SIGMA
PRIVATE OFFICE

Q3 2022 QUARTERLY REVIEW AND OUTLOOK

Q3 2022 QUARTERLY REVIEW AND OUTLOOK

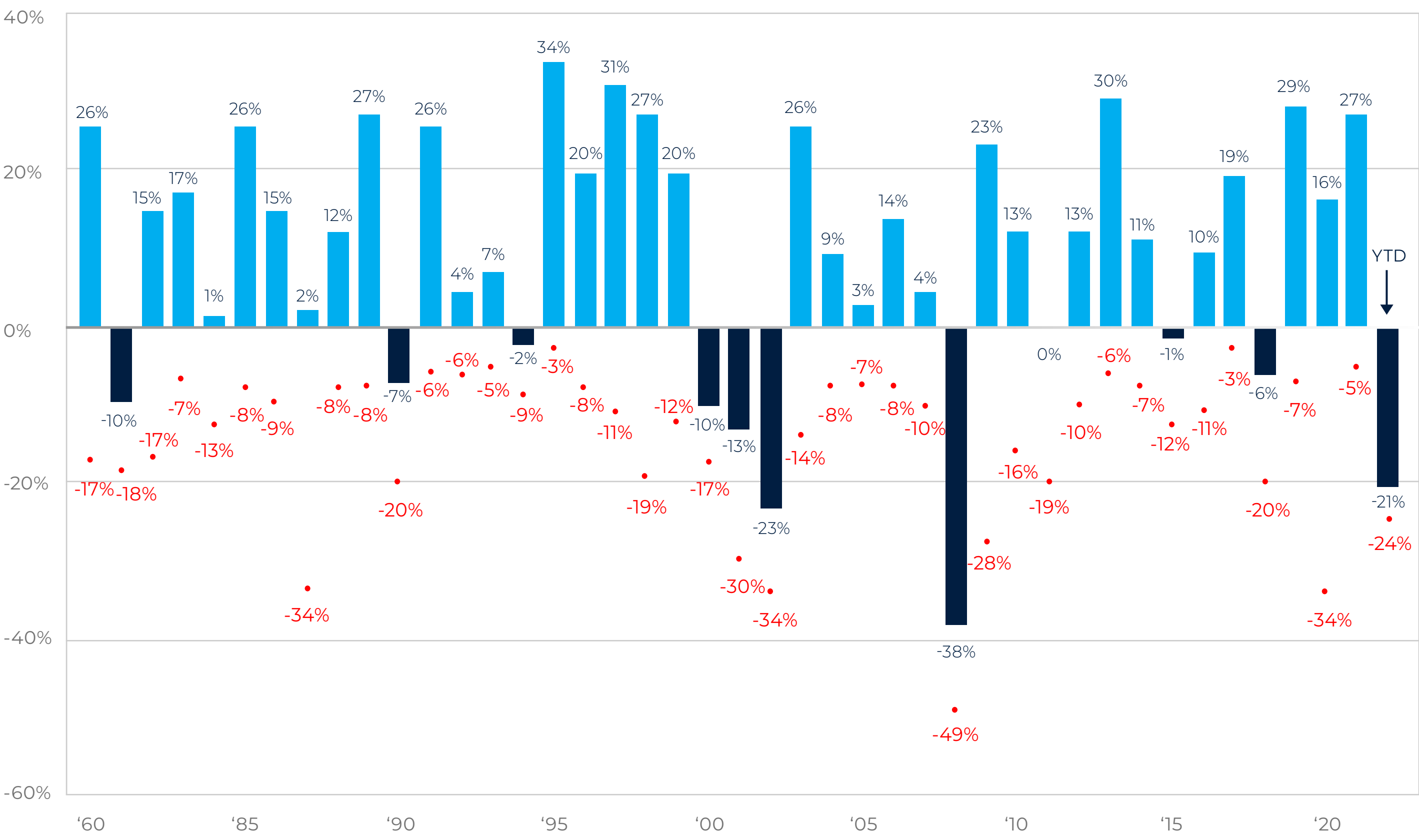
The third quarter of 2022 was a classic tale of two halves. We will proceed to cover this quarter's many events but before doing so we start with an important message. Amidst the depths of this bear market, investors must look forward; at this point there is little to gain and potentially a lot to lose from making significant portfolio changes. History suggests that once you breach -20%, the trough is usually much closer than the beginning. As such, appropriate asset allocation, diversification and capturing the bounce that typically follows sharp downturns will be crucial to ensuring today's bear market is just another period of volatility on your way to strong long run returns. After all, the S&P 500 has returned 10,200%, or 11.5% annualised, since 1980 despite many occurrences of double-digit intra-year pullbacks, as shown in chart 1.

After reaching a year to date low of 3666 on 16th June, the S&P 500 rallied 17.4% through mid-August amid better than feared corporate earnings and hopes of slowing inflation and rate hikes in the US. The summer rally sparked debate on whether markets had entered new bull market territory or if it was merely a bear market bounce. Bulls pointed to the S&P 500's retracement of 50% of its losses and its surging breadth, with 92% of stocks trading back above their 50-day moving average, which historically have marked the start of new bull markets. Bears argued further downward earnings revisions would be needed and saw the S&P 500's failure to break through its 200-day moving average as reasons to argue markets would hit new lows before a new bull market transpired. Unfortunately, the second half of the quarter saw markets resume their sell off and new bear market lows were reached at quarter end.

What was the turning point you might ask? The answer; the Federal Reserve's annual Jackson Hole Economic Symposium. The equity market rally was accompanied by a sharp selloff in US bond yields with 10 Year Treasury yields peaking at 3.49% mid-June and retracing to 2.6% by early August. These moves had the undesired effect of unwinding the Fed's tightening of financial conditions and markets started pricing in a hawkish tone from Fed Chair Jerome Powell's keynote address at Jackson Hole.

CHART 1
S&P 500 INTRA YEAR DECLINE VS. CALENDAR YEAR RETURNS

Despite average intra-year drops of 14.0%, annual returns were positive in 32 of 42 years



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management

> **We will keep at it until we are confident the job is done.”**
>
> – Federal Reserve Chair, Jerome Powell

This is exactly what he delivered in his short speech where he noted “restoring price stability will likely require maintaining a restrictive policy stance for some time… it will also bring some pain to households and businesses” and concluded with “we will keep at it until we are confident the job is done.” While in our opinion Powell said nothing new, equity markets sold off for 3 consecutive weeks and bond yields rallied.

The second blow came on September 13th when a hotter than expected US inflation print sparked a broad-based market sell off with the S&P 500 and Nasdaq 100 posting their biggest daily losses since 2020. The Fed responded with a third consecutive 75bps rate hike at their September FOMC (Federal Open Market Committee) meeting. Rate hikes in the US were accompanied by further monetary policy tightening in other developed nations with the European Central Bank also opting for a 75bps hike at their September meeting and the Bank of England doing another 50bps. UK and European equity markets followed a similar path to that in the US; the FTSE ended down 3.84%, the STOXX Europe 600 was down 4.75% and the S&P 500 was down 5.28% over the quarter.

Central bank responses globally resulted in significant currency moves over the quarter. Most notably, the US Dollar continued to strengthen, hitting a 2-decade high, as interest rate differentials, attractive treasury yields and the dollar’s safe haven status lured investors. EUR/USD broke parity moving from 1.05 at the start of the quarter to 0.98 and GBP/USD fell from 1.21 to 1.11. As part of the UK’s new government mini-budget, Chancellor of the Exchequer Kwasi Kwarteng announced a somewhat controversial “Growth Plan” which included tax cuts, the reversal of planned tax hikes and large subsidies to offset rising energy prices to help boost long term UK GDP growth to 2.5% annually.

The market reaction however was dismal as UK stocks sold off sharply, 30 Year Gilt yields rallied as high as 5.14%, and the pound fell sharply, with GBP/USD briefly touching record lows of 1.0384 on fears the new plan would fail to spur growth while stoking further inflation. The resulting disorderly rout in the bond market, fuelled by forced selling from pension funds, pushed the Bank of England to announce temporary purchases of long dated bonds and delay their planned bond sales under quantitative tightening in an effort to stave off a pension crisis. The UK undoubtedly faces a challenging time ahead with investors losing confidence in policymakers as outsized and unfunded fiscal policies risk counteracting the Bank of England’s fight against inflation.

The dollar also strengthened relative to the Japanese Yen pushing the Bank of Japan to intervene in currency markets for the first time since 1998. Given the Yen’s depreciation and the Bank of Japan’s continued accommodative monetary policy stance, Japanese equities have outperformed global equities year to date.

Geopolitical tensions remained at the forefront of investor concerns. Following Nancy Pelosi’s visit to Taiwan, China increased its military activities around the island as US/China tensions rose. Furthermore, Russia announced a full indefinite shutdown of the Nord Stream 1 pipeline, cutting off gas flows to Europe and Putin declared a partial military mobilisation. The market fallout however was relatively muted.

While it was a highly volatile quarter, looking beyond market moves at the underlying economic fundamentals there was little of real surprise this quarter. US inflation showed obvious signs it peaked in June. Supply chain pressures continued to ease and commodity prices retreated further. US Q2 GDP data confirmed a second consecutive quarter of economic contraction, albeit marginal, and stopped short of meeting the National Bureau of Economic Research (NBER) criteria for a recession. Inflation is yet to peak in Europe and the UK, although signs still point to a rollover in Q4 and central banks globally hiked interest rates at an accelerated pace. All of which were largely anticipated and therefore one would assume already priced into markets.

However, what seems to set this bear market apart from previous bear markets is the extent to which sentiment, typically the defining feature of corrections, has played a role in driving markets lower. While this is a bear market by magnitude and length, extreme fear of not one but rather multiple factors have led markets to price in a mild global recession already. Sentiment today is back below its June lows and the American Association of Individual Investors (AAII) bull-bear spread has only ever been lower on two occasions; September 1990 and March 2009. On these two occasions, the S&P 500 was up 22.6% and 50% respectively over the following six months. Furthermore, as table 1 shows, average returns 6 and 12 months from -20% decline troughs were 29.4% and 38.7% respectively. In our opinion, current sentiment is too depressed compared to the economic outlook, perhaps setting the stage for a strong rebound sooner than most may fathom.

Looking ahead, we expect the next few months to remain volatile as markets find their footing and Q3 earnings will likely provide some direction. Earnings expectations have already come down meaningfully, however many are still calling for further downgrades. Furthermore, many expect to see capitulation before the market bottoms out; while this is entirely possible, it is unclear where investors fleeing equities would flock to with bonds, gold, commodities and cryptocurrencies also experiencing bear markets. But remember, markets also have a long history of surprising investors, especially around turning points, by doing the opposite of what most expect, leaving them backfooted.

Unfortunately, we cannot predict when this market will bottom, but we do know that staying invested during periods of heightened volatility has proven to be the best strategy for long term investors as it ensures you capture the best days that follow.

Moreover, looking at positioning, the stocks and sectors that fall hardest during bear markets rebound strongest. Another sentiment driven feature of this bear market has been value's huge outperformance of growth; the MSCI World Value Index is down 18.05% year to date versus the MSCI World Growth Index which is down 32.28%. Economically sensitive value sectors, like energy, materials and industrials normally lead the market lower in bear markets as their profits are closely tied to economic growth. Growth stocks typically hold up relatively better as their profits are tied to longer term economic trends. Not this time. Growth has been hammered on the fear of rising interest rates and value's strength would suggest markets are not expecting a deep recession imminently. We have also observed a strong correlation between value's leadership on down days and growth's outperformance on up days, suggesting to us that growth will likely outperform significantly in the rebound. As such, we continue to favour high quality growth stocks for long term investors as part of their globally diversified equity positioning.

TABLE 1
WHAT TO EXPECT IN A RECOVERY

-20% Decline Dates		Post-Trough Performance	
Peak	Trough	Return 6 Months From Trough	Return 12 Months From Trough
02/28/1973	09/30/1974	30.3%	24.1%
11/20/1980	08/12/1982	36.2%	47.3%
08/27/1987	10/26/1987	21.4%	24.7%
01/04/1990	09/28/1990	18.6%	20.9%
07/20/1998	10/05/1998	32.6%	35.8%
03/27/2000	10/09/2002	9.7%	35.5%
10/30/2007	03/09/2009	60.7%	70.5%
05/02/2011	10/04/2011	20.2%	23.7%
01/26/2018	12/25/2018	20.5%	31.0%
02/12/2020	03/23/2020	43.9%	74.0%
	Median	**25.9%**	**33.3%**
	Average	**29.4%**	**38.7%**

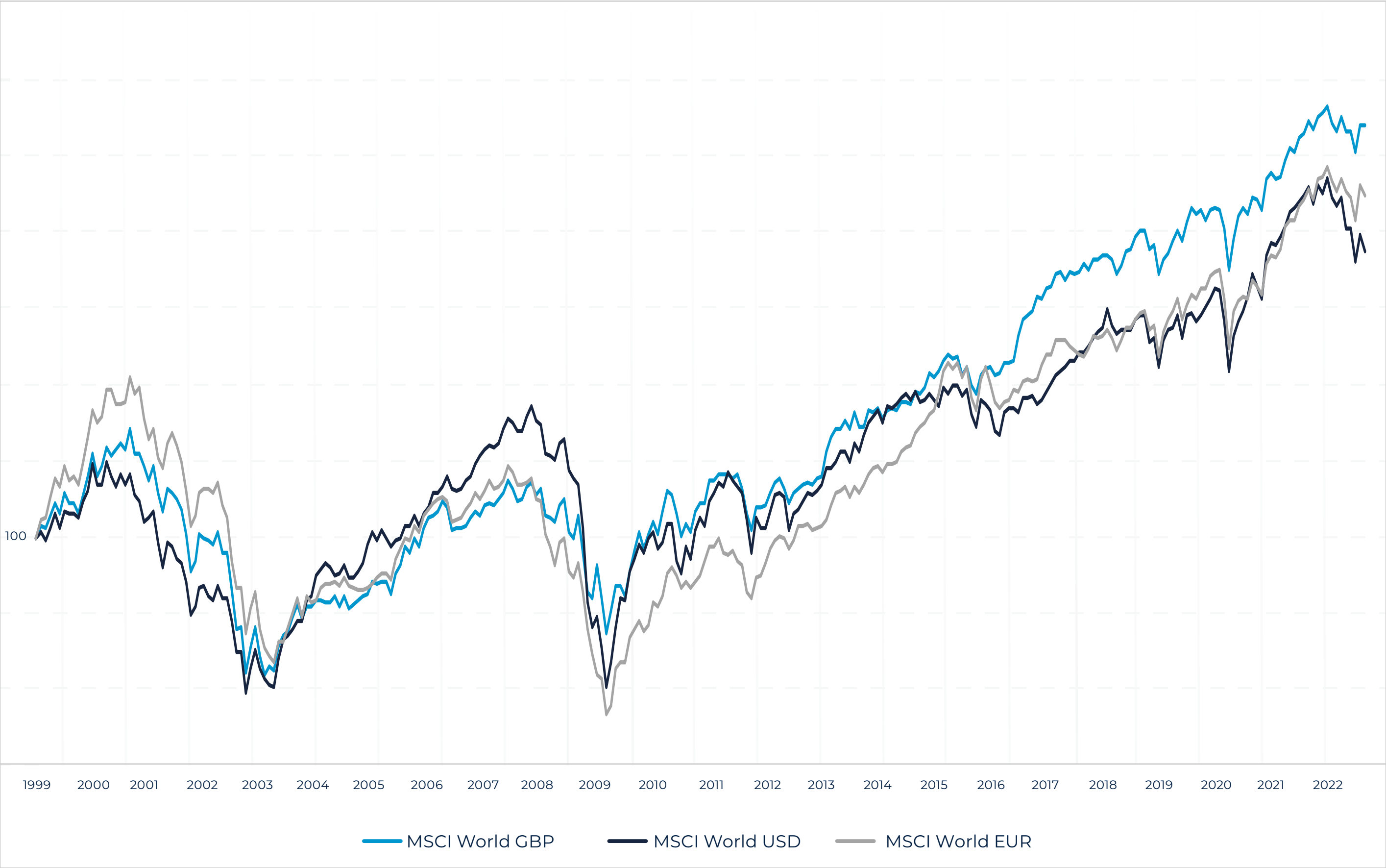
Source: FactSet, as of 06/30/2022. MSCI World Index price returns, 12/31/1969 - 03/23/2021.

CURRENCY HEDGING

Following some of the strongest currency moves we have seen in decades, it seemed appropriate timing to touch on the topic of currency hedging. Currency markets are among the largest, most efficient and competitive markets out there. They are notoriously difficult to predict and top investment banks are rarely correct in their forecasts. Alan Greenspan, Former Chair of the Federal Reserve, even said "to my knowledge, no model projecting directional movements in exchange rates is significantly superior to tossing a coin." Most investors therefore neither have the speed nor any edge to outperform consistently.

As most global investors will have experienced, currencies are prone to sudden swings in the short-term. However, over the long-term, currencies have an expected zero-sum return. In other words, foreign currency moves can have a major impact on portfolio returns in the short run, but over the long run that impact diminishes. Chart 2 shows how the MSCI World's returns in USD, GBP and EUR converge again over time.

CHART 2
MSCI WORLD RETURNS IN USD, GBP & EUR



Source: FactSet, as of 30/09/2022. MSCI World Index price returns, 31/12/1998 – 30/09/2022

> **To my knowledge, no model projecting directional movements in exchange rates is significantly superior to tossing a coin."**
>
> – Alan Greenspan, Former Chair of the Federal Reserve

Investors are often tempted to time currency moves through hedging. A currency hedge is a form of insurance that cancels out the loss you experience from a falling overseas currency. Sadly, the contract also cancels any win you experience from rising overseas currencies and it comes at a lofty cost which detracts from your long run returns. Furthermore, in times of market stress the US dollar appreciates strongly, thus a currency hedge would eliminate a welcomed source of return for a foreign investor.

Rather by investing globally, without any home country bias, you create better diversification across regions, sectors and currencies which acts as a natural hedge and generates far superior risk adjusted returns as seen in charts 3.1 and 3.2. Common practice is to therefore leave foreign equity investments unhedged and fully hedge foreign fixed income investments where currency hedging has proven to reduce volatility.

CHART 3.1
RISK & REWARD: HEDGED VS. UNHEDGED

GBP Investor

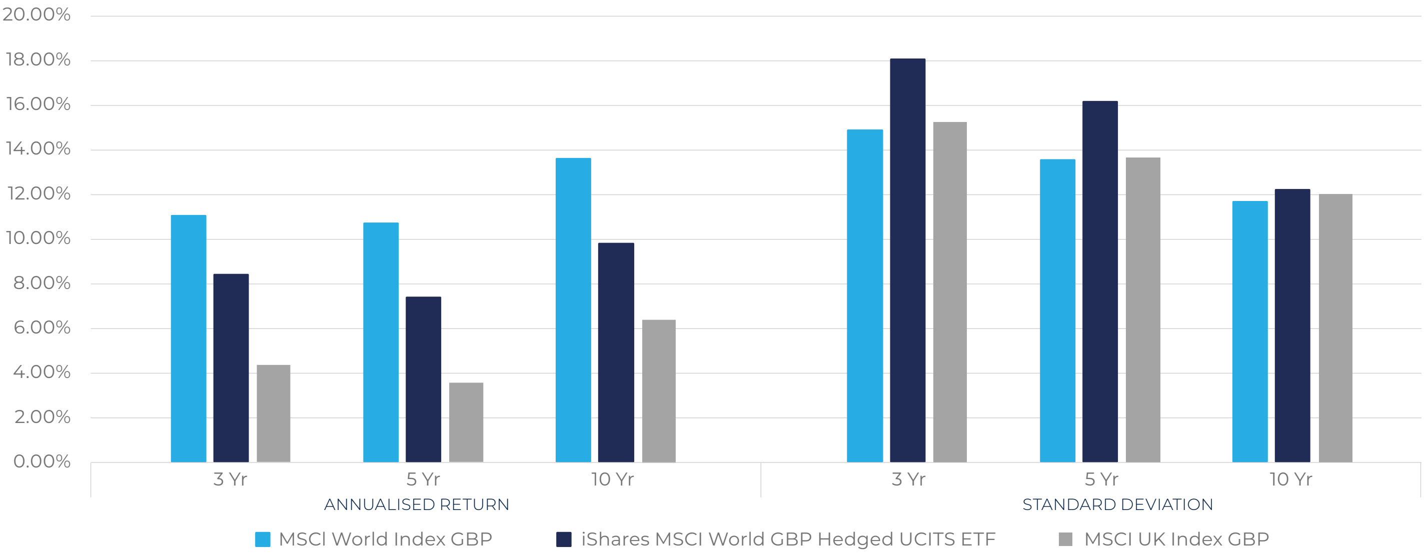
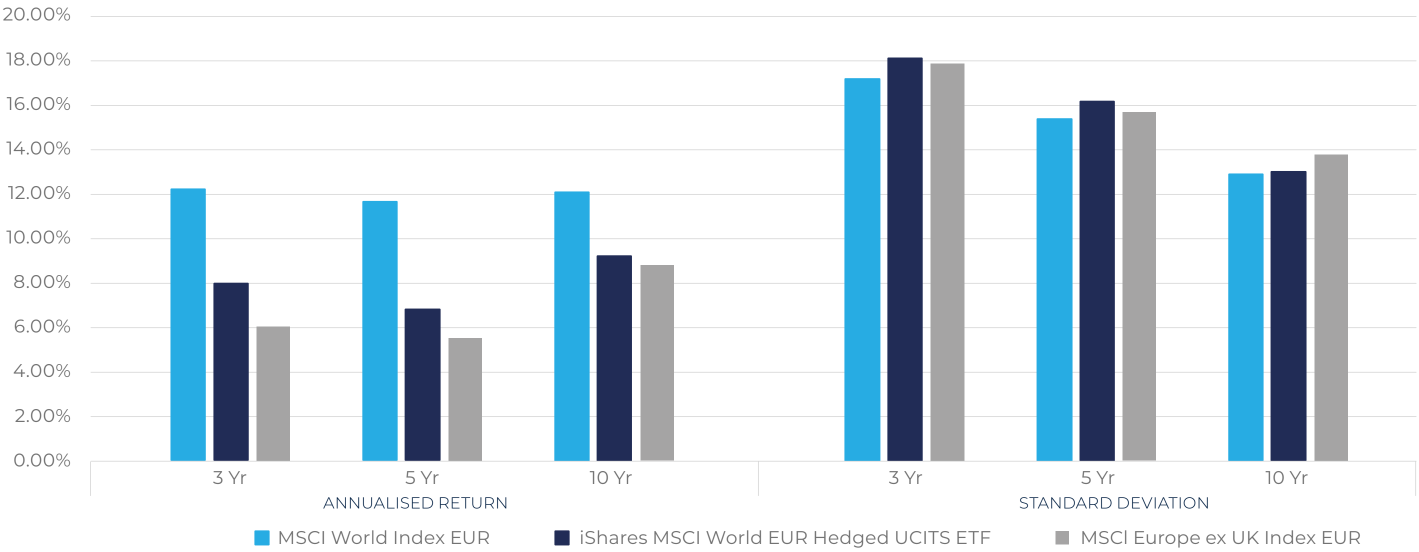


CHART 3.2
RISK & REWARD: HEDGED VS. UNHEDGED

EUR Investor



Source: MSCI & iShares, as of 30/09/2022.

Thank you for taking time to read our Market Review.

Sigma Investment Committee