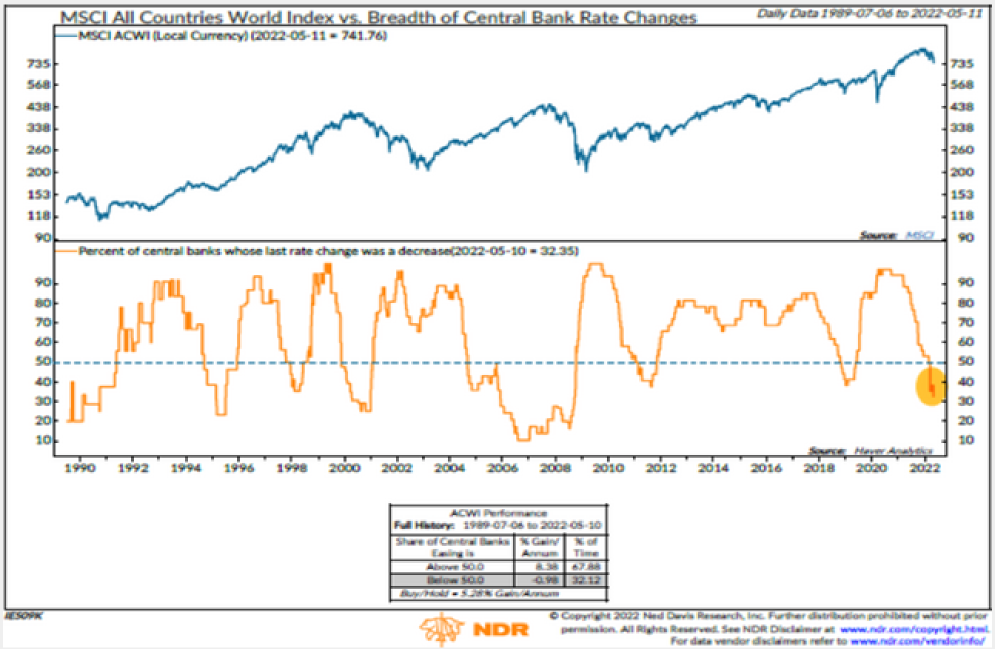
SVpartners
SUSTAINABLE VALUE INVESTING

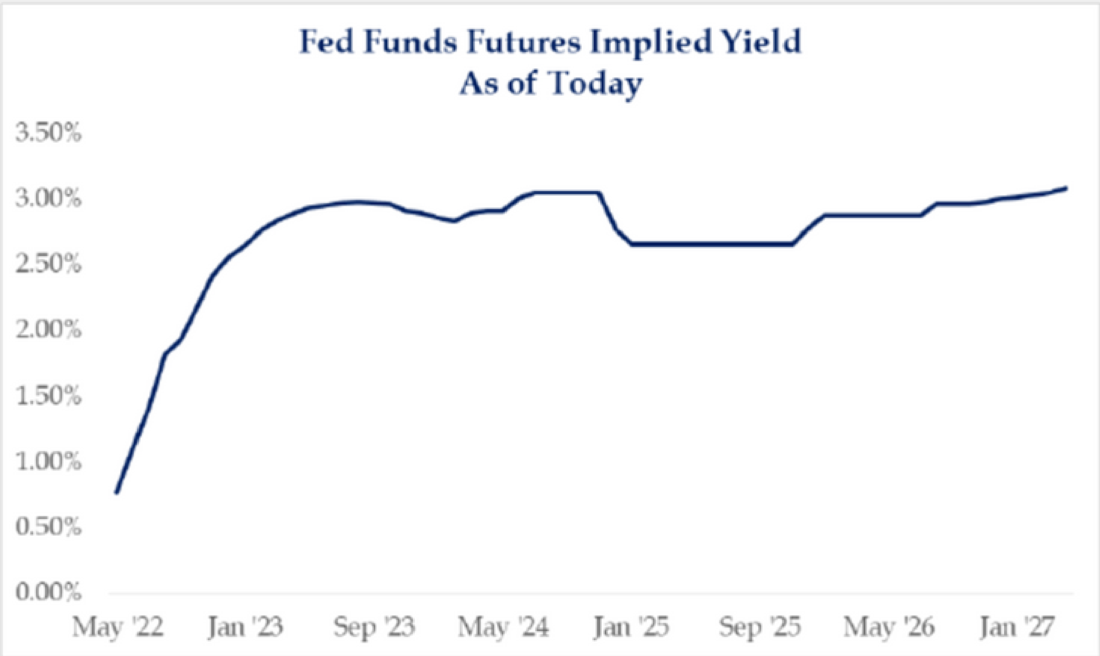
WEEKLY INVESTMENT **UPDATE** 17-19

Persistently high inflation is forcing central banks to respond to these pressures at the most aggressive pace since before the Global Financial Crisis. The breadth of global central bank tightening is reaching its highest in 15 years. As shown in the chart below, the share of central banks whose last rate change was a decrease has dropped from nearly 100% in early 2021 to 32%, the lowest since 2008. Historically, global equities have not taken too kindly to this degree of broad-based tightening in monetary policy. As also shown in the chart, when fewer than half of the world's central banks have been in easing cycles, global equities have tended to decline.



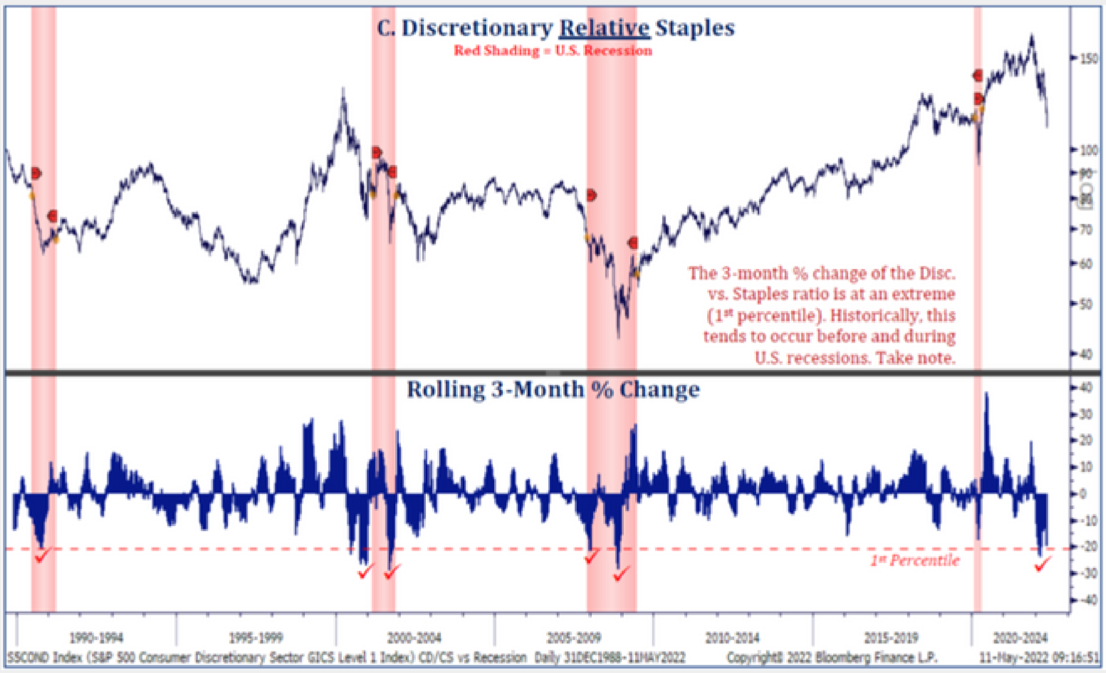
Source: Ned Davis Research

The chart below shows current market expectations for U.S. interest rates. With the Fed expected to raise rates 50bps the next couple of meetings and then 25bps in the ones that follow, the market expects all rate hikes to be jammed into 2022 with maybe one in 2023 currently. It could be argued that if these rate expectations prove accurate, then the recent sell-off in equity and bond markets should be almost complete. This rate expectation does imply that inflation will slow both rapidly and significantly. This may prove optimistic given that headline CPI figures have been over 5% for 12 months in a row and over 7% in each of the last 5 months. If inflation pressures persist, the Federal Reserve will have no choice but to guide higher market expectations for rate increases – a scenario that would almost certainly put further downward pressure on risk assets.



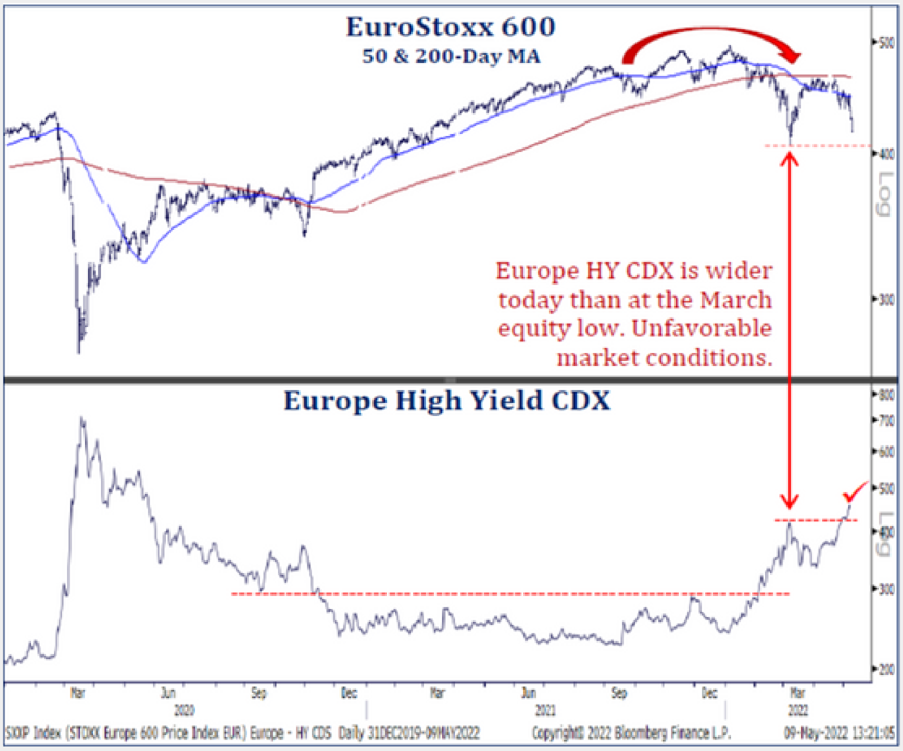
Source: Strategas Research Partners

What is clear is that as global interest rates have climbed steadily during the year, the cracks in risk assets have grown in depth and quantity. The following three charts highlight some of the key warning signals for global equities that are flashing red. The first chart below shows the relative performance of Consumer Discretionary versus Consumer Staples. As inflationary pressures have intensified, the Consumer Discretionary sector has experienced a magnitude of underperformance that has historically occurred only immediately prior to and during recessions (shaded red areas).



Source: Strategas Research Partners

Consistent with this cautionary message is the continued rise in European corporate high yields (chart below) – a sign of rising financial stress. Equities will struggle to post positive returns until these yields stabilize and start to move lower.



Source: Strategas Research Partners

A common theme during the current reporting season is concern about higher costs, slowing growth, and rising inflation. The result: a weakening outlook for corporate profit margins (chart below). It is imperative that margins and profits hold up to provide an earnings support for company valuations. Any further evidence of accelerating downward pressure on margins would spell more trouble for equity markets.

Source: Strategas Research Partners

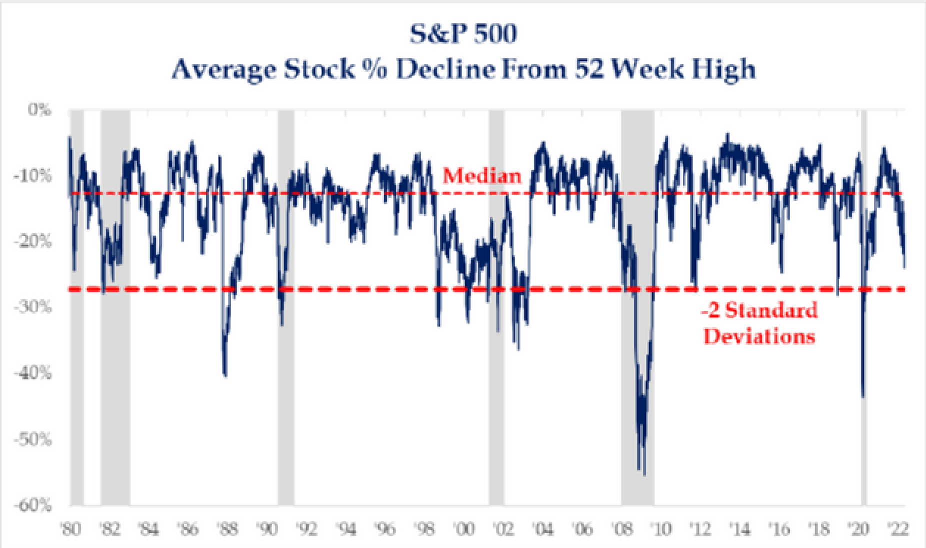
As global investor concern has risen on the back of these warning signals, global equities have seen $11 trillion of market capitalization disappear during a six week streak of losses which is the longest such stretch going back to 2008. The table below shows that over 40% of the largest 1000 companies in the US are actually trading below their pre-Covid level.

% of Russell 1000 Stocks Trading Below Pre-Covid High (February 2020)

Communication Services	65.1%
Utilities	64.9%
Real Estate	61.5%
Information Technology	42.3%
Consumer Discretionary	**42.1%**
Health Care	42.0%
Financials	37.8%
Industrials	36.4%
Consumer Staples	28.8%
Materials	13.2%
Energy	10.0%
Russell 1000	40.6%

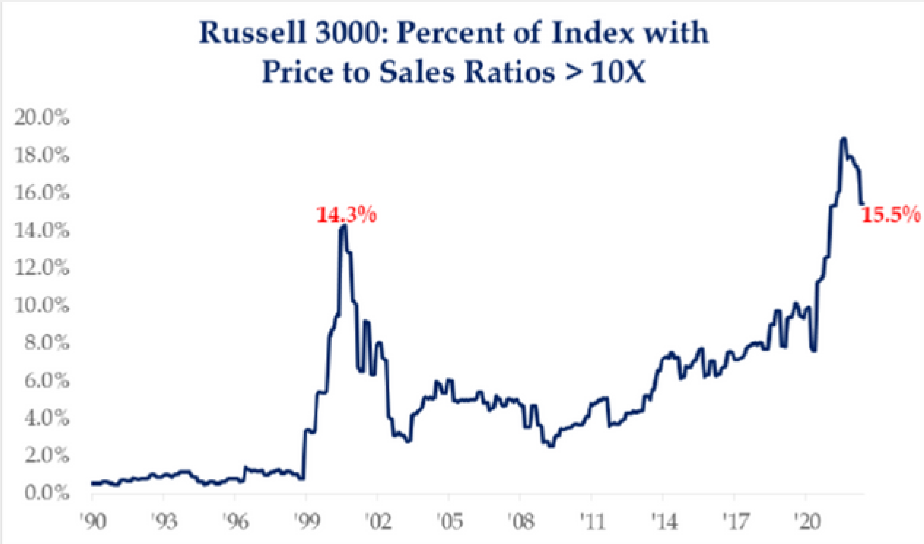
Source: Strategas Research Partners

This broad based decline would suggest that a large degree of bad news is already priced into the equity market. As the chart below shows the average stock in the US is now down -24%.This magnitude of decline is approaching levels that have historically marked an increased probability of a tradeable equity bounce. The only caveat is that during the six periods where the outcome was a recession (grey shading) the average decline was -36%. With the Fed insistent on raising rates to combat inflation, more pain will likely be felt by equity investors without a major reversal of policy.



Source: Strategas Research Partners

While the probability of an equity bounce has increased following the substantial decline of the last six weeks, one reason we believe the equity market may have further to decline is due to the outsized number of companies still trading at lofty valuations. The chart below shows the percentage of US companies still selling at more than 10x sales. During the Tech bubble, this figure peaked at 14.3% before falling back to its pre-bubble peak. Even after the recent market decline the current percentage remains above the peak percentage of the dotcom era. With easy monetary policy coming to an end, we suspect this figure will reset.



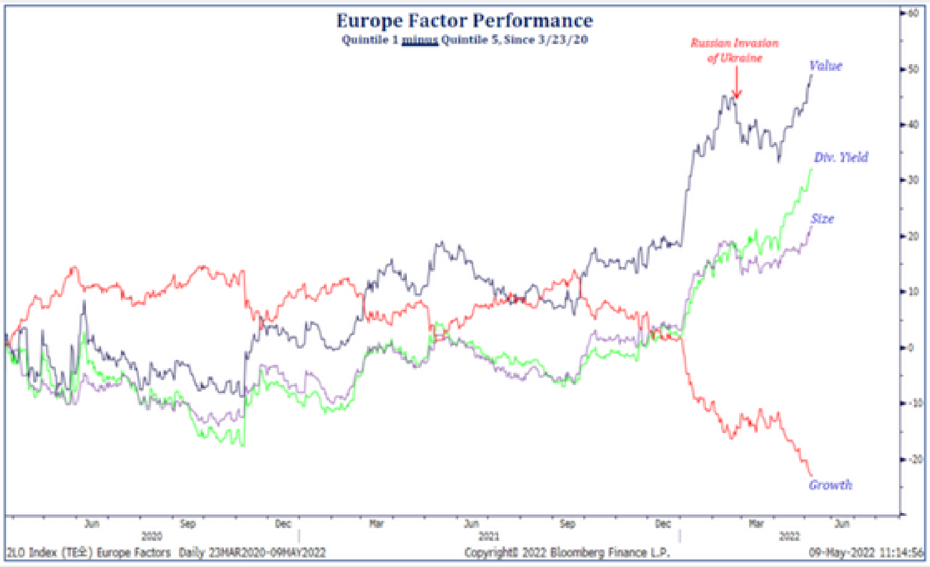
Source: Strategas Research Partners

Furthermore, although many investor sentiment indicators are reaching levels of pessimism historically associated with some attempt at an equity rebound, the table below suggests that investor positioning still stubbornly clings to the playbook associated with an era of zero interest rates and excessive quantitative easing. Flows into the three times leveraged QQQ (Nasdaq 100 Index) and the ARK Innovation ETF (a concentrated bet on many of those companies selling at 10x sales mentioned above) have dwarfed those inflows into the Energy sector despite the latter outperforming by +100% in the first five months of this year. This suggests that investor positioning still remains skewed to the most overvalued segments of the market most at risk from rising interest rates

ETF	YTD Performance	YTD Flows ($MM)
3x Leveraged QQQ	-65.4%	$7,416
ARKK	-61.0%	$1,539
Energy Sector	40.1%	$345

Source: Strategas Research Partners

Given the increased uncertain investment backdrop, the obvious question remains where are the best areas for equity investors to hide until more clarity returns. The chart below shows the relative performance of four of the most important factors driving equity performance – Value, Growth, Dividends and Size (market cap). As market volatility has increased the relative performance of cheaply valued and high dividend paying stocks has increased at the expense of those stocks whose high valuations are dependent on meeting high growth expectations that will prove unrealistic in the majority of cases. Our portfolios continued to benefit from a concentration in these segments of the market.



Source: Strategas Research Partners

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