Logical Thoughts

MARKET LOWS REACHED OR FALSE START?

Overview of recent market performance

There's no use sugar coating how challenging the last seven months of 2022 has been with investment markets around the world struggling to generate any meaningful returns.

Bond markets, the canary in the goldmine, led the downturn on the back of expected higher inflation and interest rates, followed by equity markets as higher interest rates started being factored into company share price valuations.

This led to considerable falls in global equity markets such as the US technology index, NASDAQ and the 500 largest companies in the US, S&P 500. Fortunately, since mid-June these markets have recovered somewhat, clawing back some of this underperformance.

Closer to home the domestic equity market (S&P/ASX 200) has performed much better mainly due to our larger exposure to energy and materials. For example, energy stocks have been a standout performer (up 36.33% for the calendar year to the end of July 2022). Among the laggards, until mid-July, was the fall of long duration growth stocks such as technology.

Current market volatility and what we can expect.

Interest rates and inflation

At the beginning of the year, bond and equity markets on aggregate decided interest rates were too low (reflecting expectations of higher inflation) and adjusted bond prices and stock price valuations downwards to reflect this view. This in turn drove down a number of market indexes (bonds and equities) around the world into bear territory.

After a while the US Federal Reserve Bank agreed with the markets view about inflation and started hiking rates by the fastest pace in decades. So far this year, they have raised rates by 2.25% and now the target range is 2.25% to 2.5%. The Fed's benchmark rate could rise to a target range of 3.25-3.5% by the end of this year, according to policymakers' latest rate projections.

The US is not the only central bank around the globe lifting interest rates, many more major developed and emerging market central banks are doing the same. These central banks delivered a staggering 1,200 basis points interest rate hikes in July alone, ramping up their fight against multi-decade high inflation.

It is expected that developments around US inflation and interest rate policy will continue to determine the strength and weakness of financial markets over the short to medium term.

This was confirmed with the release of the latest US inflation numbers. They were lower-than-expected, 8.5% down from 9.1% (previous) vs market expectations of 8.7%. The market believes this could signal a peak in US inflation with further declines likely (year-on-year) going forward.

Still remain cautious – this may be a false start

History is littered with false starts

Short-lived bursts of enthusiasm are common during downturns. There were nine double-digit rallies in the NASDAQ-Dot Com bear market between February 2000 and February 2003, as the index speared from over 4,500 to below 1,000 before eventually bottoming. Similarly, there were numerous double-digit rallies in the Global Financial Crisis bear market.

The tech-heavy NASDAQ Composite has led the US recovery getting support from falling bond yields and the rapidly easing fears of the US Fed. Having lost near 5,000 points or 32% from 31 December 2021 to the mid-June low, it has added just over 2,000 points or 19% to 3 August. The S&P 500 shed 1,100 points and has rebounded some 490 points or 13.3%.

US earnings season resulted in more companies issuing negative guidance than positive

The US second quarter 2022 earnings reports have been reasonable although consensus estimates were progressively trimmed prior to 30 June 2022. The blended earnings growth rate for second quarter 2022 is 6% for the S&P 500 and if this becomes the actual performance, it will be the slowest quarterly increase since fourth quarter 2020. Full year estimates are being downgraded and more companies have so far issued negative guidance than positive.

Quantitative tightening will result in a withdrawal of liquidity from the financial system

Interest rates are only one component of monetary policy tightening. **Central banks are also reeling in excess liquidity by reducing balance sheet assets, known as quantitative tightening (QT)**. From 1 June 2022, the US Fed was to reduce its balance sheet at a monthly rate of US$47.5bn for three months. This was to be achieved by allowing Treasury securities (US$30bn) and agency mortgage-backed securities (MBS) (US$17.5bn) to mature and not reinvest the proceeds. The monthly rate will double from 1 September to US$95bn.

As at 27 July 2022, total assets were US$8.89 trillion, just US$25bn less than 1 June 2022. US Treasuries were US$37bn lower and agency MBS US$10bn higher. The US Fed holds just US$47bn in MBS with maturities between 91 days a one year making it impossible to meet the monthly reductions without selling securities into the market. The target to 1 June 2023 is for a reduction in the MBS holding of US$367.5bn.

Remember since 2008, the Fed and other central banks have supported financial markets by buying debt as part of an economic support program that started in the aftermath of the Global Financial Crisis. These programs were supercharged in response to the COVID-induced fallout in financial markets. **This liquidity fuelled a rally in assets from equities, bonds, and real estate to crypto currencies. This is about to work in reverse.**

As a result of the widespread central bank intervention in global debt markets, they now own a disproportionate percentage of government debt. The US Fed currently owns a quarter of all outstanding Treasury debt and a third of agency MBS. The European Central Bank and the Bank of England each own almost 40% of their government bonds, while the Bank of Japan owns nearly half of the outstanding government debt and is still buying.

Morgan Stanley estimates balance sheets at the Fed, the ECB and the BOE will shrink by US$4 trillion by end 2023. That assumes they stick to current plans. This could have meaningful implications as the monetary base contracts. **The withdrawal of liquidity of this dimension is the equivalent of an interest rate increase of at least another 1.5%.**

The fall in US inflation unlikely to be straightforward

Also, some equity analysts believe the decline in US inflation from 9.1% (currently 8.5%) to 2% - 3% will not be straightforward– based on the composition of inflation. Their view is that U.S inflation will easily fall from 9.1% to 6%. It will then be a battle to get inflation down to 5% and then an excruciatingly painful process to get inflation down to 2%-3%.

If this scenario eventuates then financial market volatility will likely increase as the US Fed officials signals a continued interest tightening policy. Bond yields lift (price falls) and equities will sell off, especially long duration assets, such as growth stocks. US Fed Reserve Chair Powell has committed to bring inflation back down to 2% and used the words ‘unconditional commitment’.

Final Comments

The big debate is whether the equity market’s rebound is a false start or whether we have put in the lows for this cycle. At this point the rebound is almost bang on the average bear market rally (in terms of rebound and length) in the S&P 500 since 1950.

Even with the recent rally in equity markets and declines in yields, there continues to be head winds facing investment markets and investors need to be careful, especially as we enter into the traditional weaker equity months of September and October. These include:

- The withdrawal of liquidity (quantitative tightening) from the financial system which acts like a lift in interest rates and reduces the support for risky assets like equities.
- The outlook for energy such as oil. A bounce-back in the oil price would lift inflation and drive bond yields higher (bond prices lower) and equity markets lower.
  - This may come from the recognition of the structural imbalance between supply and demand (demand is greater than supply) as spare capacity is very limited and no buffer for demand recovery,
  - China re-opens its economy after COVID, increasing oil demand by 500,000 to 1,000,000 barrels of oil per day (greater demand)
  - Europe plans to tighten sanctions on Russian oil in December, especially during winter. Greater demand from other sources.
- Another component of inflation which is not often discussed is wage inflation. Many believe this will become a significant problem, e.g., staff shortages in the services industry, and this will feed through into a wage inflation spiral. At the moment the US three-month average wage growth is stuck at just over 5%. This needs to fall back to the 3% range to help inflation back to 2%. Although a weakening economy may help this or a recession.
- Geopolitical risk between China and Taiwan. This remains the single biggest geopolitical risk for markets.

Key Take Outs

In our opinion, the era of repressed interest rates and low volatility are over.

Sensible diversification (with the meaningful inclusion of real and alternative assets that move largely independently of financial markets) coupled with active management should prosper.

Being more conservative, keeping more liquidity and refocusing on risk management will become even more critical.

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