A Shift of Focus to Global Growth

Richard Harris | October 2022

Investors have had many themes to focus on in 2022. Inflationary pressures, unprecedented Central Bank rate hikes, supply chain issues, an energy crisis, economic instability, and to top it all off, a war which has further complicated navigation of an already difficult environment.

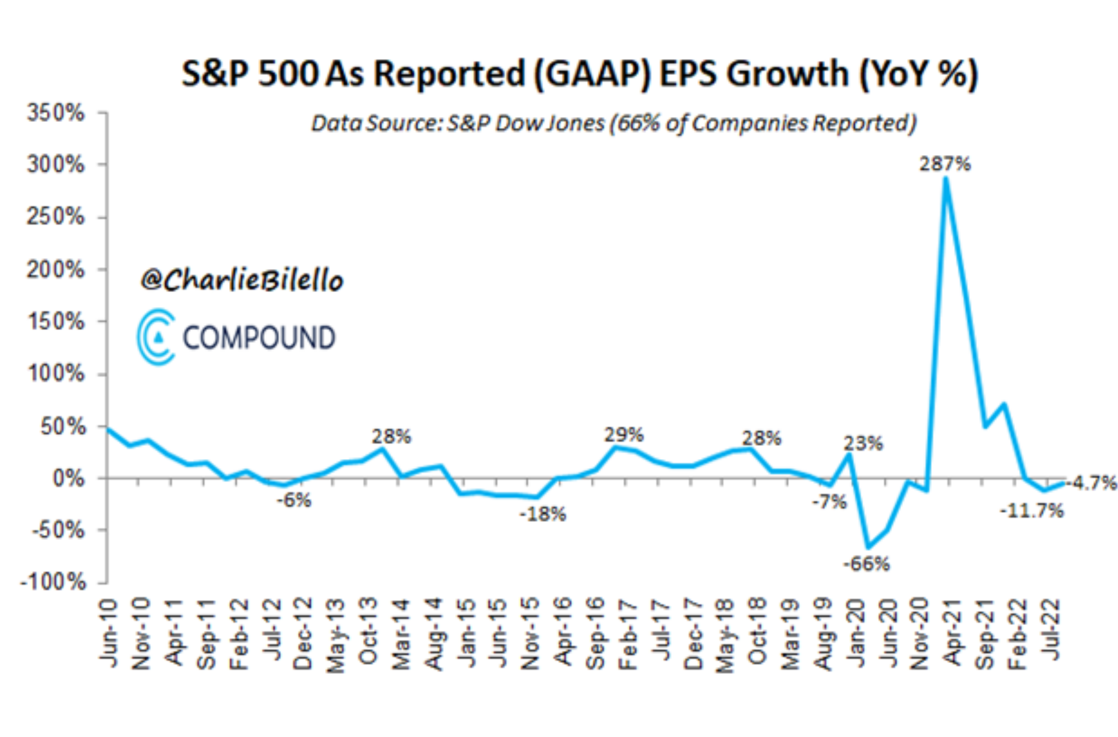
Those that have had exposure to markets this year will describe the difficulty of navigating asset allocation year-to-date. It has been a period where patience has ultimately paid off. With Global markets now down between 20% and 30%, many are wondering if prices have indeed bottomed, and are trying to forecast the path forward from here.

One thing that investors don't seem to be paying enough attention to, or perhaps turning a blind eye to, is that when Central Banks impose such aggressive tightening measures, there is often a lag-time between policy implementation and its effect on the consumer. The liquidity that was injected into the system to help economies battle the effects of COVID is now being withdrawn and we have yet to see how this scenario plays out. Based on the dramatic rise in Equity and Fixed Income valuations since 2020, one could expect further market normalisation as these forces take effect (the S&P 500 is still 16% above its pre-COVID highs of 3400 and 72% above its pre-COVID lows of 2250).

Of late, investors and traders have been trying to predict the market bottom by putting capital to use with the belief that Central Banks are likely to "pivot" and once again turn on the printing press while keeping interest rates low. The Quantitative Easing (QE) over the last decade has essentially been the fuel for the Bull market and asset prices have soared as a result. We are, however, now facing a new regime where inflation is prominent and Sovereign debt levels extreme. These two forces are likely to restrict the ability of Central Banks to inject market liquidity, once again, as a measure of last resort.

We outlined in our May newsletter what happens to Equity valuations when earnings start to show signs of deterioration, particularly when they have been trading at high multiples.

Over the last 2 weeks, we have seen a flurry of US companies report on earnings and despite most showing resilience for the time being, almost all have pointed to tougher conditions ahead as the effects of monetary tightening are felt by the consumer. The graph below shows that Earnings Per Share (EPS) growth is now negative year-over-year with two thirds of US companies already reporting.



The most important question over the next 2-3 years remains; is the consumer likely to get stronger or weaker from here?

As discussed above, companies have already guided to deteriorating conditions in the coming quarters and Macroeconomic data is also showing signs of slowing, with housing, manufacturing, GDP, and investor confidence all printing lower in recent months. Employment has been somewhat resilient up until now, but this is largely based on a lower total workforce post the pandemic and higher wages that companies have had to offer to counter inflationary pressures. The Federal Reserve is targeting high inflation by actively seeking to destruct consumer demand and this is ultimately achieved by reducing strength in employment metrics. These measures will likely play out over the coming year and as a result, the consumer in general is likely to come under further pressure.

It is true that markets are forward pricing and past evidence points to the fact that they usually bottom three quarters into a recession, however, we need to remain vigilant when trying to time market cycles especially after poor commentary from Central Bank officials and big corporates; there may be more pain to come before the storm passes. Current forces aiding geopolitical tensions and de-globalisation also contribute to uncertainty in the coming years.

Although current market conditions are uncomfortable, opportunities are created through uncertainty and despite a fairly negative backdrop, active asset management is likely to play a larger role than ever in the coming years. It is important that we continue to monitor Macroeconomic data points closely as they will ultimately lead decisions made by Central Bankers.

Over the past month or two, it seems that bad news/data has been positive for markets (as investors have expected Central Banks to "pivot") and good news/data has been perceived as negative for markets (as investors expect this to allow Central Bankers further ability to tighten). This can change at any point in time, especially if we enter into a full-blown recession while the world is still fighting the effects of high inflation.

Market Review

October saw strong gains across most major indexes as market participants tried to price in a potential Federal Reserve "pivot" and other Central Banks pointed to more gradual hikes going forward. This notion was once again silenced on Wednesday when Federal Reserve Chair, Jerome Powell, told journalists that they are expecting rates to be higher than previously forecast and that in order for demand destruction to occur, asset prices need to come lower. This sent US markets 2-3% lower on the day.

Of the Developed Market (DM) indexes, the Dow Jones industrial average led the way in October, rising a whopping 12%, followed by the German DAX (+9.5%). The local Top 40 climbed higher by 5.5%. China's CSI300 and Hong Kong's Hang Seng index once again received the wooden spoon down 3.3% and 8.1% respectively, even after decent month-end rallies. This came on the back of Chinese President, Xi Jinping, being re-elected for a third successive term and the fact that his cabinet reshuffle was seen as less favourable toward relations with the West. On top of this, continued COVID lockdowns did not aid Equity performance.

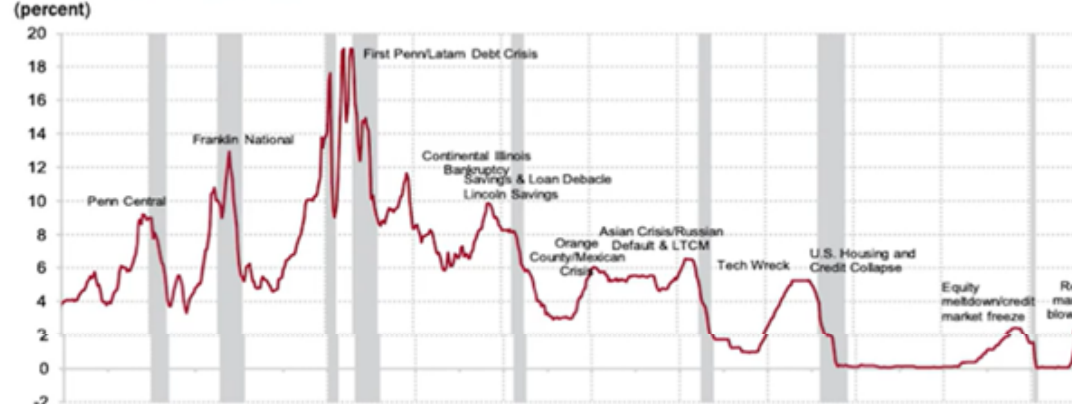
Commodities were mixed in October with Oil prices increasing as investors priced the refilling of US strategic reserves post the mid-term elections; however, natural gas prices went lower with Europe experiencing a warmer start to winter than expected. Gold and Silver prices hovered around flatline for the month.

We will be paying close attention to the results of the Mid-term election in November, along with employment and inflation prints that are likely to be market moving data points.

Our market outlook, both locally and offshore, remains cautious as we continue to monitor ongoing global developments and commentary from Central Banks. We remain defensively positioned with maximum offshore exposure and relatively high levels of cash and defensive allocations among our portfolios. Although we believe that there is more volatility to come, we have started deploying capital to certain opportunities and will look to deploy further into higher return (alpha) generating investments that offer adequate risk-adjusted returns at favourable entry points in the near future.

Chart of the month:

The chart below shows the historical time lag of monetary hiking on recessions. You can see that recessions often occur a few months after the Federal Reserve pauses or even starts cutting "pivots" as the effects of tightening are felt by economies. We are currently in unchartered territory but based on the chart below, it is likely that the true recession impacts will be felt in 2023 and 2024. (Shaded areas indicate recession).



"Price is what you pay. Value is what you get" - Warren Buffet