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What Were You Thinking?

Global Matters Weekly

12 December 2022

– Tom Delic — *Portfolio Manager*

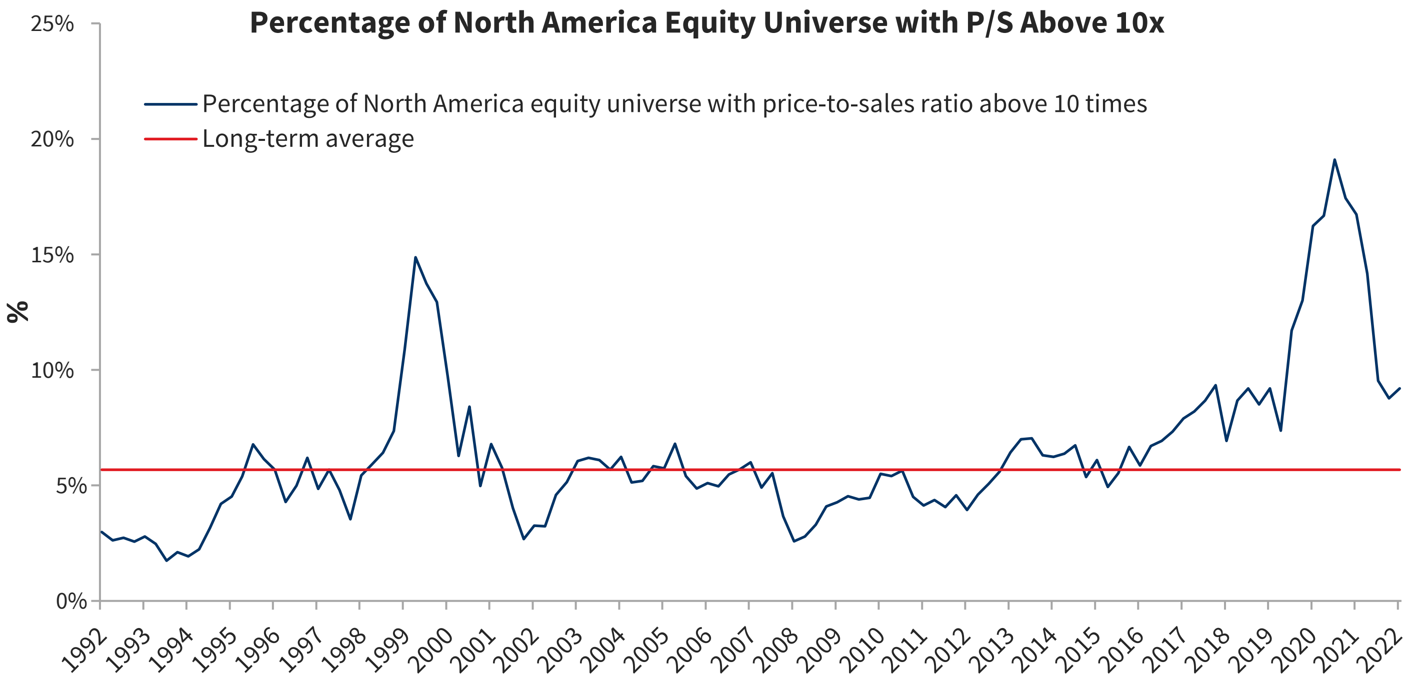
2022 has been an eventful year across financial markets, and while anything could happen during the last few weeks of December, I thought it would be worth reflecting on the extraordinary market behaviour we have seen over the past few years.

It feels as though there are numerous examples from the final throws of this cycle that could be placed under the microscope of the financial historian, decades from now. Could it be Austria's 100-year bond that yielded 0.375% in December 2020, down over 60% since? Or perhaps US CCC rated corporate debt yielding 7.5% in the summer of 2021, a credit rating that has a long-term average annual default rate of 25%? [1]

Echoes of Scott McNealy's well-known "What were you thinking?" [1] post-DotCom crash interview from 20 years ago rings in the ears, as investors have once again collectively failed to learn the lessons of history. At the time, McNealy was CEO of Sun Microsystems, a poster child of the technology bubble at the turn of the century. Valued at a price-to-sales ratio of 10 times, McNealy walked through the illogic of making an investment in his business at that price.

A valuation discipline is designed to place the odds in your favour.

As the chart below demonstrates, the speculation in the US equity market has not only matched the bubble at the turn of the century, but has exceeded it in an impressive fashion. 15% of the North American equity universe we track at Momentum Global Investment Management was trading at a price-to-sales ratio of ten times or more than in 2000. During the summer of 2021, as speculation raged in the 'junkiest' of junk bonds, the growth stock party was reaching its hedonistic highs as 19% of the universe traded above McNealy's "What Were You Thinking?" high



Sources: [1] Bloomberg Businessweek – A Talk with Scott McNealy, April 1 2002. Unless stated, all data from Bloomberg Finance L.P.

watermark. While correction since then has put an end to the festivities, if you believe the below chart will revisit the long-term average the hangover may have not yet reached its head-splitting worst

What can we learn from the latest cycle of speculative excess? It's satisfyingly easy to blame investment losses on an external factor and when the finger is pointed at central bank behaviour, there is understandable merit to this approach. The problem, however, is those kinds of external factors are never in your control, but your own actions and behaviour are.* A conservative, valuation, absolute return focus cannot necessarily shield an investor from volatility, but it can protect from the peril of permanent loss of capital.

A valuation discipline is designed to place the odds in your favour. Paying less than you think for something is a concept that appears to come naturally to most of the population - just watch the crowds of shoppers at the upcoming Boxing Day sales! Bargain hunting often gets lost for investors as the daily price movements in financial markets shifts the focus away from fundamental investing to one of speculation.

Further, the era of TINA (There Is No Alternative) is coming to an end. The philosophy has its roots in a relative return investment approach, but comparing less rotten apples to very rotten apples doesn't mean you need to take a bite out of the former. With global interest rates starting at sub-atomic levels, the normalisation of interest rates has drastic effects in a relative investing world. Like an accidental nudge of the James Webb Telescope, a two to three percent increase in interest rates has put you in a different galaxy. A reset to an absolute return world is long overdue, assessing an asset on its own risk-return profile, instead of relying on the over-valuation of one asset class to justify the other.

** Or at the very least, they are more likely to be in your control, depending on your view of free will, but that is beyond the scope of this blog and my own intelligence!*

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The **Marketplace**

- Global equities fell 2.5% on the week
- Four European Parliament officials, including vice-president Eva Kaili, were charged with corruption offences as part of an investigation into claims that Qatar attempted to buy influence in a key upcoming vote
- Brent crude fell 11.1% on the week to $76.1 a barrel
- Gold remained flat on the week at $1797.3 an ounce

Market **Focus**

US

- US equities returned -3.4% on the week
- The Federal Reserve meets this week for its decision on the policy rate with markets expecting a 50bps rise for the headline rate. Although this will be a downshift in the rate of hikes from the 75bps seen in past meetings, the policy rate is still expected to continue to rise steadily to a peak of around 5%
- Despite the aggressive hiking policy, the US economy continues to show signs of strength with the Institute of Supply Management services index coming in at 56.5, surpassing the consensus estimate of 53.5
- Other areas showed more signs of weakness as Blackstone, the private equity firm, was forced to limit withdrawals from a $69bn real estate fund due to liquidity issues

Europe

- European equities returned -0.9% on the week
- Strong economic headwinds in Europe failed to prevent a revision upwards in Euro Area growth for Q3, with the latest data showing a +0.3% expansion (vs. +0.2% previous estimate)
- With the European Central Bank also expected to raise the headline rate by 50bps later this week, the three-year expected inflation rate remained firmly at 3.0%, a full percentage point above target

UK

- UK equities fell 1.0% on the week
- UK Gross Domestic Product grew by 0.5% between September and October (vs 0.4% expected) reversing the 0.6% contraction seen in September. However, in the three months leading up to October, the economy contracted by 0.3% vs the previous quarter
- UK construction Purchasing Managers' Index fell further than expected but just about remained in expansionary territory with a decline to 50.4 (vs. 52.0 expected)

Asia/Rest of The World

- Global emerging market equities rose 0.5% on the week
- Chinese equities rose 6.8% on the week as China announced a significant loosening of COVID--19 restrictions, saying it would allow home quarantine for some COVID-19 patients and close contacts and would ditch COVID-19 testing requirements in most public venues
- China's stringent lockdown has meant that they have avoided the high levels of inflation seen globally. In November year-on-year Consumer Price Index fell to +1.6% from +2.1% in October, which was seen as offering policymakers more space to stimulate the economy if required
- Elevated inflation saw Japan's real wages (-2.6% year-on-year) post their biggest fall in more than seven years (vs -2.2% expected).

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Asset Class/Region	Currency	Currency returns			
		Week ending 9 Dec. 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	-3.4%	-3.5%	-16.6%	-14.7%
United Kingdom	GBP	-1.0%	-1.2%	7.3%	8.3%
Continental Europe	EUR	-0.9%	-0.2%	-9.7%	-7.8%
Japan	JPY	0.4%	-1.2%	1.0%	1.2%
Asia Pacific (ex Japan)	USD	1.3%	2.0%	-15.4%	-16.3%
Australia	AUD	-1.2%	-1.0%	1.2%	2.2%
Global	USD	-2.5%	-2.1%	-16.3%	-14.7%
Emerging markets equities					
Emerging Europe	USD	-0.2%	-0.3%	-72.9%	-73.1%
Emerging Asia	USD	1.4%	2.0%	-18.9%	-20.2%
Emerging Latin America	USD	-3.4%	-3.7%	9.3%	10.4%
BRICs	USD	2.9%	3.5%	-19.3%	-21.6%
China	USD	6.8%	7.8%	-20.0%	-23.7%
MENA countries	USD	-4.2%	-4.3%	-8.0%	-6.6%
South Africa	USD	2.1%	-4.1%	-4.1%	-2.2%
India	USD	-2.3%	-2.5%	-2.4%	-1.9%
Global emerging markets	USD	0.5%	0.6%	-18.4%	-19.3%
Bonds					
US Treasuries	USD	-0.4%	0.7%	-10.9%	-11.0%
US Treasuries (inflation protected)	USD	-1.6%	0.4%	-11.3%	-10.3%
US Corporate (investment grade)	USD	-0.2%	1.4%	-14.1%	-14.0%
US High Yield	USD	-0.1%	0.7%	-10.0%	-9.3%
UK Gilts	GBP	-0.3%	-0.6%	-21.8%	-24.4%
UK Corporate (investment grade)	GBP	0.2%	0.2%	-18.1%	-19.7%
Euro Government Bonds	EUR	-0.4%	0.3%	-14.2%	-15.7%
Euro Corporate (investment grade)	EUR	-0.1%	0.6%	-12.0%	-12.6%
Euro High Yield	EUR	-0.4%	0.0%	-10.8%	-10.7%
Japanese Government	JPY	0.3%	0.5%	-4.0%	-4.2%
Australian Government	AUD	0.6%	1.4%	-7.1%	-6.9%
Global Government Bonds	USD	-0.2%	1.7%	-15.9%	-16.4%
Global Bonds	USD	-0.1%	1.7%	-15.7%	-16.0%
Global Convertible Bonds	USD	-0.8%	1.3%	-18.2%	-18.3%
Emerging Market Bonds	USD	0.1%	1.6%	-23.4%	-23.8%

Source: Bloomberg. Past performance is not indicative of future returns

Asset Class/Region	Currency	Currency returns			
		Week ending 9 Dec. 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	-1.8%	-2.3%	-23.0%	-18.9%
Australian Property Securities	AUD	-1.3%	-2.9%	-21.8%	-20.2%
Asia Property Securities	USD	4.1%	2.5%	-8.0%	-10.5%
Global Property Securities	USD	-0.4%	-0.4%	-21.7%	-19.3%
Currencies					
Euro	USD	0.2%	2.2%	-7.4%	-6.6%
UK Pound Sterling	USD	0.1%	2.9%	-9.2%	-7.0%
Japanese Yen	USD	-1.3%	2.1%	-15.7%	-16.8%
Australian Dollar	USD	0.0%	1.3%	-6.5%	-4.9%
South African Rand	USD	0.9%	-2.1%	-8.1%	-8.0%
Swiss Franc	USD	0.5%	2.0%	-2.3%	-0.9%
Chinese Yuan	USD	1.4%	1.9%	-8.7%	-8.3%
Commodities & Alternatives					
Commodities	USD	-3.8%	-4.7%	15.0%	19.5%
Agricultural Commodities	USD	-0.8%	-2.7%	4.9%	7.7%
Oil	USD	-11.1%	-10.9%	-2.2%	2.3%
Gold	USD	0.0%	2.5%	-1.7%	1.1%
Hedge funds	USD	-0.2%	0.0%	-4.3%	-4.2%

Source: Bloomberg. Past performance is not indicative of future returns

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