Q2 2022 QUARTERLY REVIEW AND OUTLOOK

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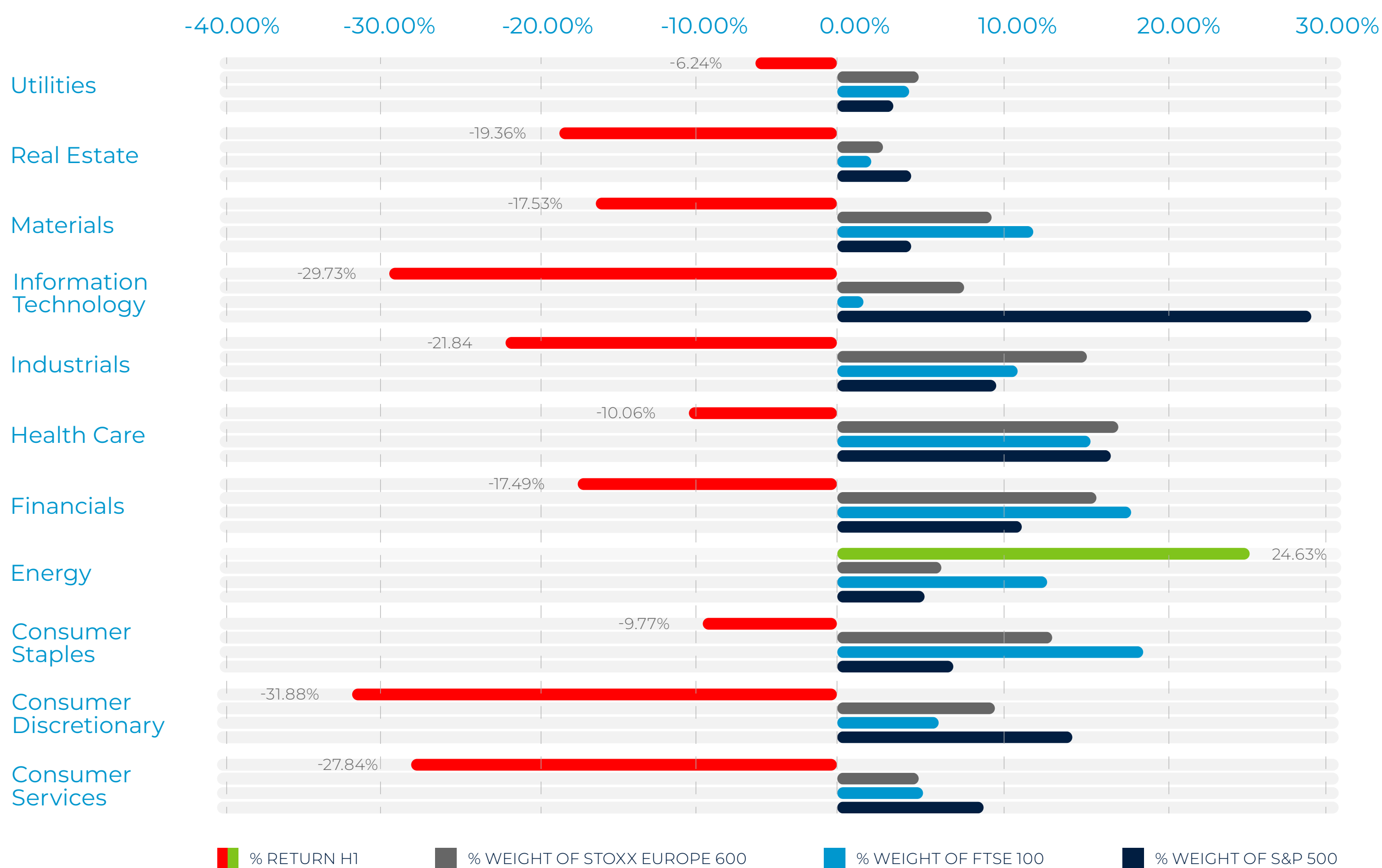
The second quarter proved to be yet another difficult quarter for investors as equity and bond market volatility persisted. The S&P 500 had its worst start to the year since 1970, falling 20.6% in H1 and officially entered a bear market. While this year's downturn started off like your traditional correction, with sharp sentiment driven declines in Q1, global economic conditions have worsened quite substantially since. Russia's invasion of Ukraine has resulted in surging food and energy prices exacerbating the global inflationary problem and leading central banks to hike interest rates at an even more accelerated pace than initially anticipated.

Markets continue to be plagued by the same fears we touched on in our June Market Review and it is unsurprising that volatility remains high with markets grappling with these various challenges. However, following poor equity returns in June, after a 75bps interest rate hike by the Fed, equity markets now seem to be pricing in at least some form of mild recession; a technical recession is a real possibility following Q1's GDP contraction. The big question is whether or not growth rebounds in the second half of this year as inflation moderates allowing the Fed to take its foot off the accelerator and navigate a 'soft' landing, whereby unemployment and credit losses remain low. This is our base case and we touch on why later in our market outlook. Alternatively, a scenario exists in which the Fed is forced to continue tightening financial conditions to bring sticky inflation down whilst the economy contracts and unemployment rises, causing a more drawn out recession, or 'hard' landing.

Across the pond, in the UK and Europe, we have seen consumer confidence levels fall to record lows as the cost-of-living crisis intensifies; real wages are falling while food, fuel and gas prices rise. The European economy faces an additional risk from the potential reduction in gas supplies from Russia which could result in outright shortages and rationing in the winter if things continue. Government subsidies will ease some of the pain but the outlook for peak inflation in the UK and Europe is, therefore, less optimistic than in the US given their energy dependence, which results in imported inflation. However, we still expect inflation to moderate in the second half of this year and come down to more normal levels in 2023.

CHART 1

SECTOR WEIGHTS AND PERFORMANCE



The UK and European stock markets have fared relatively well compared to the US; the FTSE 100 was down 2.65% in H1 and the STOXX Europe 600 was down 14.8%. It is worth noting however that the performance differences were largely driven by big currency moves in H1 and index compositions rather than regional fundamentals. The US Dollar has rallied significantly therefore strengthening foreign earnings of UK and European companies in local currency terms; GBP/USD fell from 1.37 in early January to 1.20 at the end of the quarter, and similarly EUR/USD from 1.14 to 1.01, a level last seen 20 years ago. Furthermore, Chart 1 illustrates the heavier weightings of energy (the only sector with a positive return in H1, 24.63%), healthcare and other defensive sectors in the FTSE 100 and STOXX Europe 600, compared to the more technology-heavy S&P 500 index.

Unfortunately, fixed income has also been hard hit this year and failed to provide the protection that investors typically seek from it. Globally, bonds continued their sell-off in Q2 as yields edged higher on elevated inflation data and rising interest rates. The US 10-year yield hit a high of 3.49% in mid-June before falling back below 3% by quarter end as inflation fears eased on falling commodity prices. While volatility will likely remain, we suspect that the significant upward pressure on bond yields from the past 6 months should moderate as higher interest rates have been largely priced in. Furthermore, as Chart 2 illustrates, long term inflation expectations in the US have already fallen back to nearer the 2% target. Thus, the implication is that high inflation is largely seen as a short-term problem, spurred on by supply chain disruptions, China lockdowns, the war in Ukraine, and that fears of longer-term entrenched inflation are likely overdone.

CHART 2

US INFLATION EXPECTATIONS

5-Year, 5-Year Forward Inflation Expectation Rate, Percent - United States

MARKET OUTLOOK

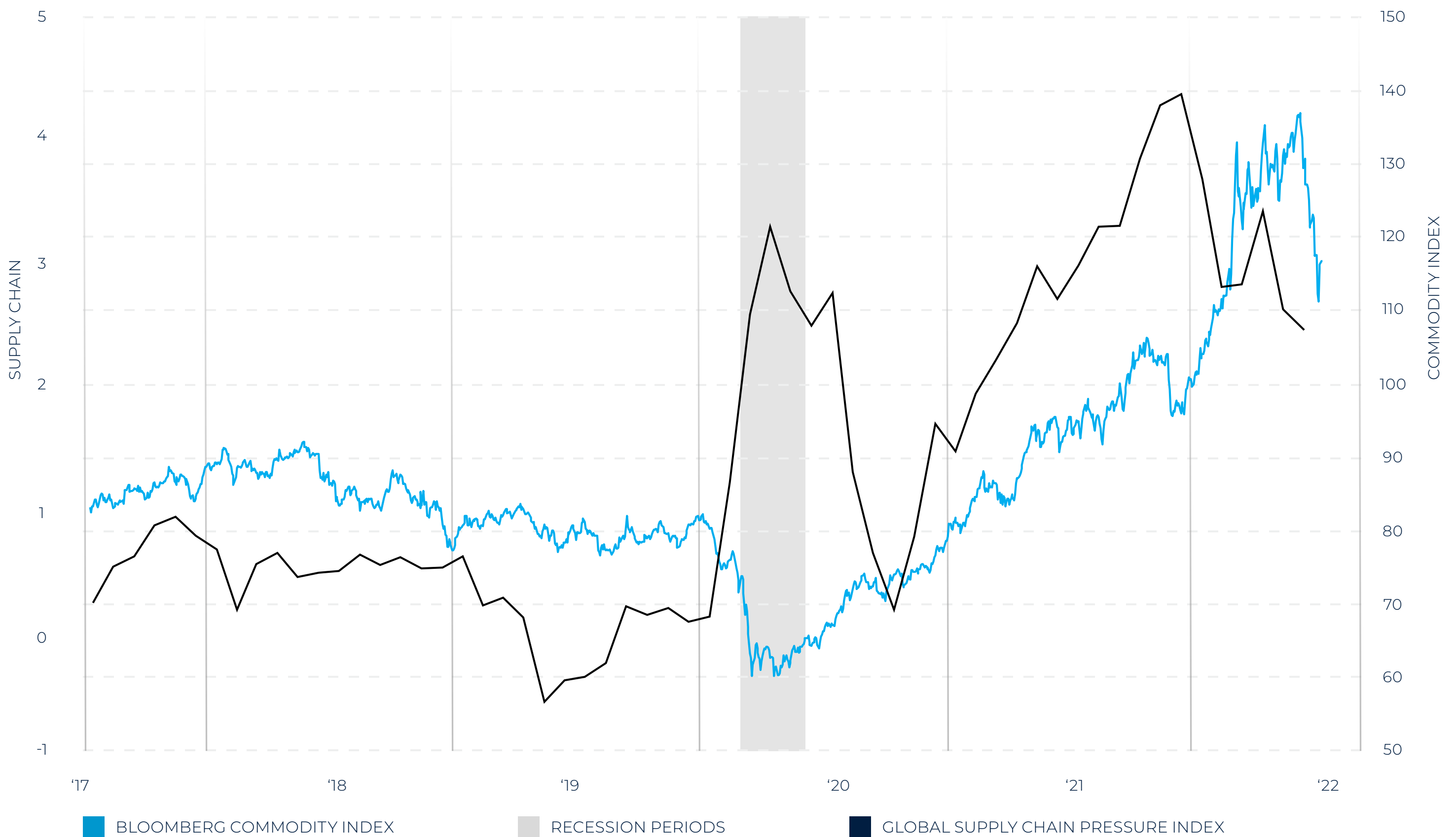
The global economy clearly faces risks, which should not be underestimated, with the biggest risk being that inflation remains stubbornly high pushing the global economy into recession. However, we maintain the view that the situation will not be as bad as the market currently fears. We continue to see the global economy growing over the next 12-18 months, albeit at a slower rate than expected at the start of the year. Consumers have stayed strong so far (the consumer accounts for 70% of GDP) and although we are starting to see some signs of weakening, we believe they are more resilient than the markets are currently fearing. After all, between March 2020 and January 2022, US households accumulated $2.5 trillion in excess savings and in the Euro Area households saved nearly €1 trillion more than they would have otherwise. This should help support consumer spending despite declining real wages and cushion any downturn in economic activity.

In addition, there should be some positive tailwinds in the second half of this year from China reopening and peak inflation being reached, which seems near in the US. When we breakdown the various components of inflation we see that energy, food and new and used vehicles, which are considered to be the more transitory elements of inflation, account for over half of the headline inflation figure. Energy and food are the two components that really continue to accelerate as the ongoing disruptions from the war in Ukraine spurred the commodity price rally. However, we have seen commodity prices pull back significantly in the second half of June (Chart 3) as markets digest weaker demand in face of a global recession. While it's too early to tell if this is the start of a more prolonged retreat in commodity prices or just a knee-jerk reaction to heightened recession fears, weaker commodity prices will undoubtedly help the peak inflation narrative.

Furthermore, the contribution of the new and used vehicle component to inflation has noticeably decelerated from the start of the year as global supply chain pressures ease. Chart 3 shows that although supply chain pressures remain elevated, there are clear signs of easing which is further supported by recent developed market PMI releases. Additionally, we are seeing global freight rates come down and a China reopening should further help restore the global supply chain. All this, and the improved base effects, supports our base case for inflation to begin to roll over in H2 and come down in 2023.

CHART 3

COMMODITY PRICES AND GLOBAL SUPPLY CHAIN PRESSURES EASE



We believe evidence of inflation having peaked will be key to seeing a sustained equity market rebound from current levels. Chart 4 shows that historically the S&P 500 bottom coincided with peak inflation, even though there was further economic pain to come. This is because equity markets are forward looking and begin to price in a brighter economic future. This also explains why historically bear markets have bottomed out long before any recession was over.

Taking a view for the next 12-18 months, we continue to favour equities to bonds and other asset classes. In light of the following, 1) closer to peak inflation in the US than in the UK or Europe, 2) fewer potential existential shocks to the economy from the war in Ukraine in the US than the UK or Europe, and 3) the significant underperformance of US equities, notably growth stocks year to date, our preference within equities goes to high quality mega-cap growth stocks. These companies, largely found in the US, should benefit from high cash reserves, low debt levels, strong balance sheets and increasing growth opportunities, making them well-positioned to outperform in the rebound. That being said, for a long-term investor it remains critical to ensure portfolios are well diversified to withstand volatility, which will remain elevated.

CHART 4

PEAK INFLATION MARKED S&P 500 BOTTOM

Most importantly for long term investors, it is vital not to allow negative news, which is plentiful, to throw you off your path to strong long run average returns. According to a weekly sentiment survey from the American Association of Individual Investors, bearish sentiment at the end of June was at its 6th highest level since the survey started in 1987 with 59% of investors being bearish.

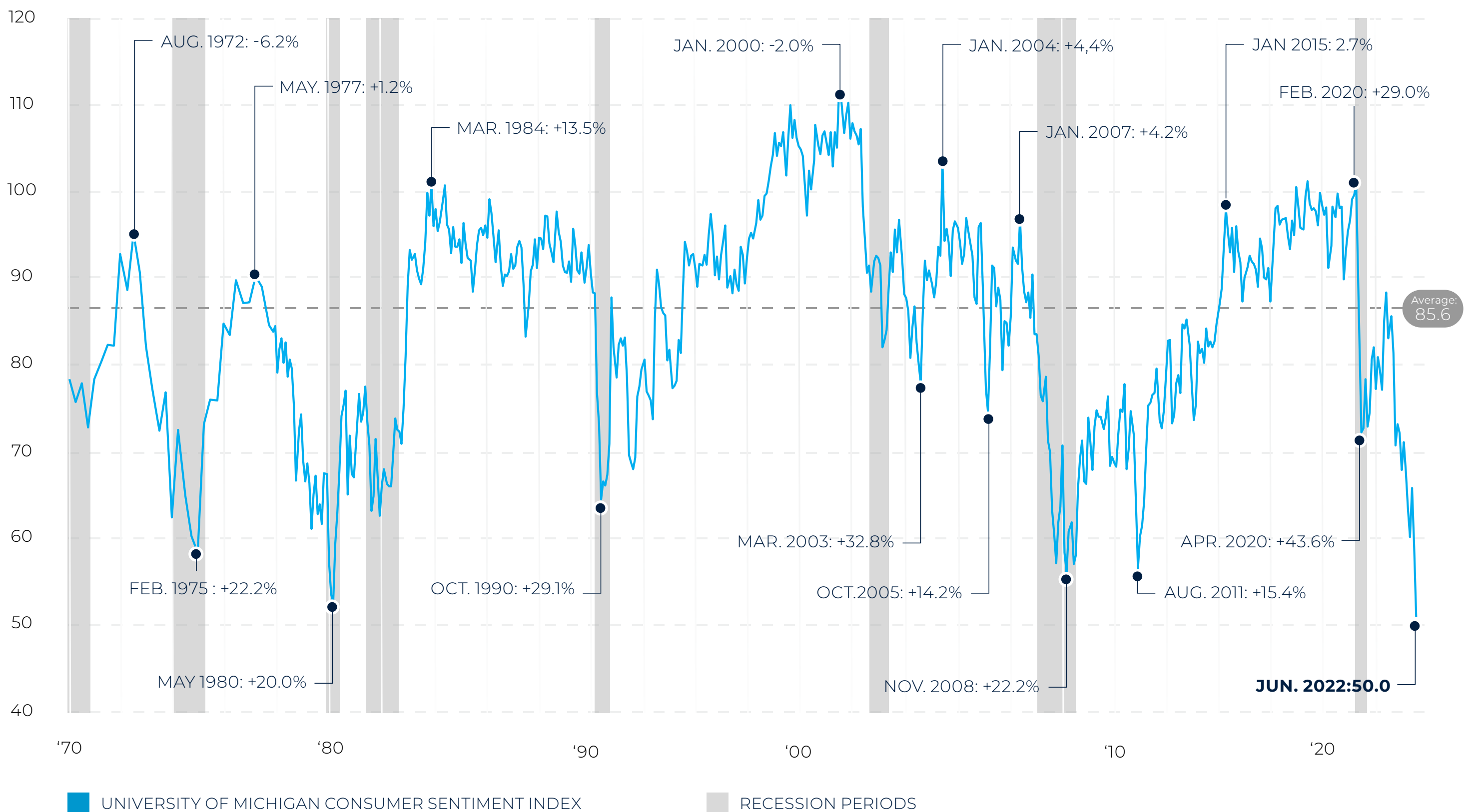
However, we leave you with a positive spin on things in this otherwise gloomy world. Investor sentiment is often a contrarian indicator. As Chart 5 shows, historically, unusually bearish sentiment (a sign of fear and cautious behaviours) tends to be followed by above-average market returns, while overly bullish sentiment (a sign of greed and risk taking) is often followed by below-average returns. In addition, during previous years when the S&P 500 was down at least 15% at the midway point of the year, the index has finished higher in the final six months every time, with an average return of nearly 24%.

CHART 5

CONSUMER SENTIMENT AS A CONTRARIAN INDICATOR

Sentiment Cycle Turning Points And Subsequent 12-month S&P 500 Index Return

AVG. SUBSEQUENT 12-MO. S&P 500 RETURNS
8 SENTIMENT PEAKS +4.1%
8 SENTIMENT TROUGHS +24.9%



We believe the rebound will be fast and strong. It will come when everyone least expects it and well before we get a clear sign that the problems in the global economy have been resolved. As such, our view has not changed; now is the time to remain disciplined and stay invested. This has consistently proven to be the best investment strategy during downturns. Warren Buffet famously said, **"the stock market is a device for transferring money from the impatient to the patient"**, and we couldn't agree more.

Thank you for taking time to read our Market Review.
Sigma Investment Committee