SIGMA
PRIVATE OFFICE

MARKET REVIEW
JUNE 2022

MARKET SUMMARY & OUTLOOK

Following a strong end to 2021, 2022 is undoubtedly off to a very rocky start. Developed market equities ended their 21-month upward streak and reached correction territory for the first time since the 2020 Covid bear market with the S&P 500 down 18.6% and Nasdaq 100 down 27.7% from peak to trough. The year started with another strong rotation out of growth stocks into value; the MSCI World Growth Index is down 20.36% compared to a 5.38% decline in the MSCI World Value Index, buoyed largely by energy stocks, through the end of April.

Risk assets began their sell off in January as inflation hit a 40-year high and a more hawkish than expected Fed tightening cycle was repriced into markets. Q4 2021 earnings season provided a short relief at the end of January but, just as it seemed the Covid hangover of supply chain disruptions, inflationary pressures and labour constraints were starting to ease, we saw geopolitical tensions flare with the Russian invasion of Ukraine on 24th of February. The resulting uncertainty and surge in commodity prices led to a further slide and continued volatility in equity and bond markets. Due to their proximity and dependence on Russian oil and natural gas, European markets were naturally harder hit with the DAX sliding 12.3% in the immediate aftermath.

The upward pressure on inflation due to higher commodity prices is likely the main channel of transmission of this crisis to the rest of the global economy. Despite the increasingly difficult landscape the Fed proceeded with ‘lift off’ raising the federal funds rate by 25bps to the 0.25-0.5% range at its March 16th FOMC meeting. The Fed initially erred on the side of caution by opting for a 25bps hike rather than the 50bps hike which was widely expected causing equity markets to rally between 8% and 15% off their lows to end the quarter strong. However, the rebound was short lived as the S&P500 posted its worst 1 month return in April since March 2020 and the Fed followed up with their first 50bps hike in 2 decades at their May 4th meeting. Volatility continued into May as inflation fears drove markets to new lows; a record was set with 8 consecutive weeks of negative returns and the S&P 500 teetered on the brink of bear market territory (-20% from its high). However, this technical barrier wasn’t broken and global equity markets rallied off their lows to end the month basically flat.

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Despite us being more than 5 months into this market correction our outlook remains optimistic for the remainder of 2022 as global economic growth moderates but remains slightly above trend. Despite heightened volatility, which we think will persist, we favour equities to bonds and other asset classes. Within equities we expect growth to outperform value in this late stage of the bull market. Our preference goes to large, high quality growth companies with low debt levels and strong balance sheets. As always though, it remains important for the long-term investor to maintain a well-diversified portfolio.

The remainder of this quarterly report looks to address some of today’s most pressing market fears; geopolitical tensions, inflation, the yield curve inversion, monetary policy missteps and what all this could mean for the risk of recession. While these topics may sound gloomy, the extreme negative sentiment it creates is in itself a positive and the amount of attention these subjects garner likely reduces the surprise power they have on markets. That being said, we expect markets to remain volatile amidst the uncertainty and so for a long-term investor the key to success is maintaining composure. We therefore finish on perhaps the most important message of all; time in the market, rather than market timing.

US INFLATION & THE YIELD CURVE

Inflation and the implications of this for monetary policy is perhaps the most widely discussed investment topic of the moment. While we focus on the US here, the same concepts apply for the UK and Europe. The US March CPI print came in at 8.56% YoY growth; the highest level since 1981. Many investors worry that rapidly rising prices will force the Fed to hike interest rates quickly and thus increase the likelihood of stagflation or a monetary policy misstep, whereby they invert the yield curve, pushing the US and global economy into recession.

Let’s tackle inflation first. Prior to the pandemic, inflation was not a concern, more investors feared deflation. Then the

pandemic hit and we saw widescale government induced lockdowns halt output; the aftermath continues to be felt in the form of higher commodity prices, supply chain disruptions and labour constraints. These have been the main drivers behind higher inflation. If we breakdown inflation in the post pandemic world, the two biggest contributors to CPI growth have been energy and motor vehicle related. These are typically transitory elements of inflation and as we see supply pressures ease on semiconductors the auto industry will be in a position to ramp up production again. We expect the supply/demand market forces to rebalance naturally as the world reopens further and spending shifts back from goods to services. As such, inflation may have already peaked in March and we expect pressures to ease in the second half of the year.

What is perhaps more concerning is the tightness of the US labour market and the corresponding pressure on wage inflation. As of March, the US unemployment rate was 3.6% and trending down, wage inflation was at 5.5% putting the Fed well behind the curve in regards to interest rates. However, there are still 1 to 2 million workers who haven't returned to work because of Covid related disruptions. If labour supply and the participation rate return to pre-Covid levels, wage inflation should moderate.

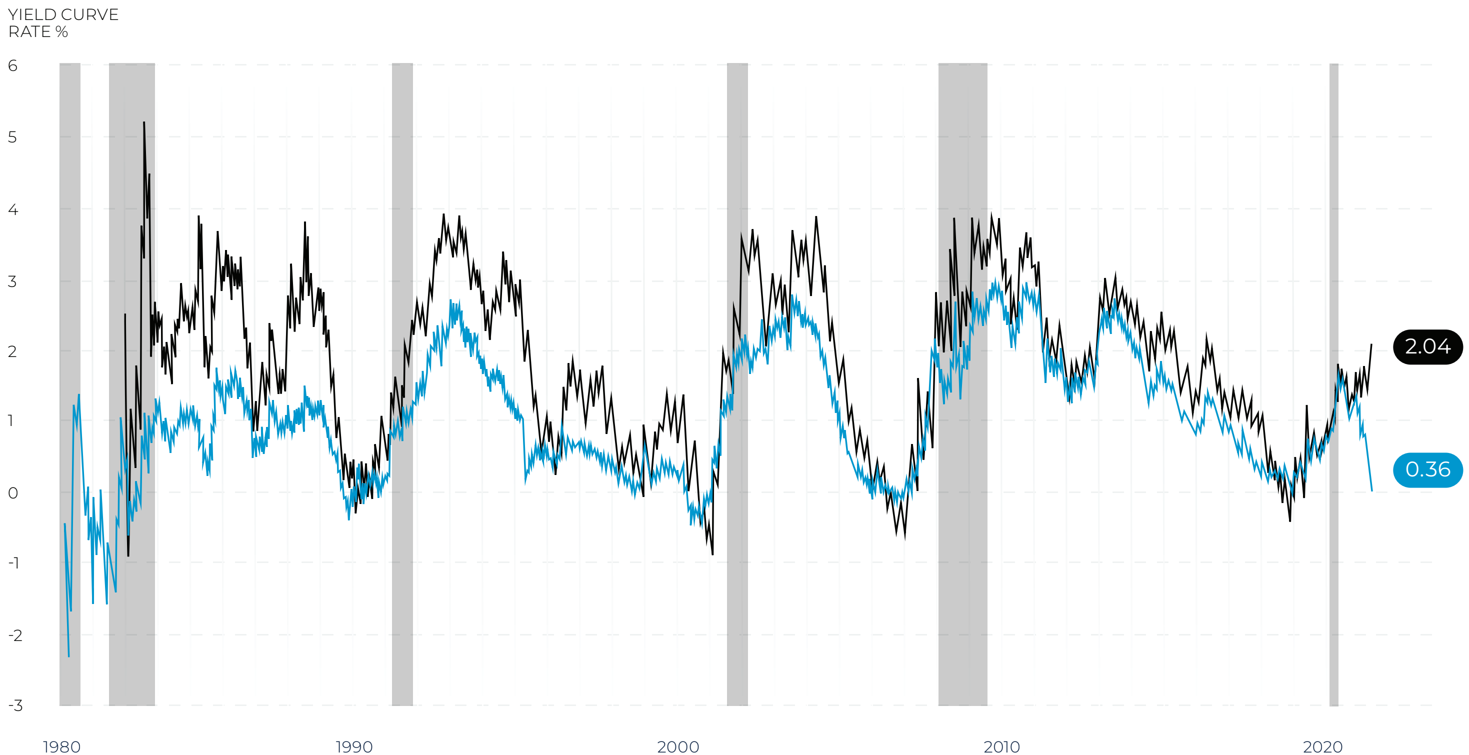
The Fed has the challenge of balancing various aspects of the economy when determining the course of monetary policy. Today's environment doesn't make it any easier and we think many elements of inflation may actually solve themselves, given time, without excessive intervention by the Fed. Although we assess the probability as low, we do think the risk of a monetary policy misstep and recession have increased as the Fed embark on a steep hike path. However, we don't see this as problem for 2022 or even early 2023 but rather beyond as the yield curve flattens or possibly inverts.

It's hard to deny the importance of the yield curve as an economic indicator given its predictive past. The yield curve has inverted prior to the last 6 US recessions, as shown in Chart 1. Most recently the 2Y/10Y inverted in March sparking renewed recession fears. However, there are multiple factors we need to consider here before fleeing for the exit.

CHART 1

YIELD CURVE INVERSION AS A RECESSION INDICATOR

- 10 Years Treasury Yield Curve Rate. Percent - United States - 3 Months Treasury Yield Curve Rate. % - United States
- 10 Years Treasury Yield Curve Rate. Percent - United States - 2 Years Treasury Yield Curve Rate. % - United States
- Recession Periods. United States



Source: Factset

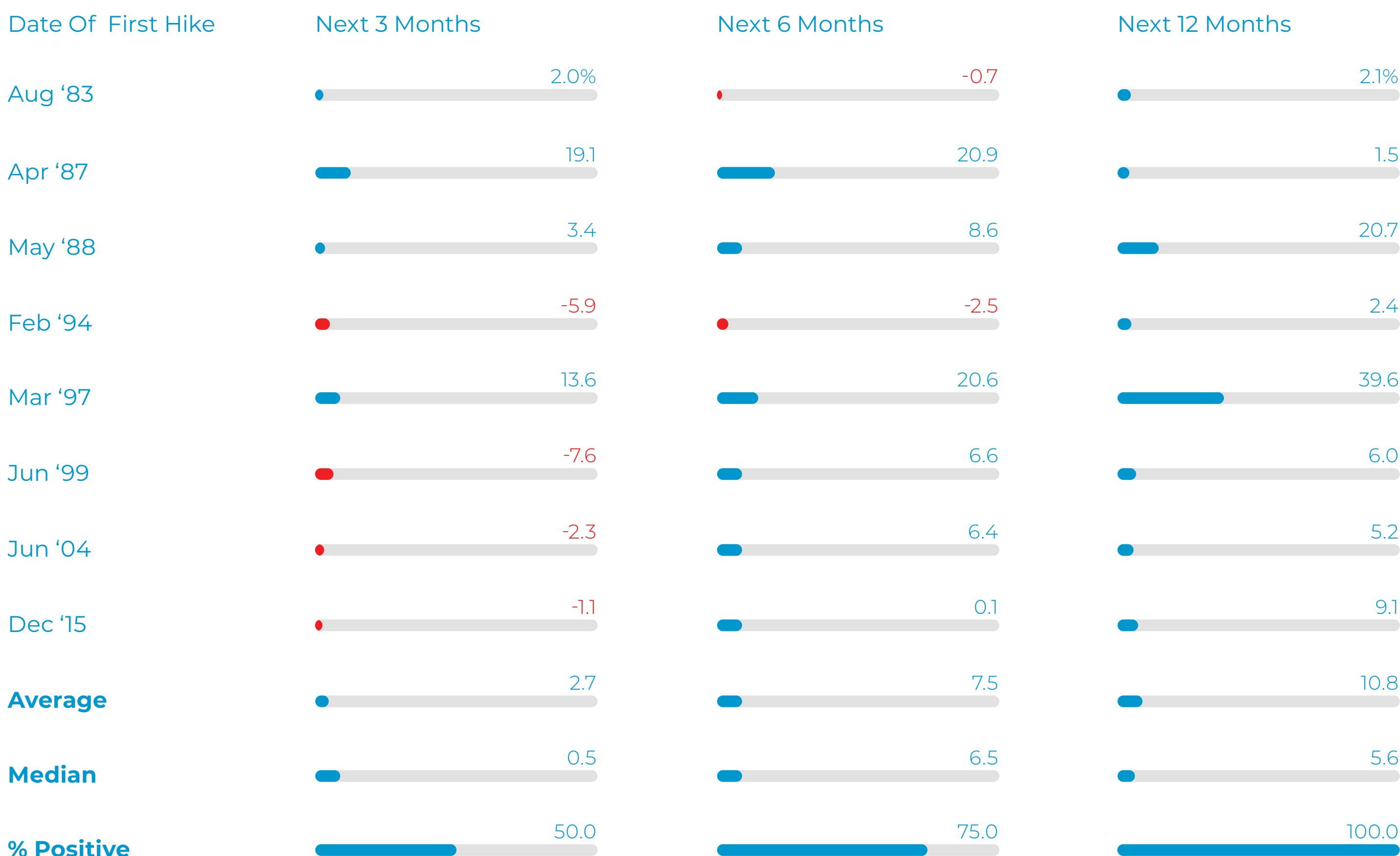
Firstly, it is a leading indicator and therefore not a precise timing tool. Historically it has taken an average of 30 months from the inversion of the 2Y/10Y curve until recession hits with equity markets rallying on average 36% from the first tightening. Secondly, which curve do you follow? While most point to an inversion of the 2Y/10Y, we think the 3M/10Y is more relevant as it is a better reflection of banks' Net Interest Margins. Bear markets don't occur just because the yield curve inverts. Rather the inversion of the yield curve implies that short term rates (the bank's borrowing costs) are higher than long term rates (the bank's lending revenue) making it costly, rather than profitable, for banks to extend credit. Over time, liquidity dries up, spending and investment falls and the economy eventually sinks into recession. On a positive note, and contrary to what the media likes to portray, we show in Chart 1 that the 3M/10Y continues to steepen suggesting there is room for the Fed to raise interest rates before a meaningful and prolonged inversion becomes a true concern. Finally, we now operate in a very low interest rate environment, corresponding to a naturally flatter yield curve, perhaps reducing its predictive power as it doesn't take much to invert it in the first place.

So, what does all this actually mean for markets? We know that markets pre-price all widely known information and markets move on the difference between expectations and reality. Markets are now pricing in 5 – 7 rate hikes this year with the possibility of at least two 50bps hikes. That means for this to have any more meaningful impact than it has already had on markets, the Fed needs to do much more; we think this is unlikely. Furthermore, history suggests that it is an outright misconception that a rate hiking cycle is in itself negative for equities. Chart 2 shows 100% positive returns from US equities in the 12 months after the first rate hike. At the same time, we believe the Fed is tightening into a healthy US economy with strong corporate earnings and therefore continue to expect attractive returns from equity markets over the next 12 months.

CHART 2

WHAT HAPPENS AFTER THE FIRST FED RATE HIKE?

S&P 500 index future returns



Source: LPL Research, Bloomberg

RUSSIA UKRAINE WAR

The prospect of war in Europe became a harsh reality in February when the Russian military invaded Ukraine. Luckily NATO beefed up their defences but stopped short of joining the conflict, which reduced the risk of a more widespread war in Europe. In addition, stronger than expected resistance from Ukraine has caused the Russians to retreat East and focus on the "complete liberation" of the Donbas.

The West continues to retaliate with harsh sanctions, crippling much of the Russian economy and sparking fears of the first Russian default since 1998. It's not that Russia doesn't have the money to pay their debts, their international reserves amount to an estimated $623bn, they just can't access it with over 2/3 of reserves held outside of Russia and therefore subject to sanctions.

Uncertainty remains and continues to drive short term market volatility, an unavoidable part of investing. But, beyond that what is the real significance of this conflict for the global economy? Yes, it's hard to see how Russia or Ukraine can avoid recession but Ukraine accounts for a mere 0.2% of the global economy, Russia about 3%. The humanitarian tragedy is undeniable but the reality is that equity markets are dispassionate and rational. The long history of regional conflicts, as shown in Chart 3, demonstrate that they do not cause bear markets. Of all conflicts, since reliable S&P 500 data began in 1925, only World War II, a global rather than a regional conflict, caused a bear market. Unless this conflict goes global or creates other lasting structural imbalances (inflation being the biggest worry) that lead to a global recession, we think that the economic fallout will largely be local and global equity markets will eventually move on and continue their upward path.

CHART 3

REASON TO SELL | S&P 500

January 3, 1978 - April 14, 2022

Source: Factset Prices

IT'S TIME IN THE MARKET, NOT TIMING THE MARKET

The old saying has never rung truer! Turn on the news and you see lots of reasons, the main ones already discussed, to be fearful for an imminent market crash and recession. In our view this is a classic sign of a correction; extreme negative sentiment driving a sharp downturn of 10%-20%. Chart 3 shows merely some of the many reasons why investors have panicked in the past, but what they forget is that equity markets rise over 70% of the time despite the short-term volatility.

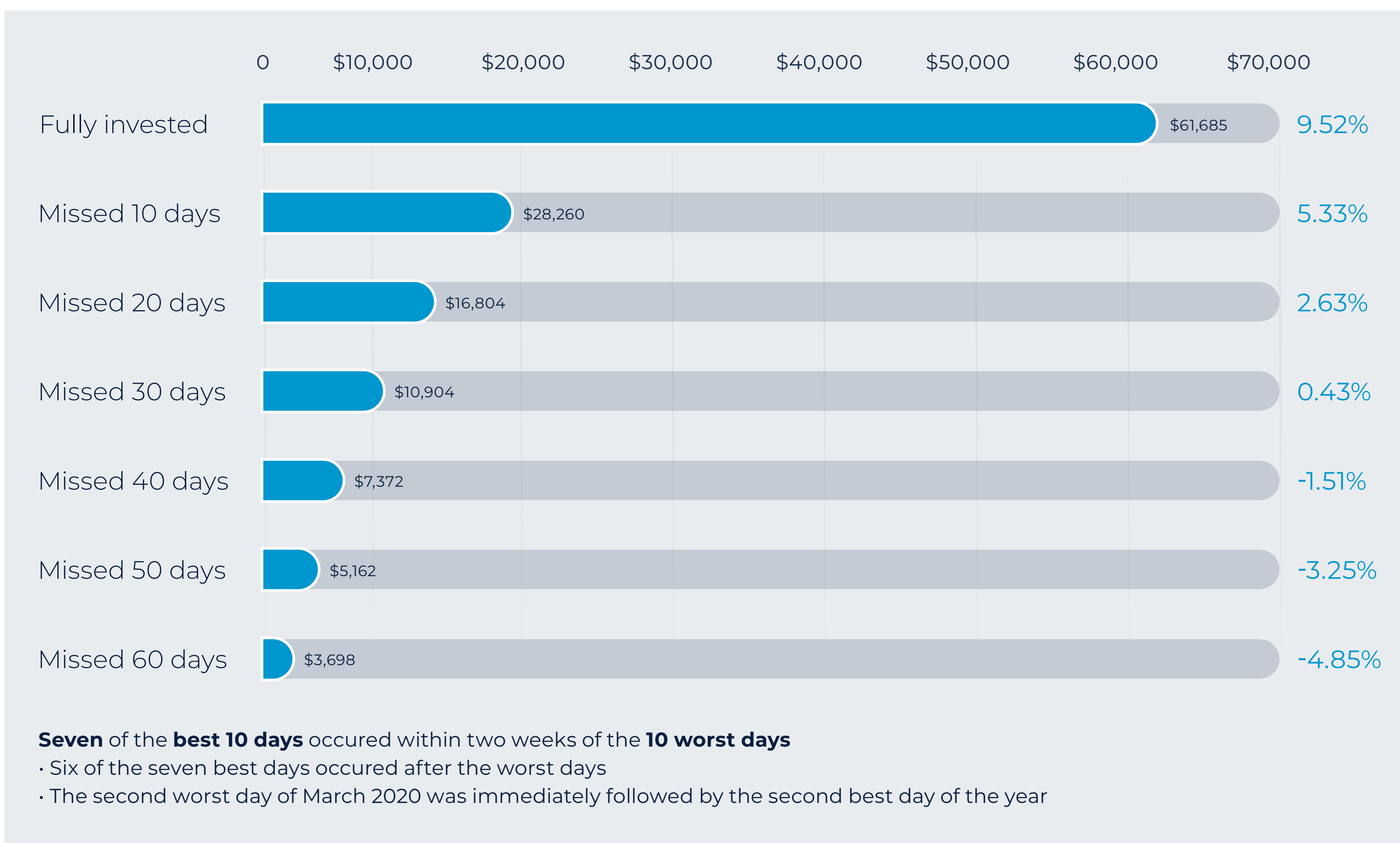
At the end of the day, the short-term volatility is the price we pay for solid long-term average returns. However, while rationally we may know this, everyone (experts included) also knows how painful it can be seeing a sharp drop in one's portfolio value and the urge arises to get out before it gets worse. It is during these tough times that behavioural discipline is a long-term investor's only saviour.

Chart 4 demonstrates exactly why staying invested is the safest and best way to achieve investment objectives. Missing out on the compounded growth from just the 10 best days is a costly mistake and would have halved your return. No one can time markets perfectly and consistently so why bother taking the risk given the below facts.

CHART 4

RETURNS OF THE S&P 500

Performance of a $10,000 investment between January 1, 2002 and December 31, 2021



Source: www.forbes.com

Has this correction bottomed out? Do we get a V or W shaped recovery? These are less relevant questions for a long-term investor. What matters is that we have assessed our clients' objectives and tailored an appropriate and well-diversified long-term investment strategy that is achievable by staying invested during turbulent times.

Thank you for taking time to read our Market Review.

Sigma Investment Committee