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MARKET UPDATE | 02/05/2022

FOR PROFESSIONAL FINANCIAL ADVISERS ONLY

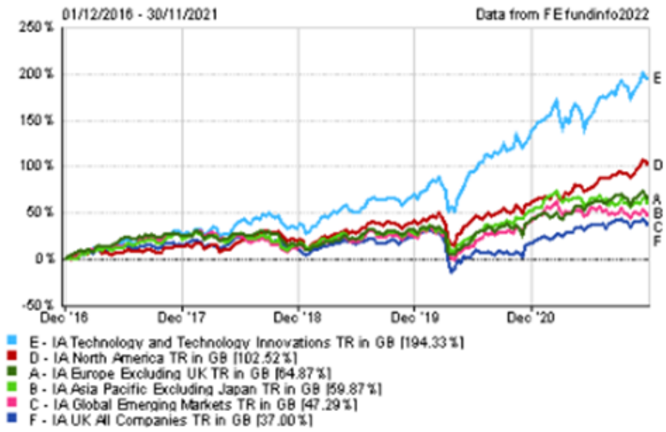
Inflation is not Transitory

The world changed at the end of November 2021. The event was a speech given by Jerome Powell, Chair of the US Federal Reserve (the Fed), equivalent to our Bank of England. For many months up to this date, the Fed insisted the rising inflation was a temporary phenomenon and described it as 'transitory'. To many market commentators and people actually running companies in the real world, his opinion seemed at odds with what they were experiencing.

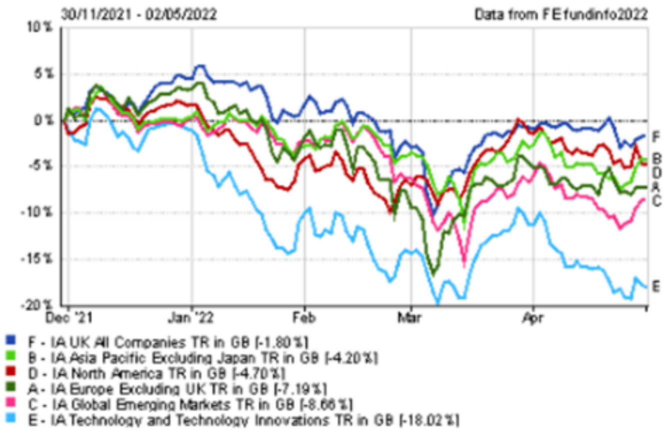
In many sectors, wages were rising rapidly, and the input costs, i.e. the price manufacturers were having to pay, were also quickly escalating. In fact, almost all the evidence pointed to the fact that inflation globally was rising and going to stay at an elevated level. On 30th November 2021, the Fed admitted what almost everybody else already knew, inflation was not transitory, and it was going to become a very big deal.

This acknowledgement of inflation is important for markets because, for most of the period since the global financial crisis (in 2008), central banks have been able to keep interest rates at historically low levels, principally due to minimal inflationary pressures. This, in turn, has been a great backdrop for companies classed as growth stocks and the tech sector, in particular, has produced stellar returns, as can be seen in the chart below. What is equally clear is that growth tech stocks have been struggling ever since that speech.

Global Equities 5 Years Performance to 30/11/21



Global Equities Performance 01/12/21 to 02/05/22



Over the period since the Powell speech, the much-maligned UK equity market has been resilient. The UK FTSE 100 has a significant allocation to mining, oil and pharmaceutical stocks. The companies in these sectors are often known as value stocks. They benefit from valuations considered cheap relative to other markets such as the US and are less affected by the rise in the UK and, indeed, global interest rates.

In recent years, one of the most significant characteristics of large swathes of global equity markets is that valuations have increased almost regardless of the business model and a company's ability to generate profit.

The Pandemic Winners

Many of the 'working from home' stocks, such as Peloton and DocuSign, were good examples of where investors were ignoring a company's fundamentals. Momentum also played a crucial role in the valuations of such companies reaching eye-watering levels. More money was invested in global equities in 2021 than in the previous nineteen years combined, and much of it went into chasing whatever had been working before. This meant investors piled into US assets and, in particular, growth stocks. Anytime the market fell, more money would come back into the market. This has happened for such a prolonged period; there is now a three-letter acronym to describe the Buy-the Dip approach BTD. You will often see this acronym across the media when describing particular investor behaviour.

Relative Market Valuations

There has been another event that the mainstream media have barely covered. This is the signalling by the Chinese government that the worst may be over for their crackdown on Chinese tech firms. It is easy to spot when this happened in the second chart shown below, 15th March 2022. Much is made of the Chinese government's actions in tackling what they consider bad practices, especially in health, education and housing.

After multiple regulatory announcements, which started in Q1 2021, valuations of Chinese stocks look attractive on both a relative and absolute basis when you look at how they have fallen. That's not to say there won't be more bumps in the road, but on a medium-term basis, we are optimistic for the Chinese market and Asia as well as emerging markets more broadly. China is the second-biggest economy globally, and its government and central banks are looking to support their economy; therefore, this will help support the stock market.

At the same time, we have the US central bank starting to withdraw support from their markets and raise interest rates. Given what the respective central banks are expected to do and the relative valuation position of these two behemoth economies, we feel one of the greatest dangers to investors is to invest using the rear-view mirror.

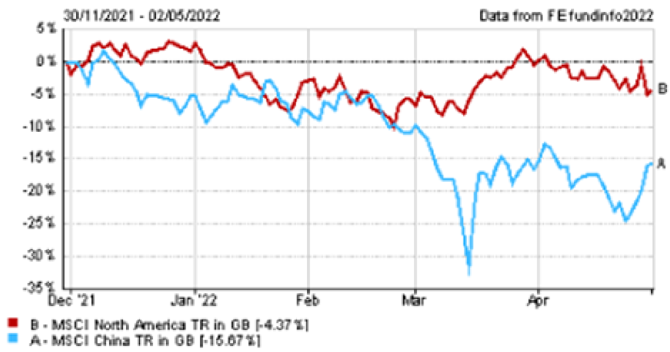
New Opportunities?

In summary, what was working (or not working) until the Powell speech and subsequently, the Chinese announcements may behave very differently in the new investing environment. In our view, maximum market complacency peaked at the end of November 2021. Still, it can take time for some investors to come to terms with the new inflation and interest rate regime and what they will do to the various geographies and companies' valuations. The most recent example of a stock previously thought of as bulletproof is Amazon. On 29th April 2022, it fell over 14% after a downbeat earnings report. It didn't suddenly become a bad business overnight; the stock was just reacting to some slightly disappointing news colliding with a super-high valuation. If this kind of price fall can happen to one of the largest corporations in the world, it can happen to any company.

There are plenty of companies globally, especially outside the developed markets, which have already suffered significant pain and their valuations reflect this. At the same time, there remain opportunities in areas such as commodities and Infrastructure. As maximum complacency subsides, we feel it is essential to invest looking forward based on the market conditions as they now are and not how they were for much of the last decade.

US vs China Equity 5 Years Performance to 30/11/21

US vs China Equity Performance 01/12/21 to 02/05/22



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