be just around the corner.

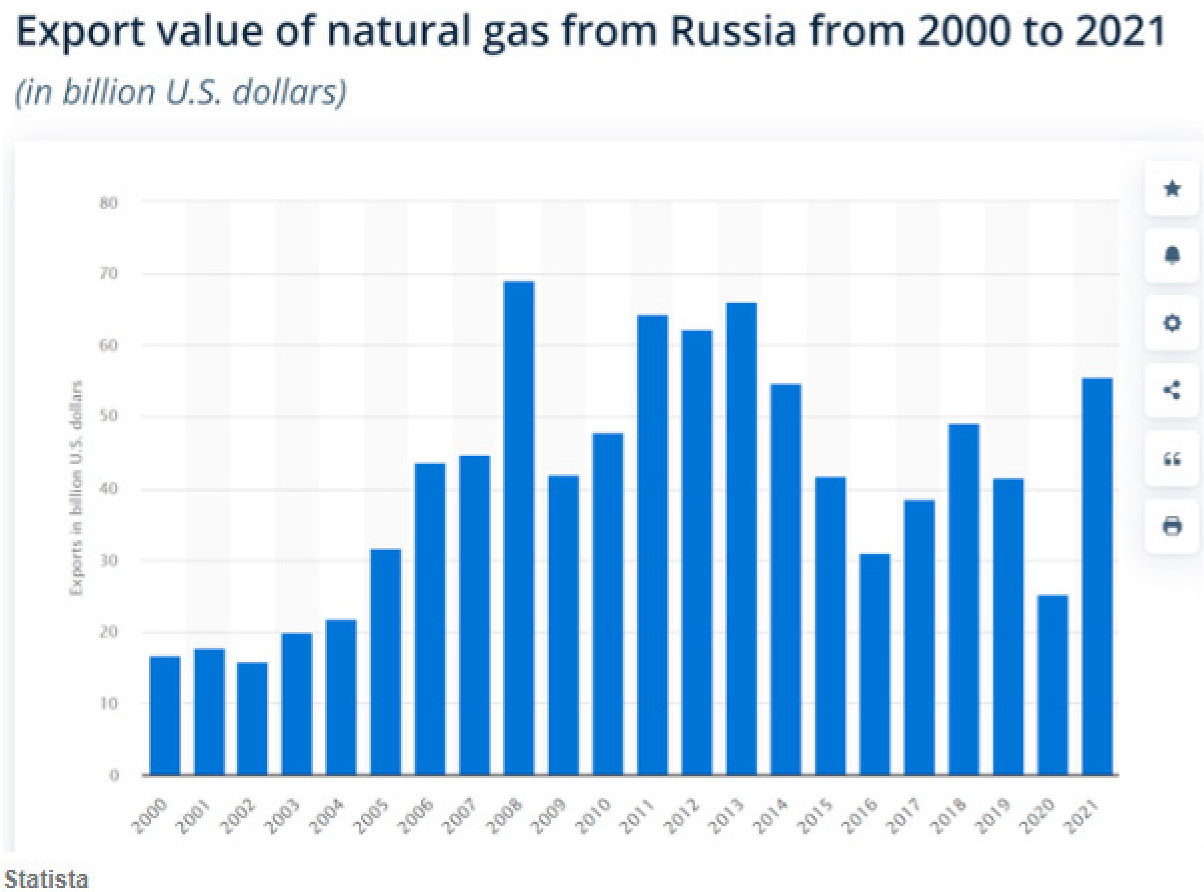
Longer term, strong positive returns a year out has been correlated following troughs in negative investor sentiment. However, in the near term, the market environment may well continue to be volatile as current hot inflation, geopolitical tensions, and increased risk of recession are still set to play out – but at least these concerns appear to be well anticipated based on sentiment.

2. Mounting Energy Concerns Further Headwinds for Europe

The main artery for Russian gas to European Union, otherwise known as Nord Stream 1, has been offline for most of the past two weeks due to pre-scheduled annual maintenance. However, many Western nations are growing concerned that Moscow could permanently turn off the flows, which are used in everything from heating and cooking to electricity and power generation. Russia supplies the block with 40% of its natural gas imports, and in nations like Germany, that figure is as high as 60%.

Putin has said that the gas will be brought back online this week but even his statement suggested that volume would remain curtailed. With limited inventories and alternatives, the risk is elevated that there could be severe shortages as the year goes on and for next winter. This has made the prospect for mandated demand destruction with the European Union telling members to cut gas usage by 15% starting in August. Mandated demand destruction would likely fall largely on industrial use, prompting further slowing in the economy.

For Russia, this would also mean a loss of revenue. Unlike oil, there are few alternative end markets for Russian natural gas that runs through the Nord Stream given the need for pipelines and the location of the gas fields.



For Europe, it is expected that efforts to source natural gas will turn away from Russia longer-term, with more gas linked to Europe from places such as North Africa and by building or expanding more liquified natural gas (LNG) terminals to receive gas from further afield such as the U.S.

Thinking Ahead

The earnings season is just kicking off, and investors are concerned about disappointments, guidance and signs that margins are compressing further. So far, the reactions to early reporters have been relatively muted as earnings and outlooks have at least met relatively low expectations. Record low sentiment is likely supportive of equities for the time being if substantial cuts to forward earnings do not materialize, which has yet to occur. Inflation, growth, and geopolitical risks continue to exist. For Europe, the future of Nord Stream gas pipeline ticks the box for all these concerns.

Pallas Capital Advisors will continue to monitor economic, political, and corporate data for implications to markets.