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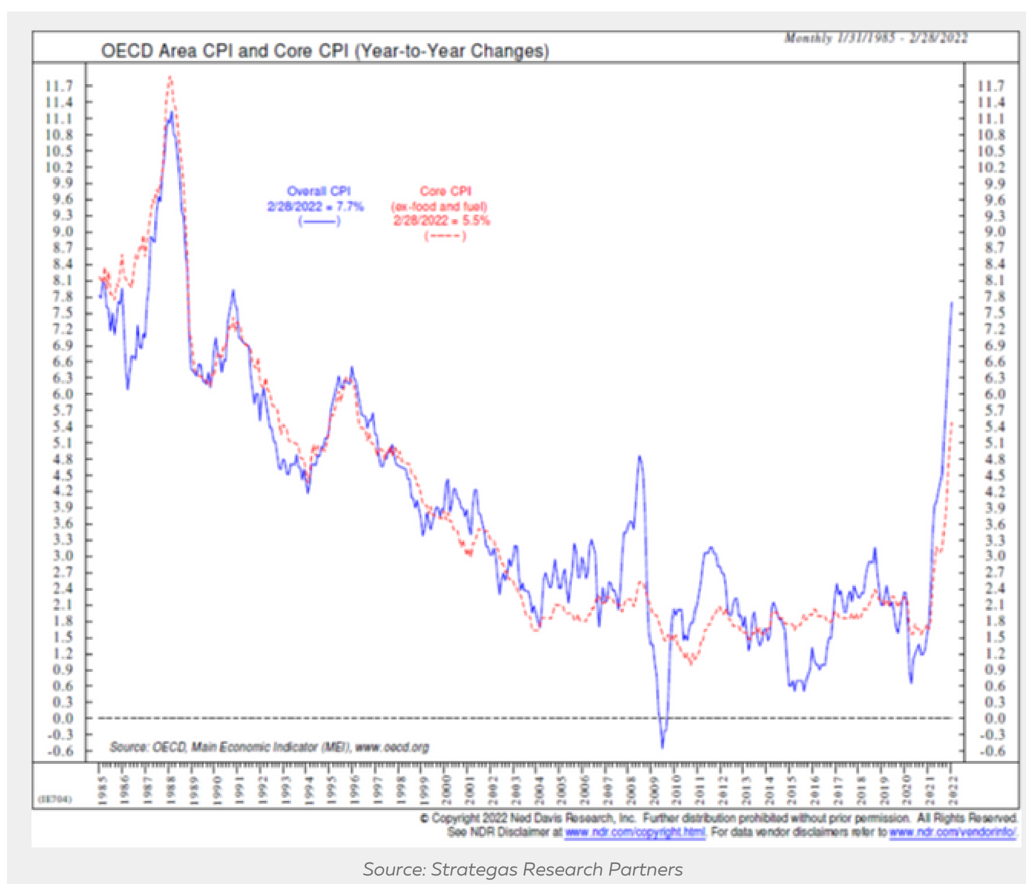
SUSTAINABLE VALUE INVESTING

WEEKLY INVESTMENT **UPDATE** 15/16

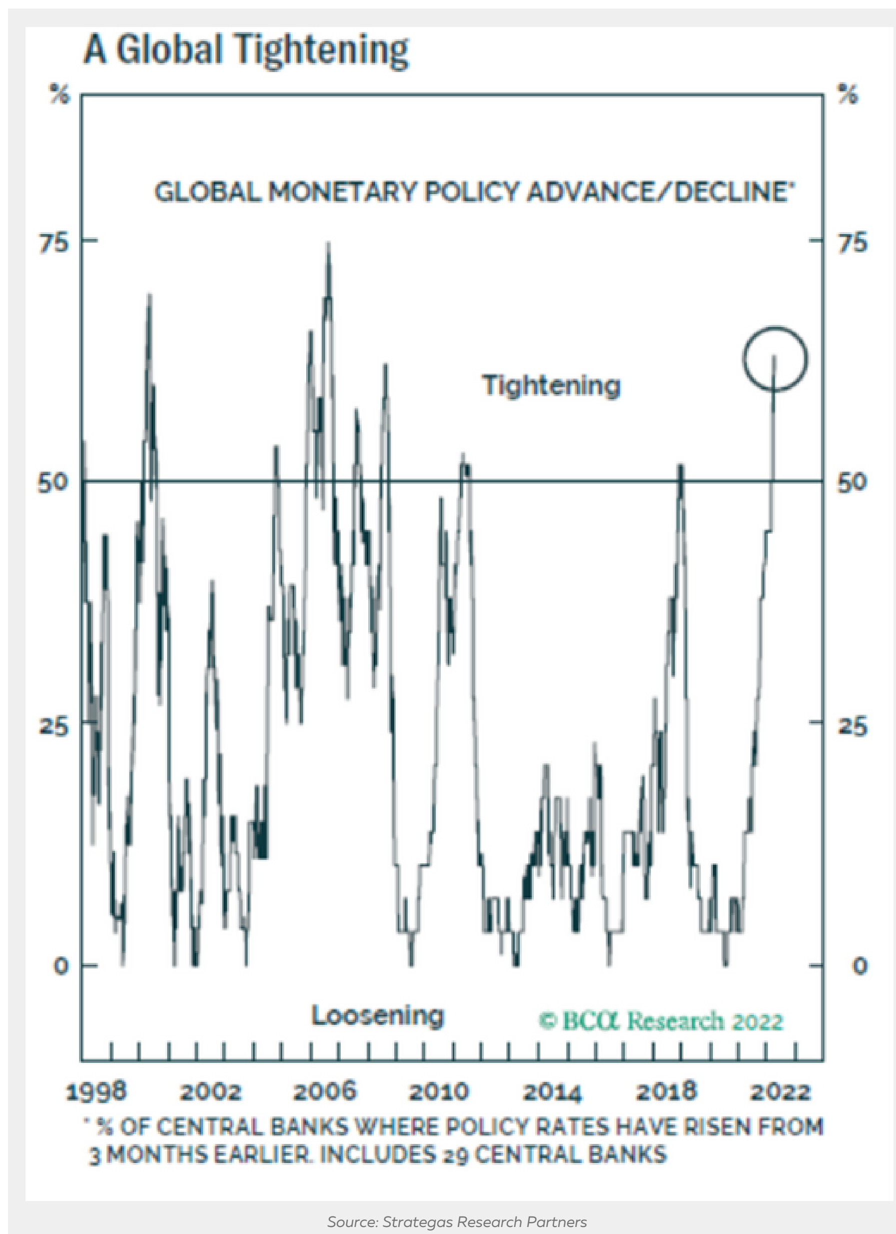
Financial markets are at a crossroads. In a more bullish scenario for risk assets, it would become increasingly evident that an inflation peak is at hand. With reduced anxiety about the return of 1970s-style stagflation, equity investors would consider the inflation and interest rates to be less threatening to economic growth and less of an obstacle to earnings growth. The combination of increased confidence in future earnings plus the improved equity valuations following the recent market correction would clear the path for higher asset prices.

A bearish scenario would be driven by evidence that instead of peaking, inflation had gained more traction globally, fueling worries that the Fed and other central banks would be behind the curve and compelled to be more aggressive in raising interest rates, drawing down balance sheets and thereby removing liquidity that would otherwise support risk assets. What is clear is that the future path of asset prices will be determined by the direction of global inflation. There is a mismatch between the increased global demand led by the economic recovery initiated by the vaccine response to the Covid pandemic, and the insufficient global supply that has been disrupted by a number of factors. Already in 2022 there have been two new supply shocks: the Russia/Ukraine conflict pressuring food, metals & energy prices, and new China lockdowns and port backups due to that government's zero covid policy. The result is a strong momentum behind the global inflationary pulse, with OECD aggregate inflation levels at +30 year highs (chart below).



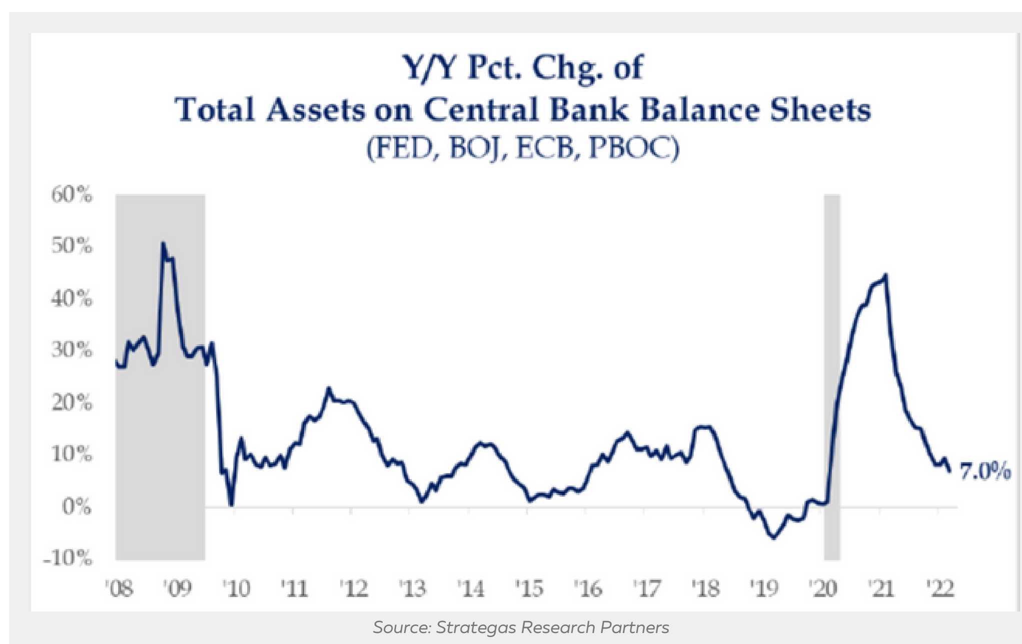
Source: Strategas Research Partners

Many global central banks have been caught off guard by the surge and persistence in the inflation data and are currently rushing to reverse erstwhile accommodative monetary policies. The chart below shows that 63% of global central banks have removed monetary accommodation over the past three months.



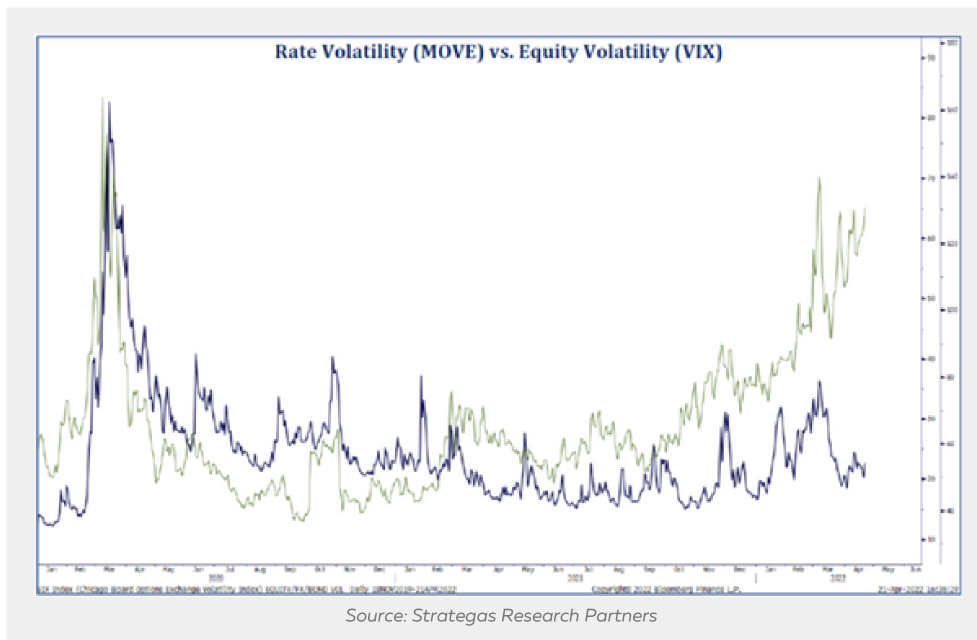
Source: Strategas Research Partners

That said, we cannot characterize global monetary policy as being anywhere close to tight right now. Global real interest rates remain low by historical standards. Furthermore, the aggregate balance sheet of the major global central banks continues to grow though at a greatly diminished rate (chart below). This situation will change shortly once the ECB stops with its asset purchases in Q3 and the US implements its decision to reduce the size of its balance sheet. Global investment liquidity is set to decline noticeably by the second half of 2022.



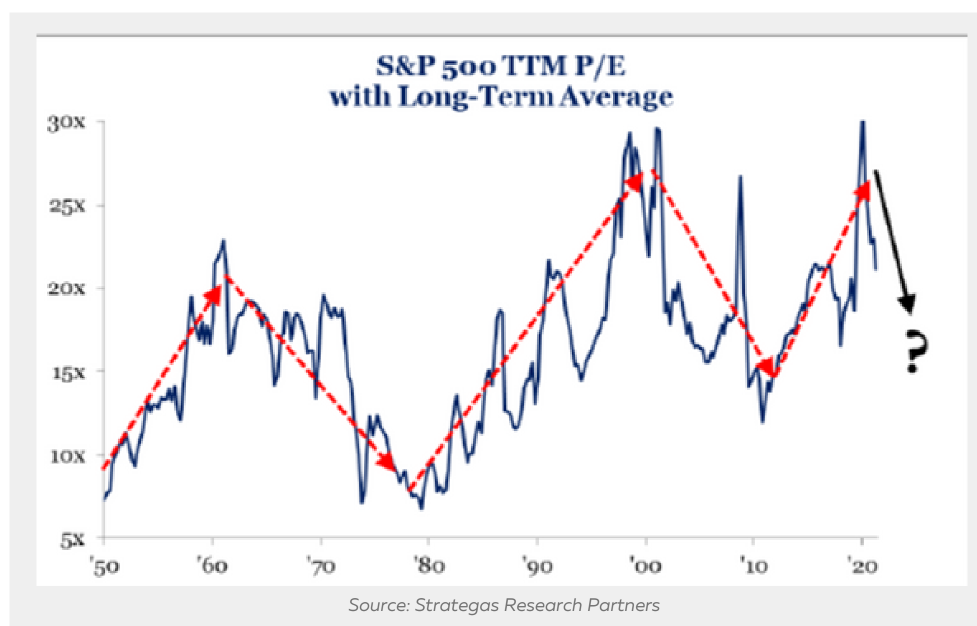
Source: Strategas Research Partners

The US Federal Reserve has stated its intention to return monetary policy to a more neutral level (seen as somewhere between 2.25 and 3%) in order to regain control over rising inflation. Of note is the resulting sharp rise in US bond volatility with only one 0.25% rate increase implemented to date and speaks to the significant overvaluation in the bond market which had previously been discounting an extended period of depressed interest rates. The chart below plots the volatility in the US bond market (light green line) with that of the equity market (dark line). Historically, there has been an extremely close correlation between bond and equity volatility as would be expected given that the change in interest rates is one of the most important determining variables in the valuation of stocks. Currently, equity volatility is remarkably low given the sharp increase in bond volatility. This divergence will be resolved in one of two ways and links back to the financial market crossroads segment at the beginning of this review. Either inflation will start to moderate allowing for bond yields to consolidate or fall (reducing bond volatility) which will then provide support for positive equity returns (and falling equity volatility). Or inflation data will remain persistently high, forcing central banks to go beyond a neutral monetary policy to one that is more restrictive and therefore negatively impacts on economic growth and equity valuations (thereby sending equity volatility higher).



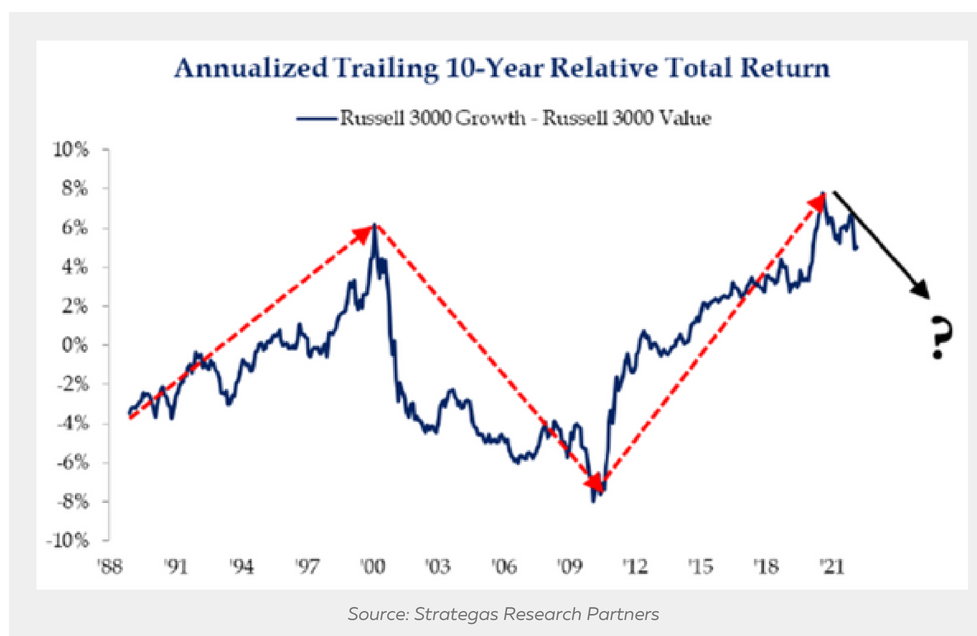
Source: Strategas Research Partners

We have been producing the following two charts since early 2021 as we judged that the vaccine rollout would result in a normalization of economic activity leading to higher interest rates and a return to more sensible valuation multiples. The first chart shows that valuation multiples tend to move in secular waves. The two biggest headwinds for multiples are elevated levels of inflation and rising interest rates. Both of which we have at the moment. While there has been some contraction in the earnings multiple it is clear from the chart that there is still some way to go before it returns closer to its historical average.



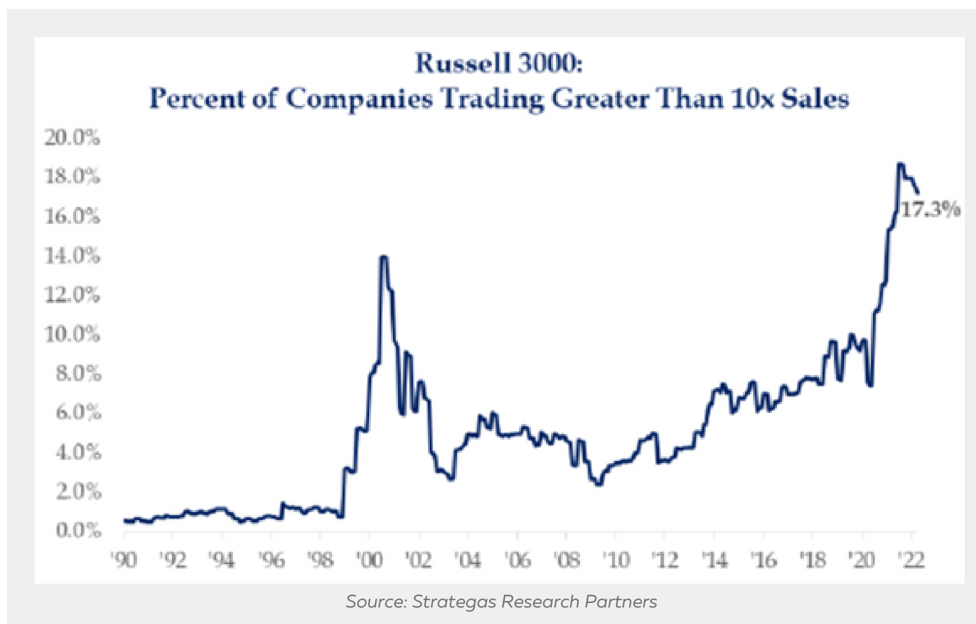
Source: Strategas Research Partners

Closely related to the topic of the normalization of valuations is the resulting relative performance between the most expensive and the least expansive stocks in the equity market (chart below). The outperformance of Growth and Value has moved in circa ten year cycles. Elevated inflation readings and rising rates are signaling the end of easy money and greater investor attention to searching for reasonably valued equities as opposed to simply betting on moonshots. Value stocks have done well following the introduction of vaccines in November 2020, but placed within a historical perspective, this move looks to be only in the nascent stages. The outperformance of value stocks has much further to go.



Source: Strategas Research Partners

The above reversal of trends makes passive investing in equity indices, which have become dominated by growth stocks given their extended period of outperformance, a much more risky proposition. Despite the recent market correction, the first chart below clearly shows that the US market still has a historically high allocation to extremely expensive stocks (selling for greater than 10x sales). Furthermore, the largest five stocks in the US market (second chart below) continue to constitute a historically sizable percentage of the overall market. These stocks (Apple, Microsoft, Amazon, Tesla, and Alphabet) currently sell at multiples significantly higher than their longer term averages and thus, any return to more normal valuations, would have a noticeable negative impact on index returns.



Source: Strategas Research Partners

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