Monthly market blueprint

Investment management service

July 2022

mazars

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Foreword
Have we seen the worst of it?

We find ourselves in the midst of a once-in-a-decade paradigm shift for financial markets and the global economy.

Is this a time to be adding to risk?

There is always a point of capitulation for stocks and bonds, a place where a rout becomes opportunity. While we acknowledge that, in our quarterly investment committee we felt that this was not a good time to increase risks despite lower equity valuations and higher bond yields. Downside risk is still significant. The confluence of quantitative tightening, rising rates and an economic slowdown, contributes to the possible emergence of second order risks and dislocations currently not on the radar. Additionally we feel that equity valuations, while reduced, are still above their very long term average.

Instead, we focused on our bond exposure. We reduced our underweight in bonds, as we feel that bond yields are becoming more attractive. Our overall position is still an underweight one, with low duration risk, but at this point we felt that we needed to take some profit from this underweight and not try to exactly time the market turnaround.

The investment committee feels that the 'Fed Put', an unofficial pledge by the Fed that it will support risk assets, is still in effect. After all, the Fed has not proceeded with any significant removal of liquidity, via Quantitative Tightening just yet. So while it tries to curb inflation, its movements (or lack thereof) in the asset market may be betraying its true nature: that of a market-friendly monetary dove. Where is that Fed Put? It could be significantly lower, perhaps when the S&P 500 breaks the 3000 point limit. At current projected earnings, this would be near the traditional capitulation point for equities. Or the Put may be more relevant to the bond market. The Fed could intervene with more liquidity if it sees significant dislocations in the credit space.

George Lagarias
Chief Economist, UK

However, until markets gain a clear upward direction again, we remain strategically cautious. We feel that this is not the time for complexity, risk or leverage. It is not the time to try and guess when the situation will reverse itself. It is a time of caution, diversification, liquidity and patience. Our long-term views remain flexible, as we don't know what the world will look like in a few years. But we do know this: every decade in the past fifty years features some sort of capitalistic crisis and in each and every situation, capitalism successfully reinvented itself.

Despite the volatility, we feel that investors should stick to long-term principles. They should still adhere to their risk profiles and trust that investing for at least 10 years in a diversified portfolio, at any given moment in time - even the worst of times, has very few probabilities of absolute loss, around 1.5%. The probability tends to zero after a loss such as the one we are experiencing.

The month in review

June marks the end of a challenging first half of 2022. The downward trend in asset prices continued.

June capped an abysmal first half of the year for risk assets. The US market entered a formal correction, falling more than 20%, and US equities endured their worst first half of the year since 1970.

For the month of June, US stocks fell by -8.3%. The best performing sectors were consumer staples and healthcare, which benefitted from their defensive characteristics, while the cyclical sectors of materials and homebuilding suffered the most. Despite the sharp fall in equities in 2022, PE ratios remain above their long-term averages indicating they are not yet offering "good value".

European stocks fell by -7% . The highest performing sectors were healthcare and telecoms while the worst performers were materials and automotive.

In the UK, equities performed well relative Europe and the US, despite falling -5.5%. Again it was the defensive sectors that did best, healthcare and telecoms. Energy and housebuilders performed worst among sectors as recession fears and higher interest rates weighted on their performance.

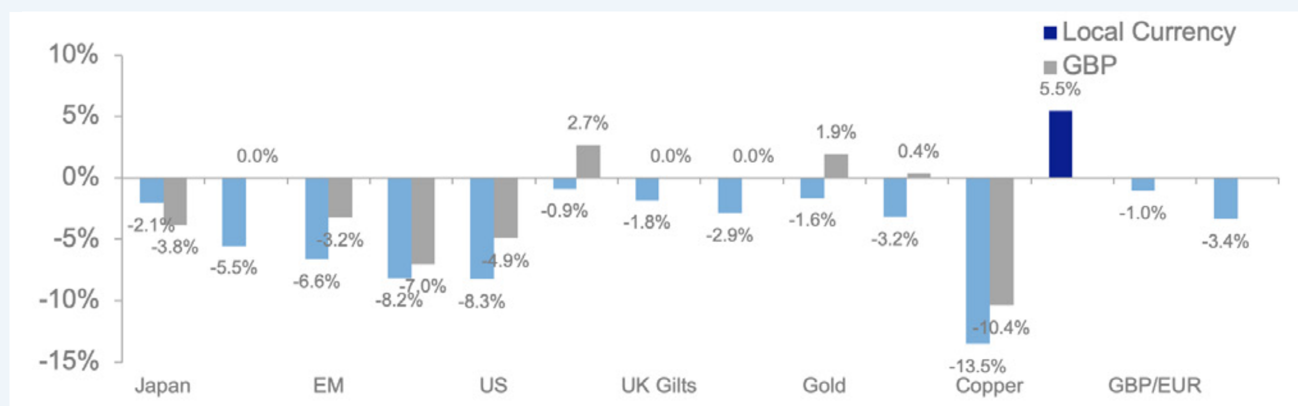
Meanwhile, Japan was the best performing of the developed regions, falling by -3.8%, as lower inflation means that the Bank of Japan may yet be some time away from raising interest rates. This creates downward pressure on the Yen, which is a boon to the export-led economy.

Bonds continued their downward slide and did not offer any hedging benefits to volatile equities, although the difference between yields at the beginning and end of the month does not reflect the swing seen during the month. The sell-off was greater in the middle of the month but as recessionary fears grew, prices regained some ground. US 10-year government bonds rose +17bps to 3.01%. UK 10-year government bonds rose +13bps to 2.23%, German 10-year government bunds rose +21bps to 1.34%.

Gold remained in the same territory as it has been all year, rising +1.9%, in spite of volatile equity markets and rising inflation in developed markets. Copper, however fell sharply as concerns about growth forced demand expectations for the economically-sensitive metal down.

Sterling weakened 1% against the Euro and 3.4% against the US Dollar as investors fear the UK economy may suffer from more persistent inflation than other developed markets.

Basic asset classes



Charts Source: Mazars Calculations

Asset allocation

Changes in our Strategic Asset Allocation

Asset Class	Stance	Comment
Equities	Neutral	We believe equity volatility will continue throughout the year. However, we also see the post-Covid recovery continuing and therefore keep equity weight at neutral to participate in economic growth. Within our equity allocation we include positions in value equities and dividend paying stocks in order to tilt the portfolio away from the sectors more sensitive to economic growth and rising interest rates.
Fixed Income	Underweight	We believe that the bond re-rating has further to go. Interest rates will continue to rise and inflation may persist for at least Q3. Fixed income has limited scope to provide its hedging benefits to equities within a portfolio. We are particularly underweight investment grade corporate bonds which offer little protection against rising rates and inflation.
Alternatives	Overweight	Given that we are in a central bank tightening cycle and equity market valuations remain elevated we see an overweight to alternatives as a suitable hedge within portfolios. We express this through overweight positions in gold, infrastructure and asset backed securities.

Outlook and portfolios

At the end of June our Investment Committee convened to decide the asset allocation for the third quarter. There were no changes to asset allocation however some duration has been restored to the fixed income allocation. We continue to hold a neutral position in equities, an underweight position in fixed income and an overweight position in alternatives.

Inflation remained at the centre of the discussion, and how far central banks are must go to curb it. With the tightening of policy, risks around European debt levels and solvency appear and the risk supply chains remain gnarled but there are some signs that pressures are easing.

In Q2 we expected that the narrative around recession would increase, which it has. Now we expect that a key turning point will be when inflation becomes a secondary concern to growth and there is less pressure on central banks to raise interest rates. At this point the market will have a clearer picture around when to expect the end of this current tightening cycle and may even expect some easing of policy. At this point we may see some risk returning to markets.

While there is no shortage of bad news in the market, we are closely watching investor sentiment. Investor sentiment has reduced to levels not seen even during the lows of the pandemic and is a contrarian signal, so any improvement in news will improve investor sentiment and stabilise markets.

Within our allocation to equities we are satisfied with our neutral allocation and the defensive makeup of our equities, favouring quality income and value companies. We do not think that this is the time to add more equity exposure, but we continue to watch out for signals to increase the allocation, including recession risk eclipsing inflation fears and investor capitulation.

We have held an underweight allocation in fixed income since before the pandemic, and within that allocation there was an underweight duration position. The Investment Committee elected to increase duration by reducing our allocation to short duration credit. We feel that as yields have risen with rising interest rates, the role of fixed income is somewhat restored as a hedge against equity market volatility.

2022 is another year of great uncertainty and a wide variety of outcomes, the third in a row. High inflation and central bank hawkishness squeeze real disposable incomes and increase the possibility of a second global recession, a year after the recovery has started. Global supply chains, which were under pressure even before the war, are now facing another shock.

The top risks we are monitoring are

Persisting inflation and a global recession: Inflation pressures are set to persist in the next few months at least. This should keep central banks hawkish and increasing interest rates, further suppressing the economic recovery. Persisting inflation also reduces disposable income, reducing consumption and further hindering growth.

China: China is still attempting to transition from the manufacturing to the services sector. At the same time it is trying to hyper-regulate businesses in a bid to stop their interests from directing long-term state policy. A Chinese recession would reverberate across the globe.

European Cohesion: The Euro is the market's weaker point. It was imperiled and almost ended right after the previous financial crisis. It could do so again. Currently, the ECB faces a conundrum. It is attempting to hike rates to strengthen the currency, and at the same time protect its weakest members from an attack on their debt.

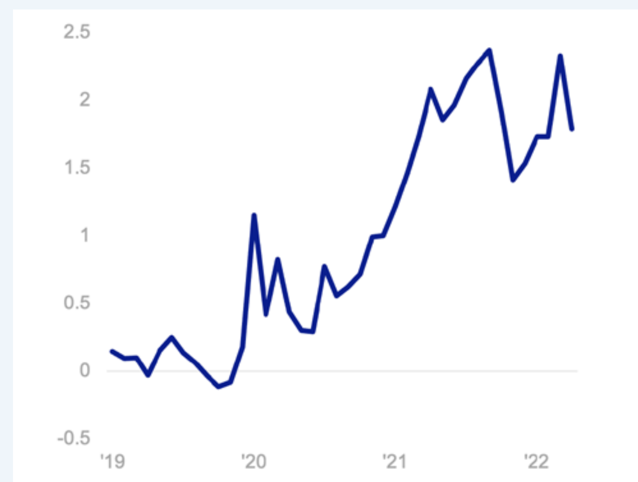
Bond market dislocations. We are already observing some (expected) dislocations in the high yield space, as well as rising dangers in the European periphery. Central banks have long dominated certain corners of the bond market and priced out private and bank trading desks. Now that they retract liquidity, organisations and even nations who learned to depend on them will find themselves faced with steep funding cost rises and concomitantly rising risks.

The Fed's focus on inflation means that all the above risks could have a bigger impact on risk markets than previous years. We now begin to doubt even the core investing theme in the past 22 years, the Fed Put. Simply put, the central bank safety net for markets is not that certain anymore. Priced in, this could significantly elevate risks.

We expect macroeconomic and market volatility to last well into 2023.

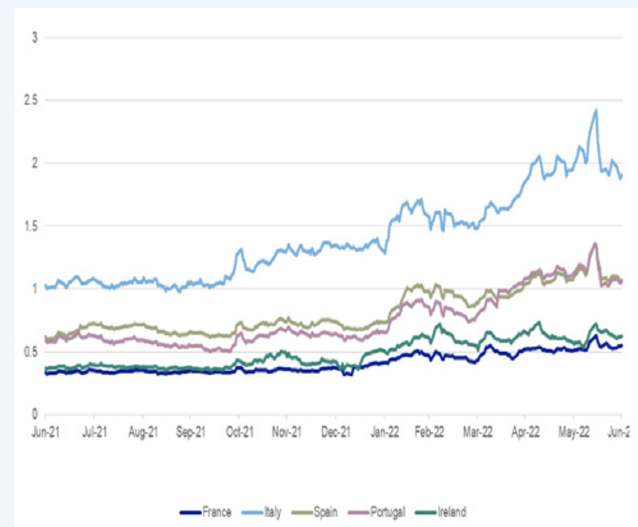
Supply chain pressures are re-intensifying

Z-score of eight key supply indicators



European Spreads rising, a sign of Euro stress

10y Spreads with Germany



Charts source: Mazars Calculations, Bloomberg

Global

Volatility persists for the global economy, as inflation and rising rates have dented the post-pandemic recovery and continue to slow growth. The next months are shaping to be difficult and volatile. Economic and financial visibility continues to be virtually non-existent, a fact not lost on business leaders.

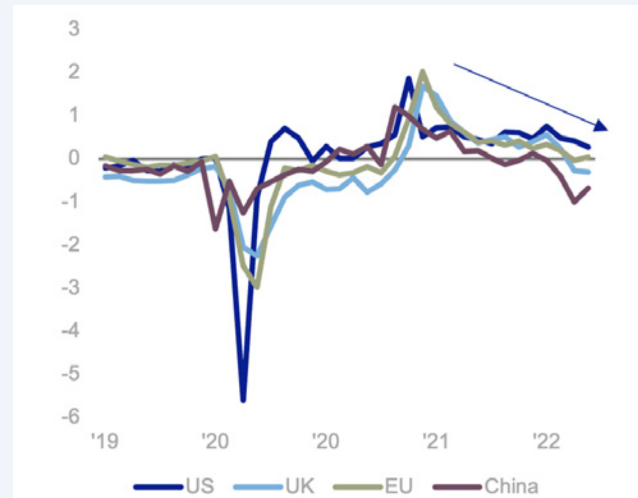
Market Performance: For the period, global stocks fell by 8.7% (6.5% in GBP). The highest performing sectors were Healthcare and Cons. Staples while the worst performers were Materials and Energy. Equities were trading at 14.92x times forward Gold fell 1.6% and oil prices fell 7.8%.

The global economy: Inflation is resilient and exacerbated by the war in Ukraine, which will likely drag on, despite some easing in input prices. As a result of persistently high prices, wage pressures in Developed Markets intensify, prompting central banks to tighten the supply of money. It remains debatable whether headline GDP in most developed markets will fall enough in 2022 and 2023 to technically qualify as a "recession". Nevertheless, the point is moot. Many consumers are already seeing higher energy prices and overall inflation squeezing their real incomes. Business and consumer surveys across the globe paint a picture of pessimism.
As a result, we are seeing significant reduction in expenditure, especially from marginal consumers.
At the same time, China is recovering from a lockdown period, and leadership is gearing up to significantly increase economic stimulus. Despite the short and medium term positive boost this could give to global growth, the country's macroeconomic picture is still volatile as it endeavours to manage the transition away from the world's manufacturing hub and the fallout from the government crackdown on the Real Estate and Tech sectors.

Outlook: We are experiencing significant volatility as the economy looks for a new paradigm. Even if the old paradigm persists, we believe that once global economic growth slows down significantly, inflation would subside, giving central banks and governments more room to support the next economic rebound.
For the next 3-4 months, we expect to see intensifying economic pressures, as well as persisting supply side (cost-push) inflation. Fiscal and monetary solutions will be less available than any time in the previous twenty years. Weaker economies and structures could come under significant pressure.

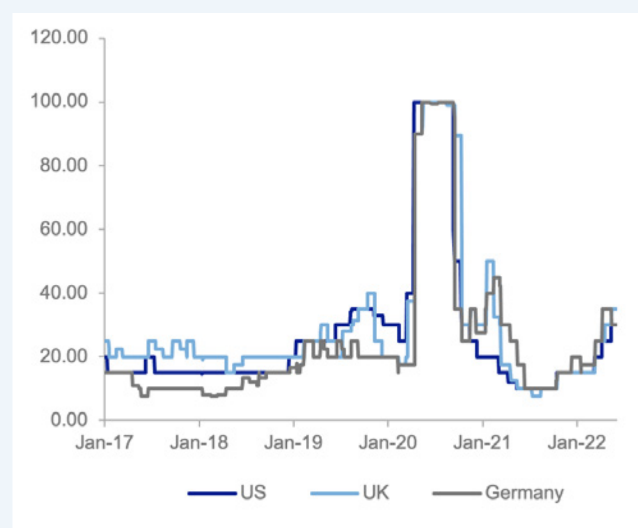
Global macroeconomic conditions deteriorating

Z-score of 87 global macroeconomic indicators



Recession risks rising

Bloomberg Poll: What is the probability of recession in 12m?



Charts source: Mazars Calculations, Bloomberg

UK

The Uk’s economy is under pressure. The mid and small cap indices reflect that but the large cap index is moving to a different tune.

The UK’s economy is facing a number of challenges, more than other developed economies. These are described in detail in this month’s Macro Spotlight about GBP.

The UK economic turmoil is reflected in the performance of small and mid-cap companies, which are exposed to the pincer of higher interest costs and less consumer demand as the cost of living crisis bites.

Large cap companies are not meaningfully exposed to the UK economy. More than 70% of profits are generated outside the UK so when the UK consumer is squeezed more than in other developed nations, that is not relevant to large cap equities in aggregate.

Furthermore, the index of the largest UK companies is very specific in its make up and benefits from its large allocations to consumer defensive, healthcare, energy & basic materials companies. Defensive sectors have performed well as investors seek safe havens as the global economy deteriorates and energy has been supported by heightened tensions in Ukraine.

While the current trend is compelling, investors looking for an opportunity may do better to wait for this trend to reverse. UK large cap companies may come under pressure as commodity prices increasingly discount recession, which has been limited so far. Markets also tend to look ahead 6-12 months so while the current data from the UK is bleak, it may not be long before the low valuations of small and mid cap companies start to look attractive relative to the UK’s economic prospects.

Outlook: For now, large cap equities may continue to benefit from the defensive sectors, even if commodity prices fall away. Looking ahead, rationale for rotation from large cap into mid & smaller companies could come into focus.

UK large cap equities to outperform small and mid-cap

Rebased to 100, 3 years

Mid Cap valuations are well below the long run average

Price earnings ratio, 10 years

Charts source: Refinitiv Datastream

Macroeconomic backdrop

US

The narrative adopted by Federal Reserve over the last months has become increasingly hawkish over fears of sustained, widespread inflation. However, cracks are materialising in the picture for domestic demand, and much of the current inflation continues to be imported due to supply constraints.

In June, US stocks fell by 8.3% (4.9% in GBP). The best performing sector was Consumer Staples, while the worst performer was Materials. Equities traded at 16.63x times forward earnings. 10-year Treasury yields rose 17 bps to 3.013%.

The Federal Reserve raised interest rates by 75bps in June in response to the headline inflation rate reaccelerating and and consumer inflation expectations spiking. Language in the policy statement was also strengthened, with firmer pledges to return inflation to 2%, and predictions that the labour market would remain strong removed. Markets are now pricing in rates above 3% until year end.

Economic data released this month pointed to a slowdown in the US economy. In contrast to May, consumer spending indicators fell Retail sales dropped by 0.3%, as inflation and high gasoline prices caused consumers to cut back on non-essential spending.

The US Manufacturing PMI also fell from 56.1 to 53, its lowest value since June 2020, as new orders and employment dropped within the sector. That said, one possible point of optimism was that supplier delivery times and order backlogs retreated, suggesting that supply shortages could be easing.

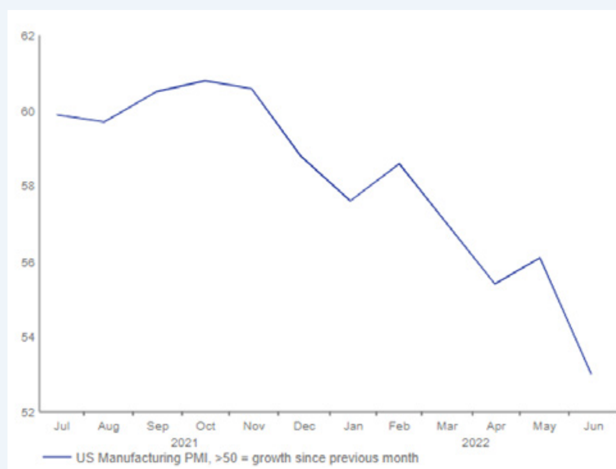
Services held up better than manufacturing, with the PMI declining only 0.6% from 55.9 to 55.3. Nevertheless, the June reading set a 12 month low for a second consecutive month.

The Federal Reserve has made it clear that it has no intention of swaying from its path so long as inflation remains high. Thus, we expect the effects of higher interest rates and the removal of quantitative easing to continue to put pressure on the economy in the months going forward.

Outlook: Given weakening consumer spending data and a hawkish Federal Reserve, we expect that US growth will be considerably slower in the coming months.

Manufacturing activity fell in the US

US Manufacturing PMI



Consumer spending declined in May

US retail sales versus US real consumption

Charts source: Refinitiv Datastream

Macroeconomic backdrop

Europe

June was a dreary month for the European economic prospects, as record levels of inflation prompted falling demand and weaker consumer spending. However, all eyes are currently fixed on the European Central Bank (ECB), whose impending monetary policy decisions may prove to be crucial in deciding the fate of the European Union for decades to come.

For even the most enthusiastic of European asset managers, it is becoming increasingly hard to deny that the balance of risks to the European economy has tipped significantly to the downside. Inflation continues to surprise to the upside, coming in at a record 8.6% in June. Despite some signs of supply chain pressures easing, the worsening energy security problem and ever-rising food prices all but confirm that inflation has yet to reach it's peak.

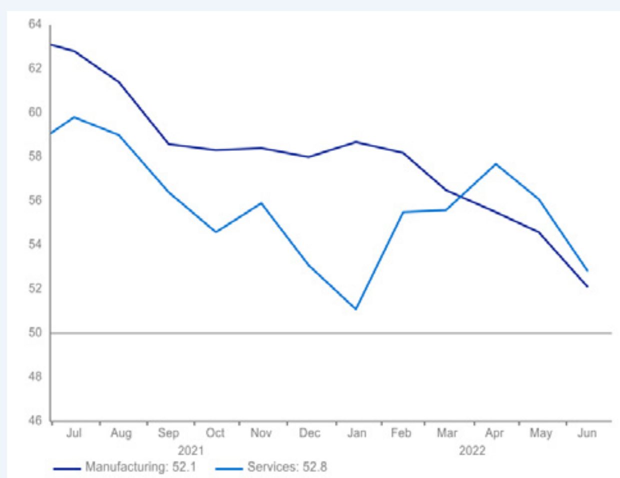
This has also hampered demand across the region, and the much-publicised narrative of a two-speed European economy is waning fast. Latest PMI results indicate a sharp slowdown in Europe's once thriving services sector. Additionally, manufacturing output declined in June, as price increases discouraged new orders. The gearbox has truly fallen out from under the once mighty European economic engine, an economy now running on fumes.

However, these factors are merely complications to the major problem faced by the ECB. Their shift towards an increasingly hawkish narrative has encouraged spreads to widen across the European periphery nations. Concerns grow over the ability of these heavily indebted countries to pay back these funds if interest rates are hiked. The ECB's current solution, injecting cash into the most exposed periphery nations using the profits from maturing French and German sovereign debt, appears to have placated bond markets temporarily. However, the fragility of the European monetary system means that it will be subjected to further testing.

Outlook: Our current outlook on the Europe is negative; the severity and increasing probability of tail risks emerging across European economies suggests this is a region to watch. The ECB is saddled with the monumental task of maintaining a cohesive monetary union, and their actions could prove decisive in shaping economic landscape of Europe moving forward.

The end of Europe's two-speed economy

Euro area June PMI data, Index = 50, no change



The ECB has placated the bond market... for now

10-year government bond yields, spread over German Bunds,%

Charts Source: Refinitiv Datastream

EM and Japan

Post a strict Covid-19 lockdown, China reopened in June. Monthly economic data has pointed to a strong rebound in activity in the region, giving some optimism. The economic situation in Japan appears to be improving, a slight tick up in inflation is pointing towards an potential interest rate hike by the BoJ.

Market Performance: In June, Japanese stocks fell by -3.8% in sterling terms. The highest performing sectors were Utilities and Consumer Staples while the worst performers were IT and Materials. Equities were trading at 11.99x times forward earnings, 19.5% above long-term average and 19.7% below the MSCI World. EM stocks fell by -3.2% . The highest performing sectors were Consumer Discretionary and Healthcare while the worst performers were IT and Materials. Equities were trading at 11.34x times forward earnings, 10.6% above long-term average and 24% below the MSCI World.

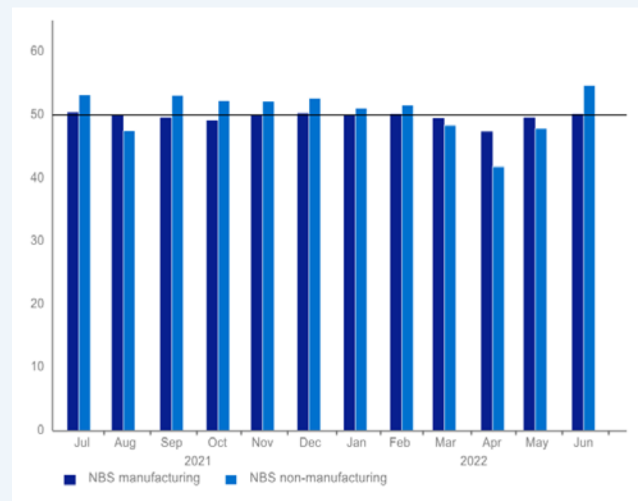
Economy: June official data echoed that the worst of the Covid-19 shock has passed in China. Manufacturing activity expanded for the first time since February and the steepest pace in six months, as major economic hubs, including the financial capital Shanghai, emerged from virus lockdowns. Domestic demand improved less than exports – with supply normalising faster than demand. Overall, sequential growth improved notably but not enough to recoup all of April's losses.

In Japan short-term economic indicators remain consistent with growing activity. But the manufacturing PMI declined to 52.7. The yen has lost ~6% against the dollar since last month, due to the growing gap between the US Fed and BoJ's planned normalisation paths. At its June's meeting, the BoJ renewed its commitment to maintain a "very" accommodative policy.

Outlook: In Japan, the improvement is marked. Along with monetary accommodation, the optimism is reflected in risk assets. However, we feel that the current economic performance of its biggest trading partner, China, will weigh heavily on the near-term outlook for the Japanese economy. Consequently, we are neutral on Japanese risk assets. Meanwhile, we remain sceptical about the course of the Chinese economy, both in terms of the realised impact of the current economic slowdown, and its effect on the global economy.

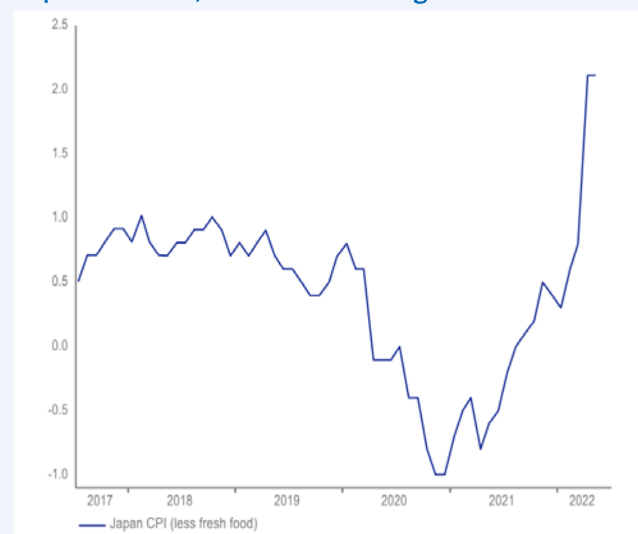
China headline PMIs point at recovery

NBS Services and Manufacturing PMIs, 50=no change



Inflation ticks up in Japan, above the BoJ's target

Japan inflation, 12 month % change



Charts Source: Refinitiv Datastream

Our themes

Macro theme 1
Global recession

The global economy was projected to grow above-trend in 2022. In the second half, an increasing amount on analysts are predicting a recession. In the battle against inflation, growth is usually the first victim.

More often than not, it takes a confluence rather than individual risks to cause catastrophe, as any veteran of the Global Financial Crisis will attest. As we enter the third quarter of 2022, we believe that there's a mounting probability that we are seeing such a confluence of risks now, one that could significantly derail growth:

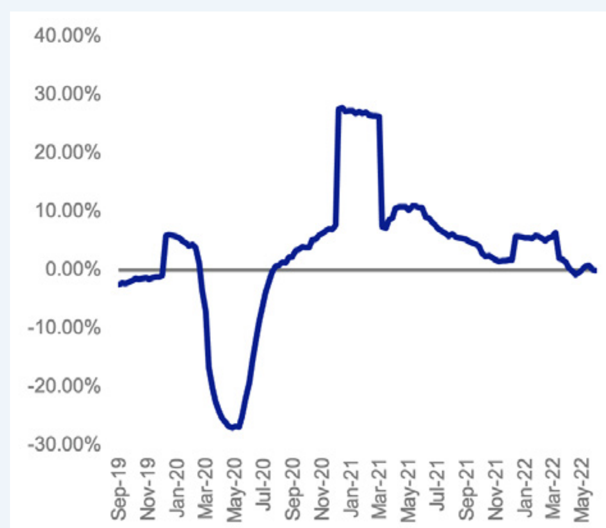
1) A weak economic backdrop: Last year, policymakers assumed that supply chains were robust and global supply would quickly snap to when post-lockdown demand picked up. The only thing that snapped was factory capacity. Lead and delivery times grew significantly. As a result, orders multiplied because merchants wanted to build inventory. This led to chaos. Materials became scarce, delivery times grew exponentially and orders were simply left unfilled. This erratic demand pattern caused inflation to spike. In early February, the overall backdrop was improving, but remained weak and fragile.

2) Broad-based high inflation. The war in Ukraine and the concomitant sanctions on Russia have amplified inflationary pressures. Global supply chains are still very weak, and heavy sanctions on a key energy and materials provider are re-igniting inflation. The fact that these inputs are at the origin of supply chains exacerbates the problem, as the impact of shortages will branch out. Scarcity in energy affects almost every product. Scarcity and high prices of wheat and corn mean that costs will go up throughout the food chain, affecting nearly all products, irrespectively of whether they are produced locally or they are imported.

This means that prices for meat, for example, will rise, even if the livestock comes from just a few miles away. Thus, unlike the previous inflationary bout, which focused on some sectors experiencing shortages, like cars, this one will see even higher prices and will be significantly more broad-based. That will be of particular consequence to lower income households across developed and emerging

Global earnings projections have flattened

12m forward earnings projections for the MSCI World



Source: Mazars Calculations, Bloomberg

nations. In this environment, consumers will have to curtail costs.

Because that will be difficult consumers will seek higher wages asking their employers to share their costs. This increases the cost of goods produced, and manufacturers further raise their prices.

3) Policy mistakes: At this point, the economic rebound and inflation have become competing targets. This puts policy makers in a bind, raising the probability of policy mistakes on either side.

4) The final element for this recession perfect storm, but perhaps the most important, is the potential of a profound Chinese economic slowdown.

Macro theme 2

Our inflation outlook

Inflation may persist for at least 3 or 4 months, during which time we expect central banks to remain hawkish. However, beyond that, the economy is cooling. Consumers, who have suffered many crises in the past decade, could continue to postpone or cancel major spending decisions. Once the year-on-year effect passes and if energy prices come down, deflation could become the central theme.

We don't anticipate that inflation will come down dramatically in the next three-four months. This is due to the year-on-year effect of inflation. Last summer, price rises were significantly moderated. This means that on a year-on-year basis, headline inflation pressures could persist for this summer. And the Fed is highly sensitive even to high-frequency monthly data.

The question is what happens thereafter. Following September, there's a significant confluence of factors which could help reign in inflation, and with it constrictive policy:

1.The year-on-year effect will once again begin to affect numbers. From October onwards, 2021 prices had began to rise. This is a significant headwind for 2022 year-on-year figures to rise.

2.The drop in discretionary spending and the recent mega-restocking cycle could lead to a material slowdown in inventory build-ups. This will impact demand much more than higher interest rates and help bring inflation down.

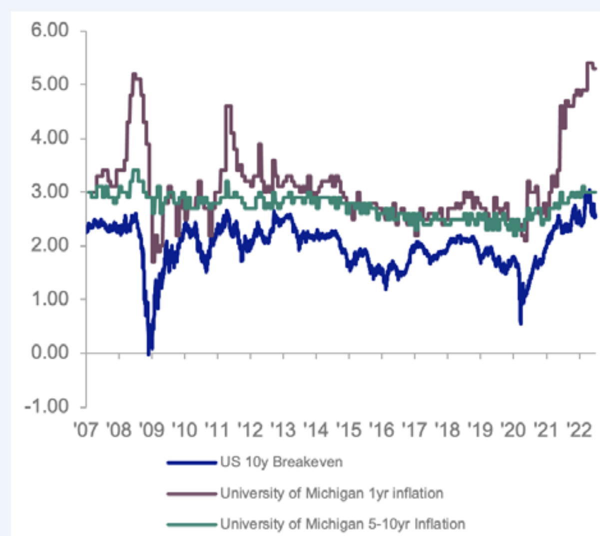
3.China is beginning to rebound post-lockdowns. While the longer-term pressures on the economy are still very relevant, including clampdowns on major growth sectors, the immediate effect of major ports and cities coming back into production should be greatly beneficial for inflation.

4.Fossil fuel prices could come down. Oil demand and supply are coming back in equilibrium. By some sources, supply may even exceed demand. This should put meaningful downside pressure in fossil fuels. Additionally, while quantitative tightening hasn't started, we have seen evidence of market deleveraging. This should also reduce speculation on the futures markets.

What would follow this, incredible by globalisation standards, inflation bout? An above-trend inflation, or deflation?

US consumers are very pessimistic about inflation

US inflation expectations



Source: Mazars Calculations, Bloomberg

On the one hand, tight labour markets give an incentive towards higher wages. However, as the tech sector sheds high-paid jobs, the equivalent of the Financial sector in 2009, the net effect on consumer wealth might not be significant.

Over the longer term, Green transition and China's shift towards consumption should, all other things being equal, add to the pre-pandemic inflation trend of 1.5%. Brexit should also be a medium to long term additive for Britain.

However, in the immediate aftermath of this inflationary bout, as oil prices come down, we expect that consumption will remain moderate. For the past decade and a half, consumers have been hit with a series of crises which have affected real disposable income. In Developed Markets, where demographics are less than favourable, deflationary pressures should be significant.

China's economy is undergoing an uneven recovery

China's latest economic indicators showcase a mixed picture. On the one hand, retail sales continued to weaken from a year earlier. On the other hand, industrial production grew, suggesting that the relaxation of Covid-19–related restrictions started to have a positive impact on the manufacturing sector.

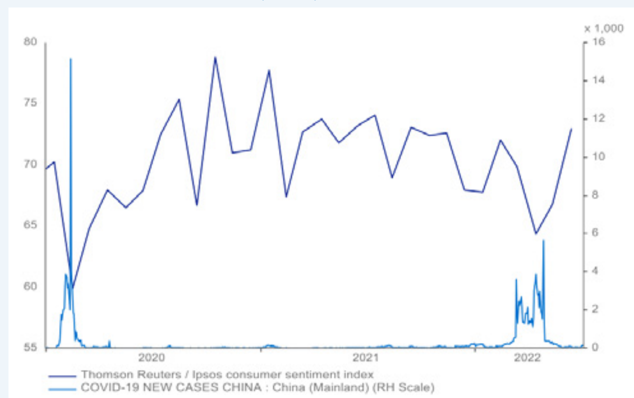
China is becoming more willing to accept single-digit Covid cases and is reopening. The government announced the decision to shorten the isolation period for positive Covid cases and adjust the frequency of Covid testing. However, the risk of lockdowns still exists, even though the probability is lower than in early June.

During the worst period of lockdowns, the (negative) contribution of the consumer market to the economy was obvious. Consumer demand should return to positive territory as Covid rules are further relaxed. Foreign exporters can also benefit from the recovery of the Chinese consumer market.

Homes sales have marginally improved. Discounted home prices in some parts of China are a short-term policy to boost home sales. Although this is a positive move for home sales, it is not positive for property developers, who have defaulted on their bonds, both onshore and offshore, as potential home buyers will stay away from homes sold by those developers to avoid non-completion risk and after-sales property management risk. As such, we do not expect defaulted real estate developers to get cash from home sales quickly, which will continue to put pressure on their liquidity.

China's drop in Covid-19 cases is boosting consumer sentiment

Reuters Consumer sentiment index (LHS), China new Covid-19 cases (RHS)



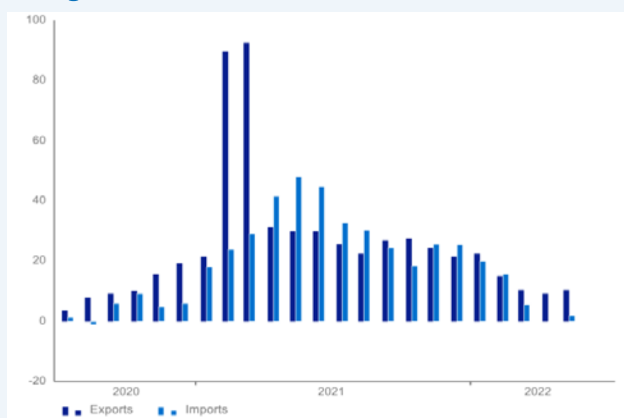
Source: Refinitiv Datastream

External demand has been robust and Chinese port congestion has eased, which implies a better international trade environment. The US is also considering removing some of the tariffs on goods imported from China.

In summary, latest economic data shows:
1) successive growth improved notably but not enough to recoup all of April/May's losses; 2) the recovery is uneven, with supply normalizing faster than demand, and exports recovering quicker than domestic activity; 3) some strength will prove transitory (exports), while others (e.g. fixed asset investment) will remain more long-lasting; and 4) policy stimulus is having an impact in some areas (infrastructure investment and development) but not others (property sector). Hence, despite beating expectations, latest economic data is far from delivering the all-clear of economic risks.

China's rebound in external demand has been robust

China monthly exports and imports, 12 month % change



Source: Refinitiv Datastream

Asset Allocation spotlight

When will stocks capitulate?

Stocks still have significant room before they reach the stage of capitulation. Historically, risk and return ration improve a lot when the S&P 500 trades at 15 times trailing earnings. Currently, the number is 18x.

Finding a capitulation point without the power of hindsight is a very difficult task.

For one, investors should de-anchor from previous stock market levels. The S&P may have fallen more than one thousand points (22%) from its highs, but this movement alone should not inform us about the possibility of capitulation (in essence the rebound). The previous high is not what we should be looking at, especially when that high was achieved during a previous paradigm. The NASDAQ peaked in 2000. It took fifteen years to reach its precious highs. The Nikkei peaked in 1989. At its best (2020), it managed to recover 76% of its losses.

Instead of looking at market levels, investors should be going back to fundamentals and looking at valuations. Currently, on a trailing earnings basis, the S&P 500 is trading at 18.3 times its earnings, a full point above its long term average. From where we are today, ex-QE investors should expect returns around the average, at 7.4% per annum on average.

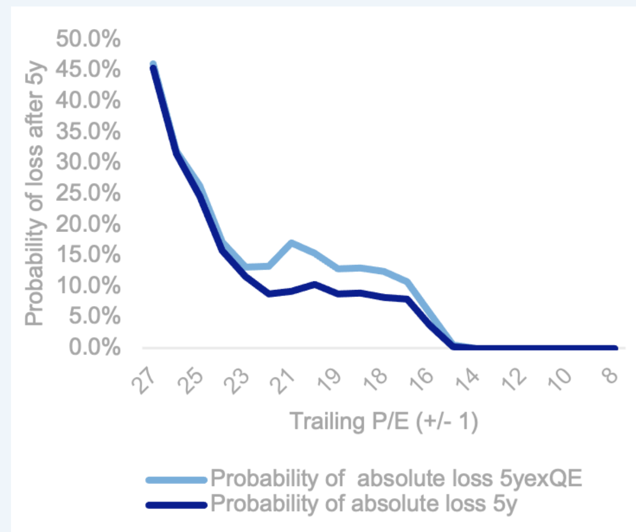
Historically, stocks don't capitulate at 18 P/E. They capitulate at 14-15 P/E.

At current earnings this would mean the S&P 500 at 2800-3000. Assuming a 10% drop in earnings as the economy slows down, we would be looking at capitulation levels nearly one more thousand points below where we are today, 2550-2700 points for the S&P 500 or another 30% drop from current levels.

And that is without accounting for possible dislocations for financial markets, further pressures on the financial system, exploding inflation and other systematic variables.

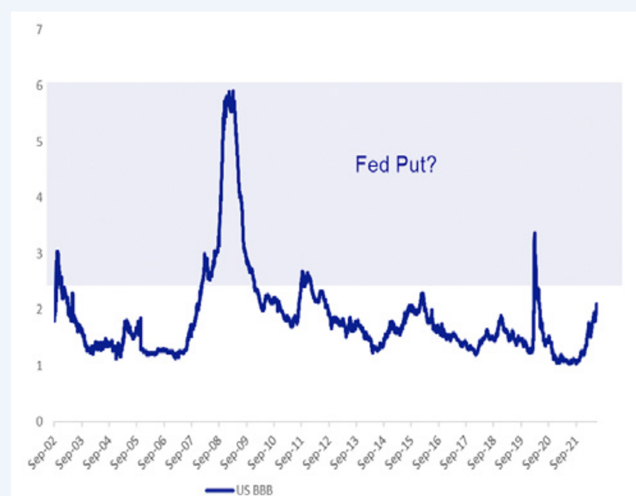
Probability of loss is reduced below 15x

Probability of net loss over the next 5 years for the S&P 500



Credit could be the key indicator for capitulation

US BBB credit spreads



Charts Source: Refinitiv Datastream

Equity spotlight
Growth vs Value

The low growth, low inflation world of the decade post the GFC and prior to Covid was one where exciting stocks with high growth potential tended to significantly outperform stocks which traded at low multiples of earnings but which were expected to grow earnings more slowly. Chief amongst these were US tech stocks, however it was a worldwide phenomenon. Funds in all regions that focused on growth stocks outperformed those focused on value stocks.

In the year immediately following the Covid outbreak this trend was further extended. After all tech stocks that could bring products directly into your home were much prioritised than traditional companies that no-one could purchase anything from.

However upon the announcement of a vaccine in November 2020 stocks that had been out of favour suddenly rallied on hope on for a re-opened economy. This lasted until about the end of Q1 2021. From then until the end of the year there was a bit if back and forth but no real trend.

Inflation then began to rear its ugly head which has seen poor performance for stocks in general, however it has been a terrible six months for growth stocks.

Now you may ask why is inflation bad specifically for growth stocks? Equity valuations are based partly on interest rate levels – this is essentially what you could have got if you held your money in cash instead. If interest rates rise to combat inflation this increases the hurdle over which equity earnings need to perform. If earnings expectations don't then rise in line with interest rates then valuations will fall. This particularly affects companies who have a greater portion of expected earnings further in the future, i.e. growth stocks.

There are other less technical arguments on why value stocks are now outperforming growth stocks:

1. Valuations on growth stocks had gotten overly high and reduced confidence in markets was always gong to hit these stocks harder.
2. Somewhat related, the outperformance in growth stocks over the past decade, which has seen the valuation gap against value stocks widen to all time highs, was always due to revert.

As inflation has spiked, value stocks have outperformed

LHS: Equity returns rebased to 100: RHS: inflation, per cent

Source: Refinitiv Datastream

In our portfolios we had been running a bias to growth stocks coming into Covid-19. In March last year we took the opportunity to add a significant amount of value exposure. Although we missed the first leg of the value trade, it has helped performance this year. In April we added further exposure to highly stable, dividend paying stocks, which we would class as quality value.

We are very cognisant that we don't want to move too far away from growth stocks. After all the key driver of equity returns should not be valuations but instead compounded earnings growth. If/when economic conditions stabilise, there is still a preference to pay slightly more for a company with great growth prospects, than paying slightly less for a company that needs to undergo a complete turnaround.

GBP in decline

USD has been strengthening as investors bet on rate hikes

The UK's combination of inflation, worsening economic outlook, rising interest rates and political uncertainty makes it hard to find the bright spots on the horizon for GBP.

By virtue of its reliance on imports, the UK is susceptible to high inflation. It is particularly consumer goods, which make up the 1/3 of the UK's CPI basket, which have added to inflationary pressures as supply chains have been disrupted by the pandemic.

The country's inflationary pressures are also evident in the employment market. The labour market has been depleted by people retiring early or suffering from long term illness and Brexit has wrought havoc as EU nationals have left the UK and others find it hard to enter. This result is high levels of vacancies despite worsening economic fundamentals.

In the UK the increased cost of living is taking its toll on consumer sentiment which is at its lowest point since records began. At the same time corporate health is deteriorating as debt burdens among smaller companies have grown and UK bankruptcies are spiking as the economy weans itself off Covid life support. The OECD has recently updated its economic forecasts of the UK and estimated that UK economic growth would slow to zero in 2023.

This combination of increased inflation and a weakening economy amount to stagflation and creates an impossible situation for the Bank of England. The Bank is set to raise interest rates at a faster rate than it has already this year in an effort to control inflation, while the economy slows.

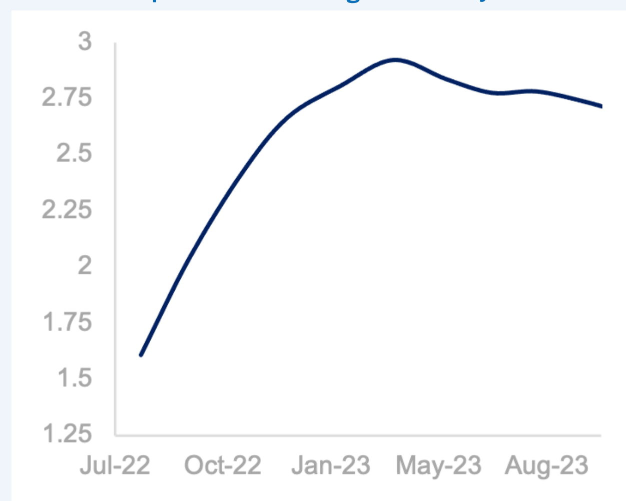
While GBP has already fallen 14% from its post pandemic high, the cloudy economic outlook still does not make owning GBP an attractive proposition.

The pound has collapsed after reaching a its post pandemic high in 2021

GBPUSD, spot rate

The market expectations for interest rates is for more rate rises into a weakening economy

Market - Implied Bank of England Policy Rate



Charts Source: Mazars calculations, Refinitiv Datastream

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