Market Musings

"Don't think in seas, think in oceans"
—Admiral of the Fleet, Lord J.A. Fisher

Lord Admiral 'Jackie' Fisher is considered by many as the second most important sailor in the history of the Royal Navy after Nelson. Quite some achievement in a nation that prides itself on its seafaring tradition.

Admiral Fisher's reputation rests not on naval victories but on leadership. He could see that times-were-a-changing and if the Royal Navy didn't abandon their traditional strengths in wooden sailing ships and embrace new technology—such as steam engines—then somebody else would, thereby ending British dominance of the seas. Fisher also realised that he needed to go further, as changing just technology was not enough by itself; the training and even the officer corps itself needed modernisation. He succeeded and secured the Royal Navy several more decades of dominance. This is an excellent, but all-too-rare example of an incumbent successfully adapting to disruptive technology and change management to achieve strategic goals.

Fisher's attitude and vision toward change is captured in the quote above. The Admiral's point was that often to succeed and achieve one's long-term strategic goals, it's necessary to have the courage to be bold and take the long-term view—to 'see the bigger picture' and not be overwhelmed by short-term events or noise.

Our monkey brains and fake news

Actually taking this long view is hard. There are many reasons for this, which often come down to how we, as humans, are wired. Repeated studies in human behaviour show that as a species we hate uncertainty and are more averse to loss than gain. There are strong evolutionary reasons for this with implications for our very survival. Unfortunately, while modern societies have advanced beyond recognition from our evolutionary origins, our biological software has not evolved in parallel. Meanwhile, a willingness to embrace change and accept that many things in life are random—as much as we try to fit patterns or meaning to them—is a key element to one's success. Studies of successful entrepreneurs show that the ability to deal with ambiguity and adaptability as circumstances change is a bigger predictor of success than a fancy CV.

While in certain domains—the military and professional sports, for example—organizations have begun to embrace this perspective, for most people, battling our inner 'monkey brains' and taking a longer-term view is hard. Humans have other, more natural ways of dealing with danger and uncertainty. We have a tendency to act in packs, to engage in 'groupthink' or panic at times of greater uncertainty. Financial markets give ample opportunity for this kind of behaviour, which is the underlying driver of bubbles and busts. The recent volatility in cryptocurrencies exemplifies the dynamic, and as market liquidity deteriorates, we expect that other, more mainstream asset classes will show signs of behaviourally driven stress.

If things weren't hard enough, whole industries have been set up to capitalise on our negative behavioural traits, perhaps none more prominent than the modern media. Quite simply, Fear, Uncertainty, and Doubt (or 'FUD' in market parlance) sells, and that in turn drives advertising. In his book, *The Science of Fear*, Dan Gardner objectively demonstrates that while everyday risk has declined, perception of risk in the general population has increased. Much of the blame for this outcome falls squarely on the media and its need to drive 24-hour news cycles and sell advertising. The Swiss psychologist Rolf Dobelli, in his book *Stop Reading the News*, goes even further, condemning the media as actively harming our mental health and financial wealth. As Dobelli points out, reporting is largely geared toward opportunistically playing upon—and, indeed, reinforcing—our deeply ingrained biases, often produced by journalists who are rarely experts in the subject matter and often miss truly salient events or features of a story, which would have actually been useful to consumers of the news.

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Oceans: What is the big picture?

What does all of this mean for investors? Recent events are making it increasingly clear that markets and the global economy are at an inflection point: the end of a long-term trend, which is giving way to greater uncertainty and volatility that accompanies a regime shift, in the prelude to establishment of a new long-term wave. The volatility arises from many market participants facing difficulty accepting the change and simply repeating what has worked for them in the past.

Some of our competitors 'bought the dip' in technology stocks in January for this very reason, imagining that—as was the case in early 2020—this was the time to load up on the Teslas and Softbanks of the world. Of course, that was not the case, things have changed, and the subsequent losses have wiped out two years' worth of gains for the client, in some cases. Whether due to laziness, lack of experience, non-existent research departments, or—worst of all—putting easy profits ahead of client outcomes, this is something we find to be almost invariably true: during long bull markets, marketing and sales departments often build portfolios, risk management and research prudence become afterthoughts (or even nuisances), and clients are the worse for it.

Just as in the run-up to 2008, seeing many of the classic characteristics of a bubble in place, we decided to stay away from highly speculative assets. In the last two years, greed, a fear of missing out, and narratives trumping valuations have dominated, as evidenced by WeWork, Klarna, Bitcoin, and Revolut. That made for a treacherous environment, and as these trades unravel, we expect to see a marked increase in negative news headlines, 'declinism', and predictions of disaster. The same talking heads who tried to convince you to buy U.S. tech in January will now try to convince you to sell everything or move into some new fund to cure all your woes. FUD at work.

Don't panic!

Faced with the situation just described, what should you do? First, and most importantly: Don't panic! You pay us to worry on your behalf and work out how to separate noise from value.

Remember what legendary U.S. investor Peter Lynch observed, "far more money has been lost by investors preparing for corrections, or trying to anticipate corrections, than has been lost in corrections themselves." The stock market has delivered consistent returns through time despite panics, crashes, world wars, and depressions.

One of the most important factors in your long-term return when investing in any asset is the price you pay for it. We have been concerned about valuations for some time and we have constructed portfolios using evidence-based, institutional-quality processes. This approach is based on data and fundamentals, not what happens to be in fashion.

Secondly, your portfolio is diversified by asset class and geography, and tactically adjusts as markets change. Along these lines, we moved to a more defensive stance earlier in the year. Things may get grim in the U.K. and in the wider Europe in the short term. Things may look increasingly gloomy in certain economies—but a macroeconomic downturn doesn't affect all firms equally. A number of our portfolio holdings in defensive sectors have outperformed, and we have generally benefit from continued weakness in the U.K. in our U.S. dollar position.

Thirdly, ask yourself when reading the news: How much of what you are being told is news, and how much is actually opinion? If opinion, what special insight does the journalist or media talking head have about the future, and why are they sharing it with you?

With these considerations in mind, we believe clients will have an easier time charting a safe course on the investment ocean—as well as navigating a presently stormy sea.

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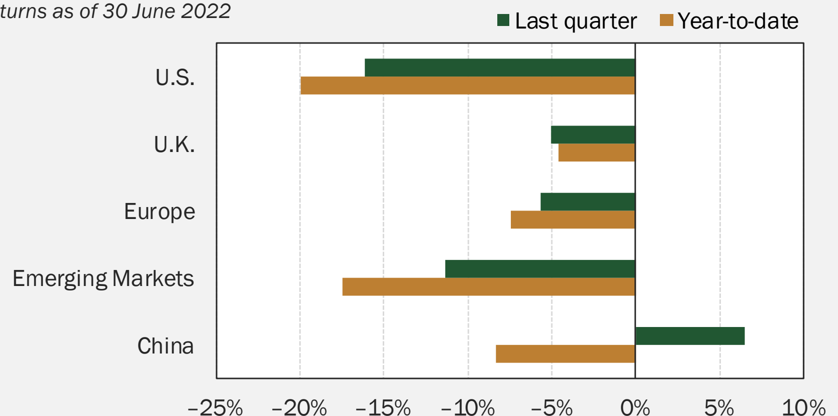
Asset Classes

Equities

Figure 1 | Equity Market Performance

Returns as of 30 June 2022



Source: S&P 500 (USD), FTSE All-Share (GBP), EURO STOXX 50 (EUR), MSCI Emerging Markets (USD), and CSI 300 (CNY), via Bloomberg

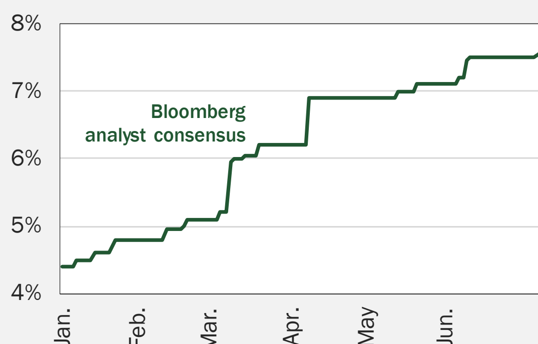
Stocks were in the red almost across the board in Q2 (see Figure 1), falling on deepening concern that unabating inflation observed in major markets around the world would prompt the Fed—fighting what chair Jerome Powell called an 'unconditional' battle against rising prices—and other central banks to overshoot and send the global economy into a recession. U.S. stocks were sharply lower, down −16.1% for the quarter. UK equities, whose sector composition is naturally somewhat defensive, suffered less, declining by −5%, while European shares, disproportionately affected by Russia's continued attack on Ukraine, lost −5.7%. Emerging market stocks declined by −11.3%, as US dollar strength and the threat of a downturn in global trade weighed on developing economies. China was a notable exception, with mainland-

Figure 2 | As Forecasts for Inflation Climb, Recession Might Have Already Arrived

With June's scorching 9.1% CPI print, it's hard to imagine economists polled at the start of the year expected inflation to hit just 4.4% through the end of 2022. Worsening data throughout the first half have sent forecasts marching higher, with the consensus June expectation pointing to a 7.6% increase in U.S. CPI for the full year. Meanwhile, analysts seemed confident in their 3% estimate for year-over-year growth in second-quarter GDP—a positive number that would avoid a recession after the economy shrunk in Q1—as forecasts barely budged over the last three months. That sentiment was starkly at odds with the Atlanta Fed's 'nowcast', which saw the U.S. economy slipping into a recession by the end of June.

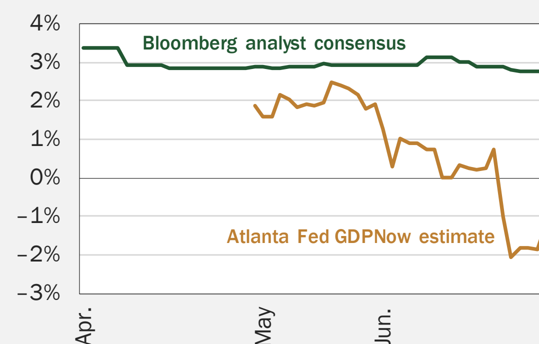
Economists grow increasingly bullish on inflation

Historical forecasts of 2022 U.S. CPI (YoY%)



Advanced forecasts place U.S. in recession as of June

Historical forecast of 2022 Q2 U.S. GDP (YoY%)



Source: Bloomberg analysts consensus forecasts of inflation and GDP, Atlanta Fed *GDPNow* forecasts of GDP, starting on 1 January 2022, 1 April 2022, and 29 April 2022, respectively, all through 8 July 2022.

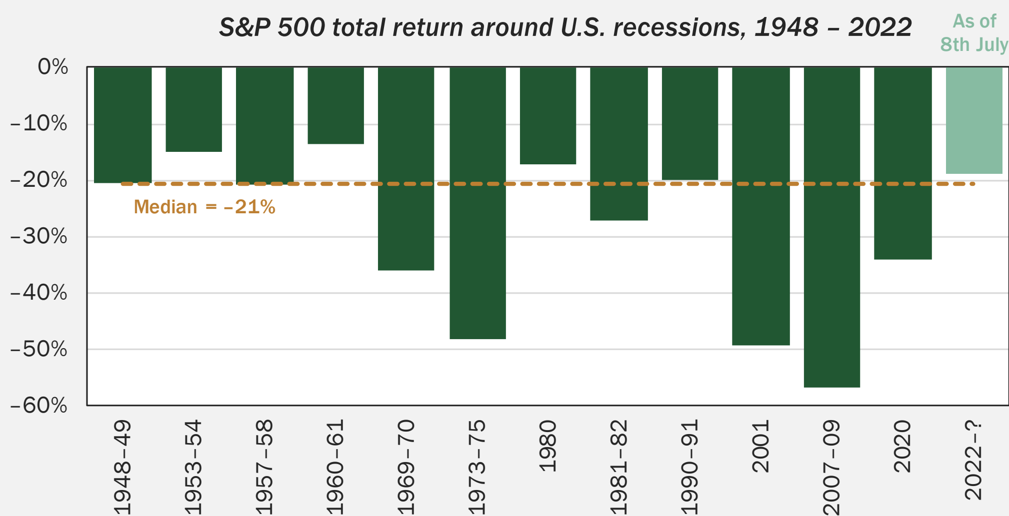
listed shares actually *adding* +6.5% in Q2, as lockdowns eased and policymakers aggressively shifted to an accommodative stance, reversing course on regulatory interventions in the country's tech sector and beginning to ramp up monetary and heavy fiscal stimulus.

The driving force behind declining stocks during the quarter seemed to be investors' slow recognition of the seriousness of inflationary pressures, as U.S. headline CPI dipped slightly in April, from 8.5% to 8.3%, before posting progressive increases to 8.6% and 9.1%, respectively, in May and June, the latter marking the worst year-over-year jump in prices in over four decades. In fact, economists surveyed by Bloomberg at the beginning of the year had much rosier expectations for inflation in 2022, imagining CPI would fall to just 4.4% at year end—an optimism which had faded by late-June, when those polled put full-year inflation at 7.6% (see Figure 2, left panel). Although analysts' predictions for second-quarter U.S. GDP were surprisingly stable, hovering around 3% throughout the quarter, the Atlanta Fed's *GDPNow* forecast—based on a mathematical model incorporating data on 13 subcomponents of GDP, ranging from residential investment to changes in private inventories—was showing an economic contraction for the second straight quarter by June end (see Figure 2, right panel).

Of course, two quarters of declining GDP is the conventional definition of a recession. What might that look like for stocks? In nearly eight decades of post-war economic history, there have been twelve U.S. recessions (see Figure 3). Market declines around significant contractions in GDP have ranged from a –57% plunge in the S&P 500 amidst the Global Financial Crisis to a less severe –14% drop triggered by a fairly average downturn

Figure 3 | Stocks Seem to Have Already Priced in a Mild Recession for 2022

Given the common definition of a recession—as two or more consecutive quarters of declining GDP—economists may only declare them in hindsight, although the market is free to sell off on mere expectations of a sustained contraction. Looking back over the post-war period, U.S. equities have fallen a median 21% around a dozen past recessions. With the S&P 500 trading around 20% off its highs at the beginning of July, equity prices appear to be baking in a mild recession. That jibes with Bank of America's latest survey of global fund managers in June, which saw 83% of those polled tipping 'stagflation' as the most likely path for the world economy in the year ahead.

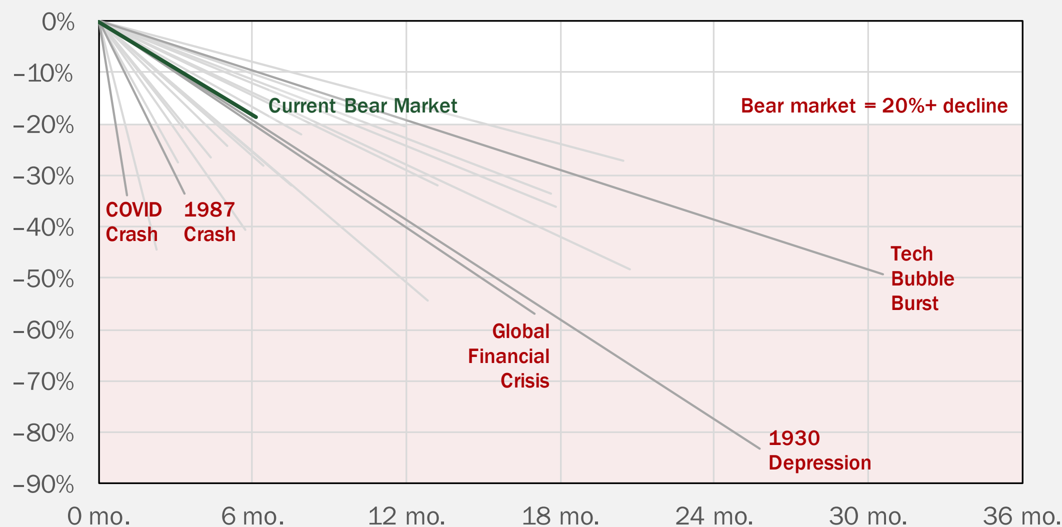


Source: S&P 500 Index, via Bloomberg, recession dating from National Bureau of Economic Research.

Figure 4 | How Does 2022 Rate Against Nearly a Century of Bear Markets?

In mid-June, U.S. stocks officially entered a 'bear market', technically defined as a fall of at least 20% from recent highs. The last time the S&P 500 found itself in such a state was March 2020, at the height of COVID panic. Prior to this year's market selloff, there had been twenty-one bear markets on record for U.S. stocks since 1929, which have varied in terms of depth and duration. The deepest bear market began in 1930, amidst the Great Depression, and saw shares plunge by 83% at their lows; the longest slide occurred in the wake of 2000's tech bubble bursting, and lasted over two and a half years. With the S&P 500 down just around 20% as of early July, despite being painful, this year's bear market is so far rather tame in its severity (33% median decline, historically) and typical in length (8 months median duration).

Peak-to-trough S&P 500 decline in U.S. bear markets vs. length of drawdown, 1929—2022



Source: S&P 500 Index, via Bloomberg, list of bear markets from Yardeni Research, as of 8th July.

beginning in 1960—which then-Vice President Richard Nixon blamed for his election loss to John F. Kennedy, perhaps hinting at political changes to come in the aftermath of a potential hard landing under Biden's watch. Judging by the median retreat of –21% around past recessions, the current drawdown effectively prices a middle-of-the-road recession into shares as of the beginning of July.

On the topic of price declines, having already breached the –20% threshold required to achieve 'bear market' status, equities present another interesting sample for investors to inspect as they consider how bad things might get: a set of twenty-one bear markets since stocks crashed in 1929 (see Figure 4). Against that long historical record, current weakness in stocks rates as relatively mild, with bear markets typically bottoming out around ten percentage points lower than where we find ourselves at present. The precedent set by past stock market slides seems to warrant continued caution for those inclined to agree with the 83% of global fund managers polled by Bank of America in June who saw 'stagflation' as the most likely outcome for the world economy over the next twelve months.

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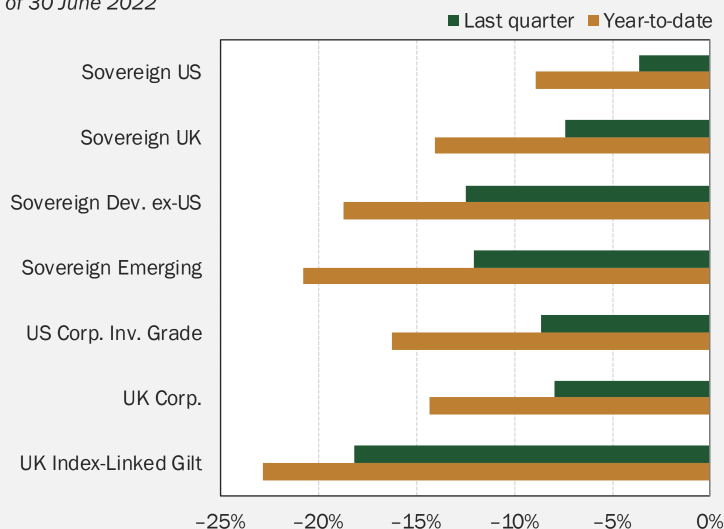
Fixed Income

Figure 5 | Fixed Income Market Performance

Returns as of 30 June 2022



Source: ICE US Treasuries Core, FTSE Actuaries UK Conventional Gilts, S&P Int. Sov. ex-US, JPMorgan EMBI Global Core, iBoxx USD Liquid Inv. Grade, Markit-iBoxx GBP Liq. Corp., Bloomberg UK Gov. Inflation-Linked All Mat., expressed in USD, except for UK indices in GBP, via Bloomberg.

Central banks maintained a hawkish stance in Q2, as inflation continued to hit multi-decade highs in major economies across the globe. The Fed contributed a 75-basis-point hike at its June meeting—its most aggressive move since 1994—following quarter- and half-point increases to the bank's policy rate in March and May, respectively. Accelerated tightening had the expected effect on bonds, with rising yields sending prices sharply lower, as falling fixed income markets gave sliding stock indices a run for their money (see Figure 5). Indeed, plotting stock and bond returns together provides a stark view of just how difficult the current market has been for even the most rationally diversified investors, with the simultaneous sell-off in equities and fixed income through the end of June marking the worst combined performance for the two asset classes at mid-year since Bloomberg's Aggregate Bond Index began tracking fixed income performance in 1976 (see Figure 6). Action in the Treasury term structure during Q2 helps to explain this year's correlation in losses on stocks and bonds, with an inversion in the yield curve that began in March reaching its steepest level in over two decades, implying rates will rise much more aggressively in the short run (bad for bonds), ultimately triggering a recession (bad for stocks) that will inevitably send longer-run rates diving back down as the Fed reverts to easing.

Yields are spiking at the short end of the curve with good reason, as June's shockingly high 9.1% CPI prompted Fed officials to signal support for more supersized rate moves, leading traders in Fed Funds futures to push the odds of a staggering 100-basis-point hike at the next FOMC meeting to nearly 80%, before settling back down to a 45% implied probability. With target rates so low for so long and inflation simmering over the last year, the Fed and other central banks are feeling increased pressure to address a growing 'policy gap': the difference between inflation and an economy's real target rate (see Figure 7). Unfortunately, as Deutsche Bank strategist Jim Reid aptly notes, the same Fed Funds futures show rates peaking at 3.4% in 2023 Q1, while the market is currently pricing in 5% inflation, which would mark the first time in 70 years that a tightening cycle ended without the real fed funds turning positive. That suggests investors are either overestimating future inflation or underestimating how aggressively the Fed will need to raise rates to get climbing prices under control. Optimism as to the likelihood of a soft landing might explain why credit spreads, despite climbing so far this year, are only slightly above their historical average (see Figure 8), making for a less compelling risk-return trade-off, which could get much better if conditions in the economy get much worse.

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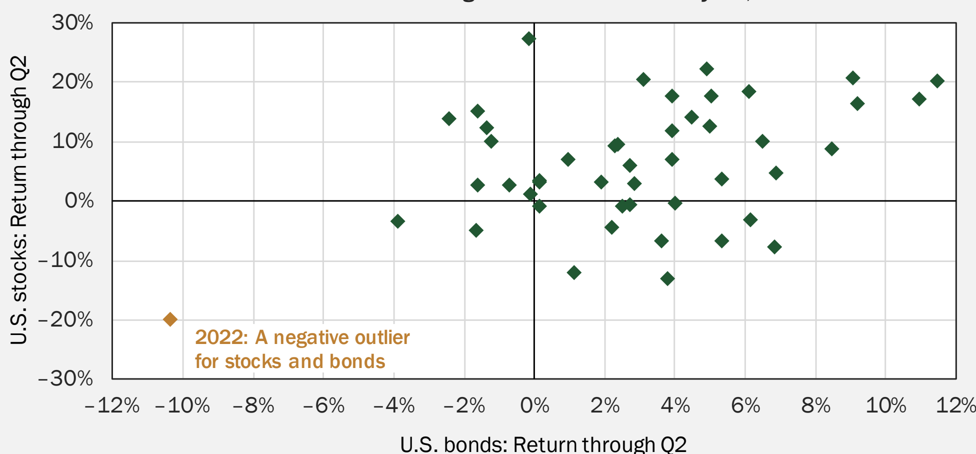
Figure 6 | Balanced Portfolios Suffer Worst First Half in Almost 50 Years

Diversification, often hailed as 'the only free lunch' available in competitive financial markets, is at the core of modern asset allocation strategy and lands most investors in a balanced portfolio of stocks and bonds. Sadly, spreading one's bets was of little help in the first half of 2022, as surging inflation and growing fears of a recession sent both equities and fixed income markets simultaneously plummeting through the end of June—the worst combined mid-year return for stocks and bonds since Bloomberg's popular index of U.S. fixed income performance began in 1976. Indeed, only twice before had bonds and stocks sold off together: amidst panic selling of Treasuries in 1984 over a ballooning U.S. budget deficit under Ronald Reagan, and when bonds crashed in the wake of Fed rate hikes in early 1994.

U.S. stock and bond returns during the first half of each year, 1976—2022

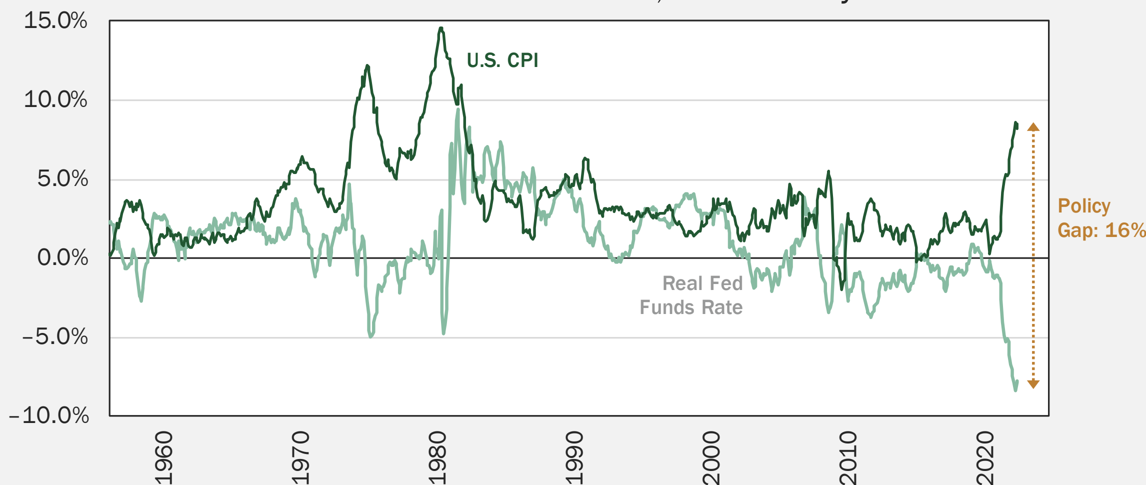


Source: Stocks represented by S&P 500 Index, bonds by the Bloomberg U.S. Aggregate Bond Index, via Bloomberg.

Figure 7 | 'Policy Gap' Reveals Federal Reserve Way Behind the Curve

While June's CPI change of 9.1% was the highest reading since 1981, one would need to go back one year further for a larger 'policy' gap—the difference between inflation and the real fed funds target rate—indicating a central bank that has fallen far behind the curve in its fight against rising prices. The remedy, of course, is rising rates, although Deutsche Bank strategist Jim Reid recently observed that futures trading implied market expections of the fed funds rate peaking at 3.4% in 2023 Q1, at which point the market is currently pricing in 5% inflation: the first time in the last 70 years of Fed policy that the real fed funds rate didn't become positive at some point during a hiking cycle. If history is a guide, this suggests investors are either too pessimistic about the path of inflation or too optimistic about the future trajectory of rate hikes.

Real Fed Funds Rate vs. U.S. inflation, Jan. 1956—May 2022



Source: U.S. Federal Reserve.

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Figure 8 | Credit Spreads Flash 'Risk Off'—But Plenty of Room to Move Higher

Credit spreads, which capture the difference in yield between higher- and lower-risk bonds, provide a measure of general changes in investors' appetite for and perception of risk. Historical peaks in the high yield credit spread serve as a record of major economic and financial crises over the last twenty-five years. Despite Treasury yields jumping through the first half of 2022, the rate on high yield issues has risen faster, leading credit spreads to nearly double in six months, a clear sign investors have moved to a 'risk off' orientation. Even so, spreads ended June only slightly above their long-term average and far short of prior spikes. With worsening economic conditions and riskier companies facing higher borrowing costs, ratings downgrades for junk issuers were ticking up, suggesting high yields might yet go higher.

Bank of America Merrill Lynch High Yield Option-Adjusted Spread, Jan. 1997—Jun. 2022

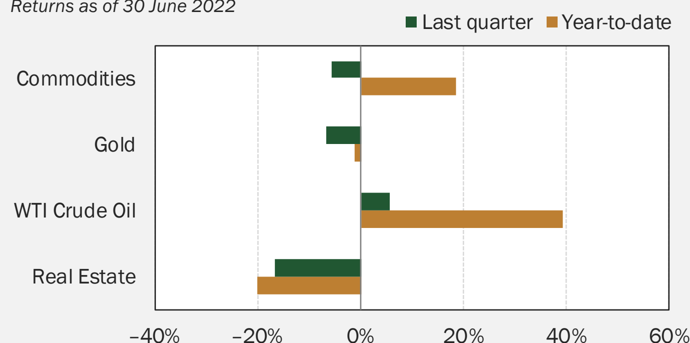
Source: U.S. Federal Reserve.

Alternatives

Even among liquid alternatives—often a strong source of diversification and the asset class offering portfolios the greatest support in the prior quarter—investors found no shelter in Q2, as both real estate and commodities posted negative returns (see Figure 9). Developed real estate led the way down, with REITs falling –16.7% in Q2, underperforming broad equities. While rising rates have prompted real estate investors to hit the exit in recent months, including a record outflow of $2.2 billion from REITs in a single week prior to the Fed's May meeting, it is worth noting that REIT fundamentals remain strong, property market conditions today bear little resemblance to those prevailing ahead of the subprime mortgage crisis that preceded the last serious recession, and real estate remains one of the few asset classes that should weather future inflation well, as rents increase in step with rising prices.

Figure 9 | Alternatives Performance

Returns as of 30 June 2022



Source: Bloomberg Commodity Index, Gold Spot, WTI Crude, iShares International Developed Real Estate ETF, all expressed in USD, via Bloomberg.

After posting stellar returns in Q1, commodities sold off through the end of June, losing –5.7% for the quarter, but still placing them up 18.4% year-to-date. As the Russian invasion of Ukraine dragged on, energy prices remained

Figure 10 | Could Economic Recovery in China Send Commodities Higher?

Commodities have been one of the few winning asset classes in a brutal year for investors, as Russia's invasion of Ukraine combined with logistical gridlock, sent prices on seemingly everything higher. Nevertheless, anxieties over an economic downturn mounted in the second quarter, cooling sentiment toward agricultural goods and industrial metals, and leading some pundits to question whether the rally in commodities might be losing steam. One interesting counterargument put forth by commodity bulls points to the high correlation between Chinese import activity and commodity price increases, noting that COVID lockdowns in Q2 had severely depressed demand, such that a second-half recovery in China's resource-hungry economy might easily carry the developing 'supercycle' forward, despite global headwinds.

Source: China's General Administration of Customs, Bloomberg Commodity Index, Jul. 2007—Jun. 2022.

elevated, although risk to demand from a cooling global economy put pressure on most other commodity sectors, particularly vegetable oils—a sector sensitive to biofuel demand and for which many commodities happened to experience better-than-expected growing conditions in Q2—and industrial metals, including tin, aluminum, and nickel, down an average of –26% for the quarter, based on data from the World Bank. One narrative heard within the commodities space over the last few years concerns the role demand from China has played in pushing up prices in what some believe represents the beginning of a 'supercycle' in the asset class. Data on the relationship between China's appetite for raw materials and commodity prices do show a strong relationship, with decoupling in the last few months, as COVID lockdowns temporarily suppressed demand (see Figure 10). A second-half recovery for the world's second-largest economy on the back of what we expect will be large stimulus, including heavy infrastructure spending could put upward pressure on prices in the months ahead.

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Closing Thoughts

Change is coming. We think the Federal Reserve getting tough on inflation marks a regime shift in markets. Things are likely to get more volatile. Don't panic.

A question we have been asked, given our cautious outlook, is why we aren't holding more cash. First, and most importantly, we are confident that in an inflationary environment it's one of the few asset classes that absolutely guarantees you a permanent loss of capital. U.K. inflation is expected to peak at 10%—if not higher—and the Bank of England is not going to raise rates anywhere near that. While other investments we hold for you might be volatile, they offer some opportunity for future return. Cash doesn't do that, and in this environment it's a guaranteed loss in every month you hold it.

Second, precise market timing is also very hard, and we are long-term stewards of your wealth, not a hedge fund taking short-run gambles for a shot at hefty performance fees. Some of the best returns in equities occur near the beginning of bull markets, and missing these days makes a huge difference to your longer-term returns. Perhaps counterintuitively, probability dictates it is often better to stay invested in some form rather than time exact market turns. Returning to Peter Lynch's point, you are more likely to suffer from staying out of the market than staying invested through a bear market.

Another key point to remember is that we follow a rigorous, disciplined process, built upon a huge body of research produced by Jason and his team at Rayliant. We are not attempting to chase the market or outperform an index over a short period; we are putting together a long-term investment portfolio that we believe will deliver superior performance with a better risk-return profile over much more meaningful horizons. This process isn't static, and just as we shifted to a more defensive stance when we saw conditions tightening, we are able to direct our models to take a more aggressive growth bias when higher-returning assets present an opportunity to capture economic recovery and expansion.

Key Economic Releases and Events for Q3 2022

UNITED KINGDOM

Bank of England Official Bank Rate Release: 4th Aug, 15th Sept

GDP Figures: 12th Aug, 30th Sept

PMI Figures: 22nd July, 1st Aug, 23rd Aug, 1st Sept, 23rd Sept

EUROZONE

ECB Monetary Policy Meeting: 21st Jul, 8th Sept

GDP Figures: 29th Jul, 17th Aug, 7th Sept

PMI Figures: 22nd Jul, 1st Aug, 23rd Aug, 1st Sept

UNITED STATES

FOMC Rate Decision: 27th Jul, 21st Sept

GDP Figures: 28th Jul, 25th Aug, 29th Sept

PMI Figures: 22nd Jul, 1st Aug, 23rd Aug, 1st Sept, 23rd Sept

In a bear market, when you feel yourself getting worried, remember Warren Buffett's observation: Panicking in a stock market correction is akin to dropping your goods after you paid for them and running out of a store just as everything has gone on sale. Instead, let us make a calm and safe trip home from the store and return later for some bargain shopping.

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