

# Investment Views



JULY 2022

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Strategy:

# From Inflation Risk to Recession Risk

Fixed Income:

# Another Tough Quarter

Equities:

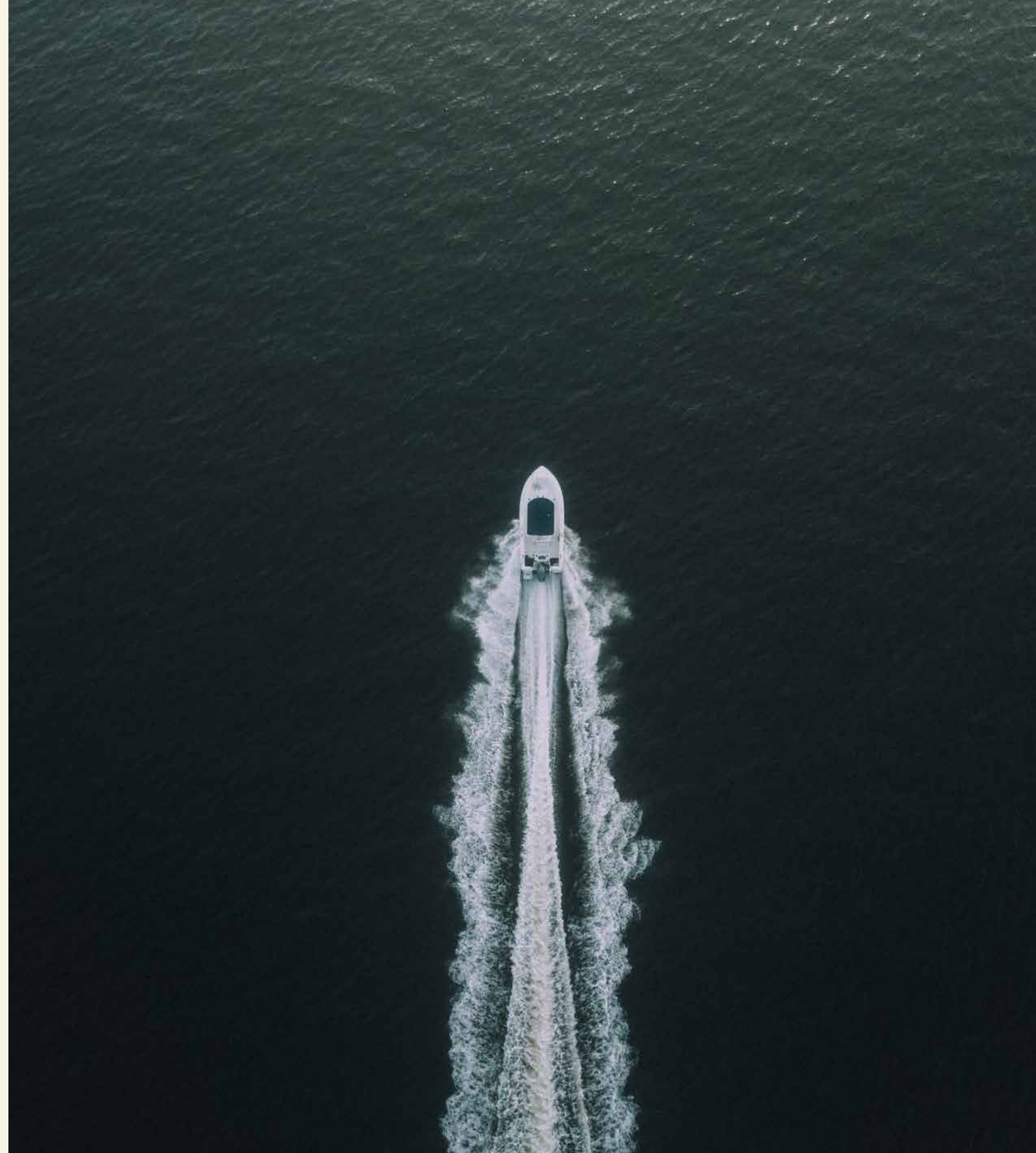
# The Fed and Inflation Inflict Pain



# From Inflation Risk to Recession Risk

The second quarter of 2022 was particularly difficult for financial markets after an already tough start to the year. Markets struggled as central banks responded forcefully to elevated inflation by increasing interest rates, while also removing monetary stimulus.

Inflation rates looked to be peaking towards the end of the first quarter. However, the Russia-Ukraine conflict came at the worst possible time and caused a commodity price shock when post-pandemic inflation pressures were already elevated. This combination of inflation and higher interest rates has been negative for both bonds and equities, the core building blocks of most investment portfolios.



For developed market equities it has been the worst first half of a year since 1970, when the US fell into recession after a long period of strong economic growth. Global equities fell -16.2% in US dollar terms over the quarter and there were few places to hide as European equities fell -14.8%, while UK equities and Emerging Market equities held up marginally better returning -10.1% and -11.5% respectively. At a sector level, the traditionally more defensive sectors like Consumer Staples, Health Care and Utilities outperformed, returning between -6% and -7%, while the Energy sector also outperformed as oil prices climbed higher.

One of the unusual features of this equity market sell-off has been that corporate earnings growth estimates have continued to rise. The return of the S&P 500 index can be split into corporate earnings and the multiple attached to that stream of earnings. Over the first six months of the year, earnings estimates have actually increased by around 6.7%, whereas the price/earnings (P/E) multiple has contracted by a huge -27.3%. This de-rating has been painful for investors; however, these lower valuations bode well for potential forward-looking returns.

With equities struggling as inflation and tighter monetary policy hit valuation multiples, bond markets were also negatively impacted by the same factors. For much of the last 20 years, there has been a negative correlation between bonds and equities. In broad terms, when growth has been good equities would do well and bonds poorly and, typically, the reverse would be the case in periods when growth was weak. This is because the global economy has had a disinflationary bias, particularly when it comes to durable goods. Globalisation has played a key role in this, especially since 2000 when China joined the World Trade Organization; lots of new low-wage, productive workers meant the world could produce more at lower costs. This backdrop was very supportive for financial markets, but this year has seen the reverse because of the return of inflation.

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# -16.2%

The amount Global equities fell in US dollar terms over the quarter.

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# -27.3%

The amount the price/earnings (P/E) multiple contracted over the first six months of the year

One of the unusual features of this equity market sell-off has been that corporate earnings growth estimates have continued to rise.





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# 6.7%

Earnings estimates have increased over the first six months of the year.

## STRATEGY

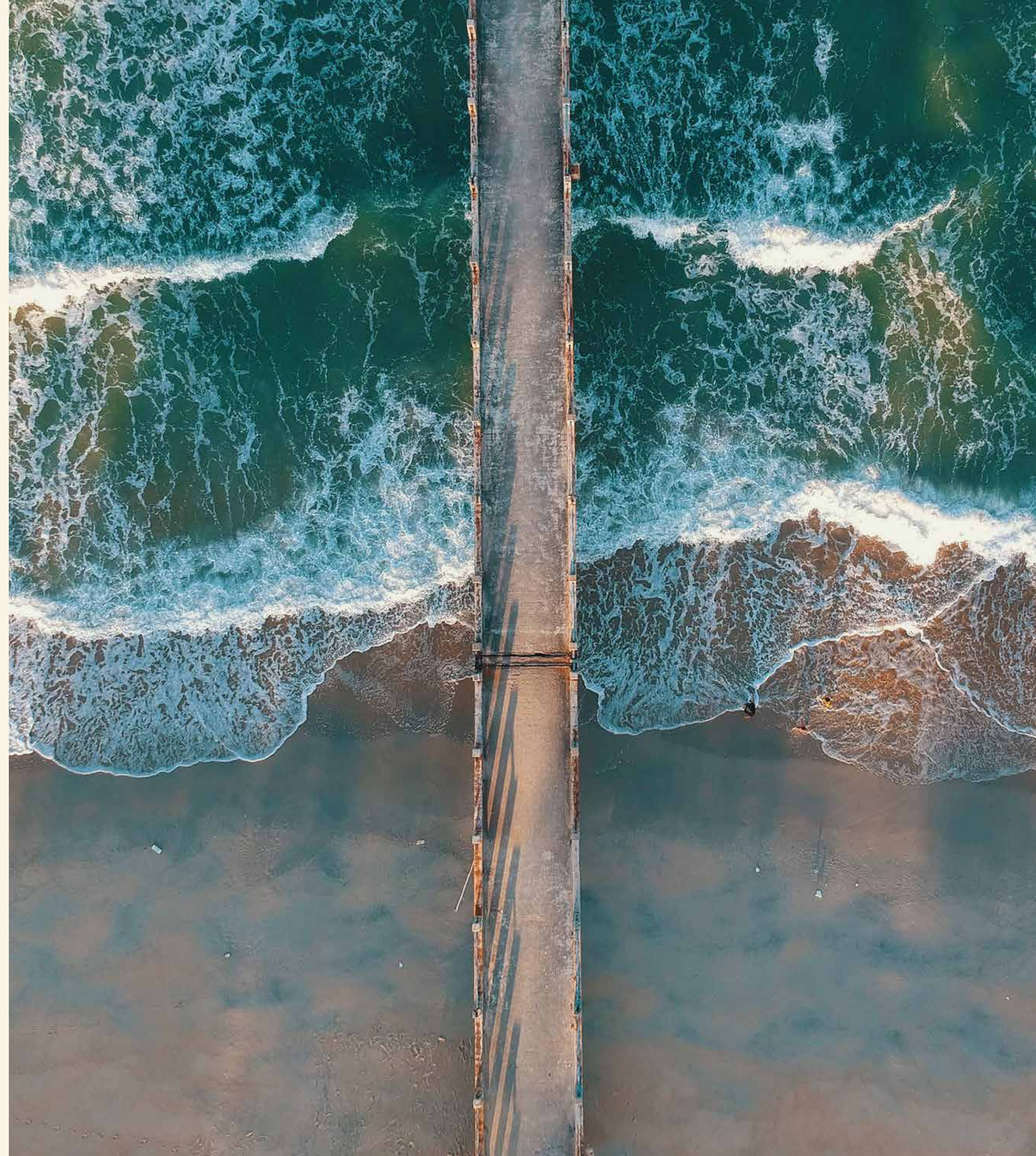
Over recent months, we have taken a number of steps to make portfolios more defensive. While we haven't sold equities, we have refrained from rebalancing portfolios as the equity exposure has drifted below benchmark weights. Allowing equity weightings to drift underweight has been a conscious decision and has been beneficial in a market trending downwards. At a sector level, we reduced exposure to the more cyclical Consumer Discretionary sector and increased exposure to the more defensive Consumer Staples sector in the first quarter. Furthermore, we increased our Health Care exposure to overweight as it has historically been a defensive sector in periods of economic turbulence.

We started the year with an overweight position in the Financials sector based on the outlook for higher interest rates and solid economic growth, however as the risks increased we pared this back. With inflation elevated, our commodity exposure acted as a good hedge during April and May, but gave back some gains during June as the focus turned from inflation concerns to growth concerns. During the quarter we reduced our exposure to more cyclical commodities and added exposure to agricultural commodities, which helps hedge against the risk that global food prices continue to rise.



# Another Tough Quarter

The second quarter followed the same theme as the first. Fixed Income markets remained under severe pressure from an aggressive Federal Reserve with a laser focus on reigning in inflation. With little sign that headline or core inflation pressures are abating, and with consumers' longer term inflation expectations remaining firm, policy makers have guided the market for the fastest pace of monetary policy tightening in decades. Following the recent 75 basis points (bps) increase in the US base rate in June, the market now expects the base rate to reach 3.50% by the end of 2022. As a result, global bond yields have increased even further with the entire US yield curve rising by over 70bps and the risk-free US two-year Treasury now yielding over 3%.





The implications of these moves in global yields cannot be underestimated and the global economy is now the closest to outright recession since March 2020. Consumers are under attack from rapidly rising borrowing costs, some of the highest energy prices on record (US gas prices approach \$5 per gallon) and governments looking to rein in bloated fiscal deficits post COVID-19. While on the surface the economy appears relatively solid, there is a shift under the surface and a transition from growth and elevated inflation to recession appears to be underway. With their recent messaging, the Federal Reserve is regaining some credibility and real yields have risen across the world. Market-based inflation expectations have fallen, with the 10-year inflation breakeven yield falling below 2.5% in June, while US 30-year mortgage rates have risen above 6%. This is the highest borrowing rate since 2007, reducing affordability and contributing to a slowdown in the housing market, which is a leading indicator for the broad economy. While real estate prices remain elevated, there are signs that the market is rapidly contracting as mortgage applications plunge, and new and existing home sales decline. This is before the large inventory of new housing units under construction come to market. Higher borrowing rates are also flowing through into auto loans and credit card debt; a concerning development with unsecured borrowing rising dramatically this year.

Outside of the US, every major economic region apart from Japan saw weak and disappointing economic data releases in Q2, with China and Europe showing signs of a rapid slowdown. A recession in Europe is now a high probability event this year. There is also rising risk of a repeat of the 2012 Euro zone crisis as bond yields for the weaker members rise to unsustainable levels. Italian 10-year government bond yields (with debt to GDP now over 150%) have risen from 0.5% to 4% over the past 12 months and this has forced the European Central Bank to design a new “anti-fragmentation instrument” to help cap the rise in borrowing costs.

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\$5

The amount per gallon that US gas prices approached this year.

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-30%

Lumber prices decreased over the quarter

Although economic activity is clearly slowing, we have yet to see signs of a sustainable reduction in inflation pressures. Recently, there are increasing signs of disinflation, with Copper and Lumber prices down over -20% and -30% over the quarter. However, the world will likely have a headline inflation problem for some time yet as energy and food prices remain firm due to supply constraints.

As we enter the third quarter, positioning remains neutral interest rate duration across the curve as we feel it is unlikely the Federal Reserve will need to raise the base rate above what is already currently priced into the bond market. The carry (income) available now on short dated risk-free US Treasuries more than compensates us for most realistic tail risks. Currency markets remain very volatile with the US dollar broadly strengthening over the quarter and we witnessed a huge weakening in the Japanese Yen (-12% vs USD) as the Bank of Japan bucks the global trend towards monetary tightening.

## A recession in Europe is now a high probability event this year.

In corporate credit, we remain neutral but acknowledge that spreads now look attractive. Before we increase exposure, we would need to see a stabilisation in global economic activity and/or a much more dovish Federal Reserve; both of these triggers are not in place at this time and in fact they are both moving in the opposite direction. In Emerging Markets and High Yield, with yields now above 7%, the asset classes look tempting and will potentially be one of the first places we deploy capital this year once monetary policy stabilises.



# The Fed and Inflation Inflict Pain

Global equity markets continued their decline in June, finishing the month down -8.7%, the quarter -16.2%, and the first half of the year -20.5%. Emerging Markets held up marginally better than Developed Markets in all three periods.

With inflation continuing to exceed expectations, the US Fed Reserve has shifted its focus away from supporting growth and employment to fighting inflation. This has meant central banks have been forced to tighten financial conditions, which unfortunately inflicts a level of pain on financial markets, particularly equities.







## EQUITIES

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# 15.9x

The S&P 500 Forward P/E ratio declined from 21.4x earnings at the market peak in the beginning of the year.

The widely followed S&P 500 Forward P/E ratio declined from a lofty 21.4x earnings at the market peak in the beginning of the year to a more reasonable 15.9x at June 30, slightly below its 25-year average of 16.8x. While market valuations now appear cheaper, it's worth bearing in mind these valuations are lower because prices have fallen without a decline in consensus earnings expectations. As the probability and magnitude of an economic slowdown increases, so too does the likelihood of downward revisions to analysts' earnings expectations. If forward earnings expectations are lowered, valuations will not appear as cheap. Note also that other valuation metrics including Price to Book, Price to Cash Flow, Shiller's P/E and Dividend Yield remained above their 25-year averages at quarter end.

The challenging economic backdrop makes it difficult for analysts to estimate corporate earnings and for companies to help provide earnings guidance to the market. Analyst earnings estimates have been too low over the past couple of years as government and central bank stimulus provided a strong tailwind to corporate profits throughout the pandemic. This helps to explain why analysts have been reluctant to cut earnings estimates aggressively. Furthermore, companies are reticent to provide guidance when the level of uncertainty is so high. Stuart Miller, executive chairman of US homebuilder Lennar, recently called it a "complicated moment in the market." While the company stuck to its previous forecast for deliveries of about 68,000 homes this year, he described current attempts at guidance as tantamount to "guessing" and not "guiding". On the flipside, very strong upward revisions to earnings estimates in the Energy sector have helped to offset weakness in other sectors. Earnings for this year in the Energy sector were revised 33% higher during the second quarter and earnings in the sector are now estimated to grow by 127% compared to 2021.

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# 127%

The amount energy sector earnings are estimated to grow compared to 2021.



## EQUITIES

Most of the equity market decline since the beginning of the year is attributable to higher discount rates due to rising bond yields. The largest sector in the benchmark by market capitalisation, Information Technology, is down -30% and includes many US companies with relatively high valuations based on high earnings projections over long term horizons. Many unprofitable, emerging technology stocks are more than -50% below their 2021 peaks. The two other sectors in developed markets with roughly -30% declines are Consumer Discretionary and Communications Services, which similarly include companies with longer earnings horizons such as Amazon, Tesla, Meta (Facebook) and Netflix. Sectors with better expected near-term earnings have outperformed, most notably Energy which is +25% in the first half of the year and Consumer Staples which has held up better than the market at -9.4%.

In recent cycles, inflation has been low and the Fed eased rates to support economic recovery as the economy weakened. This time, the Fed is constrained by unacceptably high inflation so it will need to maintain tighter policy for longer. As they showed in the first half of the year, the Fed remains relatively relaxed about falling asset prices as inflation is now their top priority. In a slowing economy with the Fed aimed at reducing inflation, defensive positioning and thoughtful security selection remains appropriate.

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# -50%

Many emerging technology stocks are below their 2021 peaks.

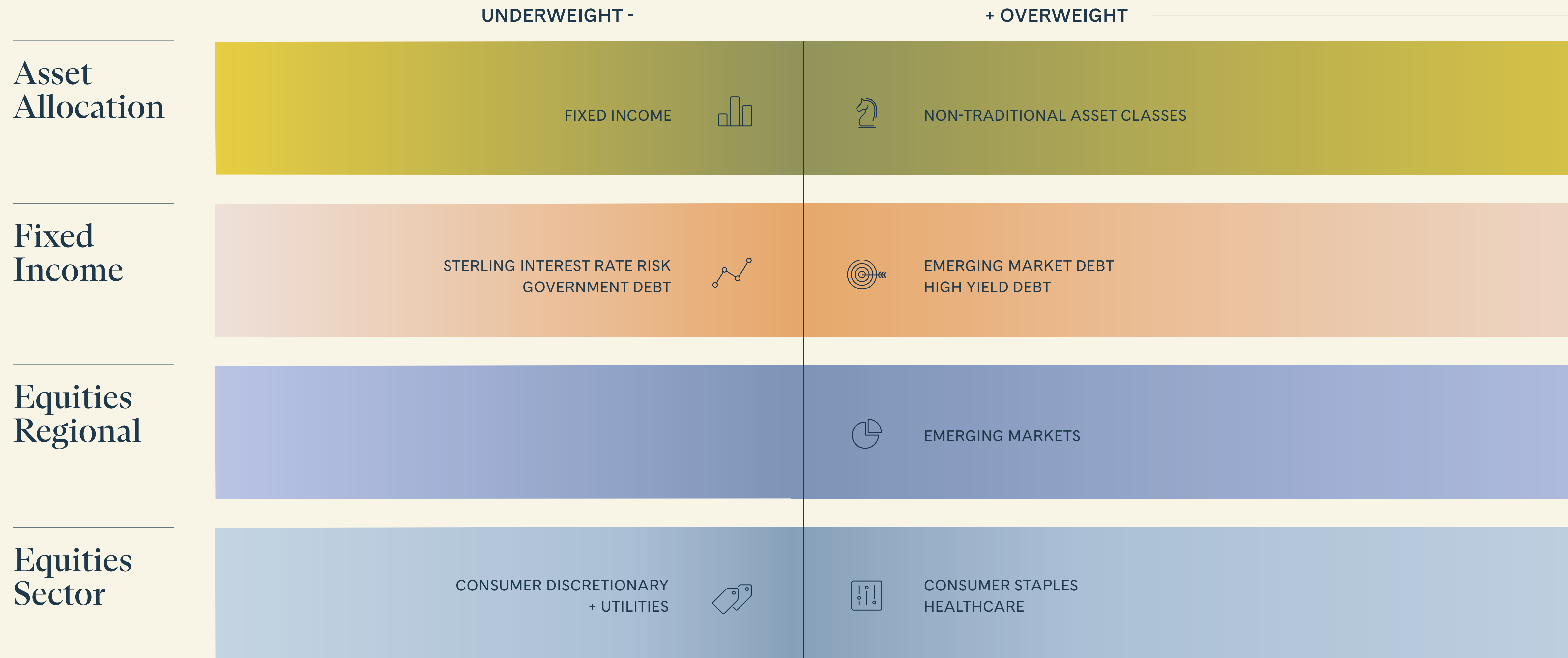
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# Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy





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