Investment*Update*

25 January 2022

Correction is painful, but we believe it will be short-lived

Investors have had a difficult start to the new year. Although stocks rallied sharply into Monday's close, the global equity benchmark, led by marked volatility in US markets, had entered so-called 'correction' territory – a greater than 10% peak to trough fall since the start of the year – earlier in the day. This was the worst intraday plunge since March 2020, when we were first getting to grips with COVID-19. We can't say for sure when the pain will stop, but for the reasons set out below, we are confident markets will rebound in the first half of the year.

Indeed, corrections of this magnitude are normal. They occur in more years than they don't, and rarely prevent equity markets from delivering positive calendar year returns. One of the main tasks of an asset allocator is to assess the risk of a more pernicious fall.

Peak to trough falls of greater than 20%, which we euphemistically refer to as a 'bear market', are very rare during the expansion phase of the business cycle. They are almost invariably accompanied by a recession. Today, a broad swathe of forward-looking indicators suggests that the US and global economies are still solidly in the expansion phase. Our analysis of some of our favoured survey-based indicators of business, construction and consumer confidence suggests that there is a less than 3% chance of the US falling into recession in the next three months.

Indicators that provide visibility beyond that are hard to find, but we use three to help gauge the likelihood of recession within the next 12 months. These include growth in the money supply, the difference between shorter and longer-dated bond yields and how far today's real interest rate differs from a theoretical optimum 'neutral rate'. Together these more anticipatory indicators suggest a 0% chance of recession occurring this year. To state the obvious, that's as low as it gets.

The cost of short-term corporate debt has not risen relative to the cost of long-term credit, which suggests bond investors don't see a near-term increase in company defaults. Indicators of counterparty risk and our own measure of financial stress are broadly unchanged since the year began.

Of course, this 'top-down' way of looking at the world is only a starting point. Yet looking at the world from the 'bottom up' – by way of company earnings – also suggests a low probability of a recession. As stock prices have tumbled, both sales and earnings expectations have been revised up. For the S&P 500, sales revisions have in fact been positive for all industry sectors during the last month and profit revisions have been positive for half of them. This is a function of the sharp downward revisions that occurred in the final few months of 2021 – a little too sharp relative to the macroeconomic backdrop, in our opinion, as we highlighted in our year end Investment*Update* and related videos.

Results for the fourth quarter earnings season are so far fairly upbeat, though with just 13% of S&P 500 firms having released their fourth-quarter results to date. Of the 64 stocks that have reported, around two-thirds have beaten consensus expectations and over half of them by a lot (more than one standard deviation, in technical terms). This is slightly below average, and COVID-related disruption, supply chain dislocation and other margin pressures continue to present risks that make us a little cautious. But, again, there is little sign of impending recession.

If earnings have been rising, equity market declines have been caused by falling valuations. This is in part due to investors demanding more compensation for uncertainty around tomorrow's earnings. This is reasonable to an extent, but sentiment is now looking too fearful. For example, a weekly US survey of 'mom and pop' investors (what we call 'retail investors') has revealed a level of bearishness that almost invariably serves as a useful 'buying' signal when a recession isn't around the corner. Other gauges of sentiment, such as institutional investors buying protection against market falls, are also sending similar signals. We haven't seen these 'fear' gauges reach such levels since March 2020, when we were in a pandemic-induced recession. It is impossible to time the reversal of such fearful sentiment with pinpoint accuracy, but this analysis gives us some comfort that the worst is likely behind us.

A rise in government bond yields, part of the rate equity investors use to discount tomorrow's earnings into today's prices, has also rattled markets. The valuations of technology and other so-called 'growth' stocks are mechanistically punished as more of today's prices are derived from distant earnings. Almost 40% of stocks in the tech-heavy Nasdaq index have fallen by more than 20%, compared with just c.15% in the broader S&P 500 or the UK's FTSE 100. Two months ago, when the Nasdaq 100 traded at a record high, interest rate futures implied that the Federal Reserve (Fed) would raise rates twice in 2022. Today they are implying four (one 0.25% rise per quarter).

Rathbones
Look forward

Elevated core inflation and sharper than expected falls in unemployment are the proximate causes of more expected tightening. Inflation pressures have definitely broadened out over the last three months, and that means we think looking for inflation resilience in stock selection and asset allocation is still important. But, as we wrote in our year-end outlook, our base case is for global inflation to fade meaningfully from the spring. Energy prices should ease as the supply of crude oil starts to outstrip demand. Energy has accounted for 6/10ths of the increase in inflation in 2021. Even with another 50% rise in oil prices – rather unlikely, even in the context of geopolitical disruption in eastern Europe and central Asia – the contribution of energy to the rate of US inflation would halve in 2022. Core inflation is pretty much all about excess demand for core goods meeting supply chain bottlenecks. In January we have observed more evidence of delivery times and input prices falling.

Now that Omicron restrictions and fears appear to be fading, we expect the normalisation of spending patterns from goods to service expenditure, which is required for inflation to begin fading again in earnest. In the UK, innovative high frequency datasets that look at restaurant reservations or sales at well-known coffee shops are rising sharply. To be sure, bottlenecks in the supply of microchips, freight and energy have non-COVID drivers and judging how long they are likely to linger is very difficult. Still, the possibility that inflation could fade *faster than expected* in the second half of the year is far from insignificant, making even tighter central bank conditions unlikely.

Market pundits also report nervousness around the Fed withdrawing liquidity by way of ‘quantitative tightening’ (QT), financial market speak for scaling back bond purchases. This contributed to an equity correction in 2018. We think there is likely much more headroom this time before QT starts to cause a cash squeeze for commercial banks. There are also new backstops (totalling c.$1.5 trillion) that are likely to be tapped as policy tightens, allowing cash back into the market and maintaining bank reserves. This should allow the Fed to proceed at a quicker pace than in 2018, but with less disruption.

Very sharp, quick increases in government bond yields as we saw at the beginning of the year tend to be associated with negative returns in equity markets. But that’s not to say that generally rising bond yields are bad news for equity markets, which is important given that bond yields have actually started to fall again over the last week. Over various different time periods and policy environments, we’ve found that the average daily return is positive when bond yields rise. When we look at real yields (yields adjusted for inflation), it’s a similar story: for example, the average return over the 12 months following a period when real yields are below a moving average and rising is positive. Another point worth making is that, historically, equities have tended to rally strongly as we approach the first hike of the cycle. Of course, there’s no guarantee that history will repeat itself in this case. But if interest rates are rising because the economy is growing, that’s obviously not a bad thing for company earnings.

Despite the increase in bond yields, the spread between companies’ return on invested capital and their cost of capital remains comfortably wider than average. In other words, businesses should still be able to borrow and invest profitably even if bond yields rise further, which again suggests a low probability of recession.

As long as profits continue to grow and inflation doesn’t spiral, we think that equity markets should rebound in the first half of 2022. Given where we are in business and interest rate cycles, we prefer stocks with ‘quality’ attributes at reasonable valuations. Factors such as strong balance sheets are positively correlated with tighter financial conditions, while track records of high return on invested capital aren’t and tend to deliver consistent excess returns in most environments. Companies whose earnings are driven partly by structural themes – such as cloud computing, green buildings and construction, or digital health and wellbeing – also warrant more attention when easy cyclical gains are behind us. We will be talking to you about these themes more throughout the year. As innovations and disruption broaden out into other sectors from the giant technology platforms that have dominated returns over the last five years, we expect these ‘micro’ themes to play a greater role in driving returns. Over the next decade market returns may be less of a contest between different styles linked to the economy.

Many commentators are talking about the rotation from ‘growth’ to ‘value’ (stocks with cheaper valuations). This could have further to run: we’ve seen only a very small reversal of the massive flows into growth stocks of the last decade, after all. Historically value rallies in Europe have tended to last for a median seven months with 25% outperformance versus growth. And the difference between the valuation multiples of growth companies and those of value companies is still unusually wide. On the other hand, value has already outperformed growth by more than one would have expected given the historic relationship with changes in bond yields.

We think a more nuanced approach to portfolio construction is appropriate. Highly profitable growth companies with strong pricing power and large ‘moats’ around their profit margins are likely to do better from here, and are important given inflation uncertainty. We also like value stocks, but not those with low quality balance sheets and weak income statements – stocks that are cheap for a reason. Interestingly, the best-performing parts of the market last year were a mix of both profitable technology companies together with financials and energy firms on cheaper valuations. We think the rest of 2022 will be characterised similarly.

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Contact us

If you would like further information or to arrange an initial meeting, please contact us on 020 7399 0000

Head Office
8 Finsbury Circus, London, EC2M 7AZ

For ethical investment services:
Rathbone Greenbank Investments
0117 930 3000
rathbonegreenbank.com

For offshore investment management services:
Rathbone Investment Management International
01534 740 500
rathboneimi.com

@Rathbones1742

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