IMPERIUM CAPITAL

momentum

New Year's revolutions

Global Matters Weekly

31 January 2022

– **Andrew Hardy, CFA**

2022 has started with a bang! Barring a recovery today January will close out as being the weakest start to a year for global equities – down 7.0% in US dollar terms – since 2009, when markets were still spiralling through the financial crisis. While that's enough to warrant attention, some of the underlying trends in markets have been considerably more abrupt. Nonetheless, rather than being cause for panic, we believe this is a healthy correction, led by parts of markets where the most excess had built up, and that the conditions for further medium-term progress in equity markets remain in place.

The vast majority of equity market falls have been driven by highly valued growth stocks, with the MSCI World Growth index down 12% in US dollar terms on a year-to-date basis. The ARK Innovation ETF, a widely held aggressive growth portfolio and poster-child for the dominance of growth stocks in the last few years, has fallen 27% over that period and has nearly halved from its high in June last year. From Zoom to Coinbase, Peloton to RobinHood Markets, highly valued growth stocks, many of which were direct beneficiaries of lockdowns, have rapidly moved out of favour and seen their valuations plunge, often with share price falls of over 60%. Larger index constituents are increasingly feeling the pain too; despite delivering quarterly earnings well ahead of expectations, Netflix and Tesla saw their share prices immediately slump over 20% and 10% respectively on the back of their latest results being reported.

It's no coincidence that real yields in bond markets (the difference between the nominal government bond yield and the market's expected rate of inflation) have been climbing rapidly since the falls in growth stocks began to broaden out. In the US, 5-year real yields touched multi-decade lows of nearly -2% p.a. in mid-November and have since climbed to nearly -1%. Real yields are still deeply negative and far below the normal historical range, so discount rates may yet need to move considerably higher before financial conditions materially tighten. Valuations for growth stocks are generally more sensitive to interest rates because they earn proportionately more of their earnings in the distant future, and the present value of those earnings is reduced more if discount rates rise, than for 'value' stocks.

Portfolios of value stocks have generally proved highly resilient over this period. The MSCI World Value index has only dipped 2% this year, supported by higher weightings in the outperforming financials sector, where many companies are benefiting from the rise in real yields and the energy sector, supported by a resurgent oil price. 'Value' stocks also tend to be more economically sensitive and should benefit most from the continued rebound in economic growth that is expected this year. Barring an extreme reversal later today, this month will see global value outperform the growth index by the most since MSCI records began in 1974. The fact that headline index returns are set to be so poor highlights how dominant expensive growth stocks have become in market indices, a risk we have long been alive to and mitigated in our portfolios.

This month will see global value outperform the growth index by the most since MSCI records began in 1974

The monetary tightening underway is set to be far more rapid than in previous cycles, clearly underlined by Fed chairman Powell's comments following the latest FOMC meeting last week. Markets are now pricing in around five 25 basis point rate hikes from the Fed this year, along with a start to quantitative tightening (the opposite of QE). The liquidity withdrawal that this is driving is rapidly unwinding other excesses that had built up: that includes sky high valuations on speculative growth stocks, but arguably extends much further; a basket of crypto currencies*, heralded by many to be an effective hedge against inflation, is down 48% from it's high (so far…).

We're witnessing a material shift in monetary policy, which is likely to be mirrored across many other major economies and will continue to have significant implications for investors. Markets were remarkably benign last year, but a continuation of the elevated volatility we have seen so far this year should be expected as we adjust to this next and more difficult phase of the cycle, especially while supply chain issues persist, and inflation remains so high. Geopolitical risks, most notably around the ambitions of Russia and China, contribute further to uncertainty, for investors but also central bankers; the risk of a policy error at this point is high.

However, as things stand, we do not believe the conditions are in place for a sustained fall in broader markets. Although growth will clearly be slower than last year, recently downgraded global GDP estimates for this year from the IMF still stand at 4.4%, well above historical trend, and corporate earnings will, broadly speaking, continue to follow suit. But with such a significant shift in the monetary policy landscape coming into view, we expect the best returns are likely to come from a very different cohort of stocks than that which led returns over the past decade. As well as maintaining broad diversification, we believe it is more important than ever to include a significant allocation to value stocks in portfolios, across a broad range of industries and geographies. New Year's resolutions rarely last beyond the end of January, but the revolution unravelling in markets may well prove more enduring.

For a more detailed outlook of the year ahead, see our latest Viewpoint article here.

*Source for all data Bloomberg Finance L.P. Index and stock returns to 28th January 2021 in US dollar terms. *Bloomberg Galaxy Crypto Index.*

The **Marketplace**

- Global equities fell -0.6% last week
- The Federal Reserve signalled a rate hike with a hawkish tilt
- Brent crude rose +2.4% to $79.3 a barrel
- Gold fell by -0.4% to $1813.

Market **Focus**

US

- Benchmark U.S. equities rallied +0.8% Oil, Gas and Energy outperformed, whilst Semiconductors, metals, minning underperformed. Modest headline weekly returns mask significant intraday volatility.
- The Federal Reserve's Powell signalled a hike with a hawkish tilt, which could raise interest rates by 50 bps in March. Powell was non-committal about the pace of liftoff and didn't specify when balance sheet reductions would begin. He was optimistic tighter policy wouldn't harm the labour market. Goldman Sachs is expecting five rate hikes this year.
- The US GDP print for Q4 was +6.9%, well above expectations of +5.5. But indicated concern , with the Treasury curve flattening considerably on the back of Powell's remarks.

Europe

- European equities fell -2.5% last week.
- The Fed's hawkish turn has been good for value stocks . The Europe Value Index is on course for its largest monthly outperformance on record against its growth equivalent of (c14%). Prospects of rising interest rates are hitting pricey long-duration equities while favouring cheaper stocks with more immediate cash flows.
- In Italy, after a week of voting, Sergio Mattarella will stay as Italy's head of state, and Mario Draghi will remain as PM. Draghi has persuaded the president to put off his retirement to break the deadlock.
- Germany January Manufacturing PMI of 60.5 was more robust (57 expected), G.D.P. for Q4 of -0.7% was low (-0.3% expected).

UK

- UK equities fell -0.2% last week.
- Prime Minister Johnson introduces a Brexit freedom bill to make it easier to remove E.U. laws from British statute books.
- UK January Manufacturing PMI of 53.4 underwhelmed (vs 56.9 expected).
- The Bank of England is expected to raise interest rates at its meeting this week, adding pressure to household budgets as prices continue to rise but giving a boost to savers.

Asia/Rest of The World

- The benchmark Global Emerging Markets index fell -4.3% last week.
- Japanese equities fell -2.6% last week.
- Chinese equities fell by -7.8% ahead of being closed this week for New Year celebrations.
- China's manufacturing PMI fell to 50.1, and the services index dropped to 51.1.
- Japan's January Manufacturing PMI of 54.6 surprised to the downside, missed expectations of 55.
- The Pentagon warned Russia has amassed sufficient military assets along the Ukrainian border to launch an invasion at any moment, a build-up that has given the Kremlin a 'range of options'. US senators are close to agreeing on a sanctions bill. President Biden said he'll send troops to Eastern Europe. Russia wants an explanation of European security obligations before making its next proposals. The U.N. Security Council will debate the situation today. The U.K. also ramped up preparations for military action in Ukraine, offering to send troops to Estonia and planning sanctions that would hit Russian oligarchs..

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Asset Class/Region	Currency	Currency returns			
		Week ending 28 Jan. 2022	Month to date	YTD 2022	12 months
Developed Market Equities					
United States	USD	0.8%	-7.0%	-7.0%	18.2%
United Kingdom	GBP	-0.2%	2.0%	2.0%	20.5%
Continental Europe	EUR	-2.3%	-5.8%	-5.8%	16.4%
Japan	JPY	-2.6%	-5.8%	-5.8%	4.2%
Asia Pacific (ex Japan)	USD	-5.1%	-5.0%	-5.0%	-12.1%
Australia	AUD	-2.6%	-6.1%	-6.1%	9.0%
Global	USD	-0.6%	-6.9%	-6.9%	12.4%
Emerging markets equities					
Emerging Europe	USD	-0.8%	-7.5%	-7.5%	6.4%
Emerging Asia	USD	-5.1%	-4.8%	-4.8%	-14.6%
Emerging Latin America	USD	0.2%	5.2%	5.2%	0.4%
BRICs	USD	-5.5%	-4.0%	-4.0%	-19.0%
China	USD	-7.8%	-5.3%	-5.3%	-31.7%
MENA countries	USD	-0.7%	6.2%	6.2%	33.2%
South Africa	USD	-5.4%	2.8%	2.8%	3.3%
India	USD	-3.8%	-2.1%	-2.1%	21.7%
Global emerging markets	USD	-4.3%	-3.3%	-3.3%	-9.9%
Bonds					
US Treasuries	USD	-0.3%	-1.7%	-1.7%	-3.3%
US Treasuries (inflation protected)	USD	0.2%	-2.4%	-2.4%	3.0%
US Corporate (investment grade)	USD	-0.9%	-3.3%	-3.3%	-3.3%
US High Yield	USD	-1.3%	-2.8%	-2.8%	1.9%
UK Gilts	GBP	-0.9%	-3.1%	-3.1%	-7.2%
UK Corporate (investment grade)	GBP	-1.2%	-2.6%	-2.6%	-5.1%
Euro Government Bonds	EUR	-0.3%	-0.7%	-0.7%	-3.8%
Euro Corporate (investment grade)	EUR	-0.4%	-1.0%	-1.0%	-1.9%
Euro High Yield	EUR	-0.8%	-1.2%	-1.2%	1.9%
Japanese Government	JPY	-0.3%	-0.7%	-0.7%	-0.7%
Australian Government	AUD	-0.2%	-1.5%	-1.5%	-4.4%
Global Government Bonds	USD	-1.1%	-1.9%	-1.9%	-7.3%
Global Bonds	USD	-1.1%	-2.2%	-2.2%	-6.7%
Global Convertible Bonds	USD	-2.2%	-5.7%	-5.7%	-9.8%
Emerging Market Bonds	USD	-0.4%	-4.0%	-4.0%	-6.6%

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

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Asset Class/Region	Currency	Currency returns			
		Week ending 28 Jan. 2022	Month to date	YTD 2022	12 months
Property					
US Property Securities	USD	-0.3%	-8.0%	-8.0%	28.7%
Australian Property Securities	AUD	-2.1%	-10.8%	-10.8%	12.2%
Asia Property Securities	USD	-1.7%	0.7%	0.7%	-2.9%
Global Property Securities	USD	-1.2%	-6.1%	-6.1%	15.5%
Currencies					
Euro	USD	-1.7%	-2.1%	-2.1%	-8.0%
UK Pound Sterling	USD	-1.2%	-1.1%	-1.1%	-2.5%
Japanese Yen	USD	-1.4%	-0.2%	-0.2%	-9.5%
Australian Dollar	USD	-2.8%	-4.0%	-4.0%	-9.0%
South African Rand	USD	-3.6%	1.9%	1.9%	-3.5%
Swiss Franc	USD	-2.1%	-2.1%	-2.1%	-4.6%
Chinese Yuan	USD	-0.4%	-0.1%	-0.1%	1.4%
Commodities & Alternatives					
Commodities	USD	1.6%	8.5%	8.5%	47.1%
Agricultural Commodities	USD	1.0%	3.5%	3.5%	34.3%
Oil	USD	2.4%	15.7%	15.7%	62.1%
Gold	USD	-2.4%	-2.1%	-2.1%	-2.6%
Hedge funds	USD	-0.4%	-2.1%	-2.1%	1.6%

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

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