



May 2nd, 2022

Plenty of Reasons to be Concerned

- **US equity sell-off has gained momentum**
- **Central bankers, meanwhile, are accelerating their monetary tightening**
- **Growth stocks are at the epicentre of the current sell-off with still more downside risks**
- **Latin America is ahead of the rest of the world in its tightening cycle – a positive for the local asset markets**
- **Chinese authorities promise better news but it's light on detail**
- **China's asset markets are in a relatively better place – maybe...**

Last week's price action in the US equity markets should worry investors. We were witness to a pattern in the markets that should ring alarm bells. In any case, we have for many weeks tried to caution investors on the prevailing downside risks.

US equities fell sharply on Friday (-3.6%), capping a week and month of dismal performance. Throughout the week, the down days for the S&P500 were much bigger than the up days, with the market witnessing heavier volumes on the down days. On Friday – a down day for the markets – volume recorded was 33% more than the previous up day. Year to date, the S&P 500 has delivered a total return of -12.9%; the US Treasury bond index has returned -10.4%. The US market year-to-date, annualised, shows a real return of -40%, the worst since 1974.

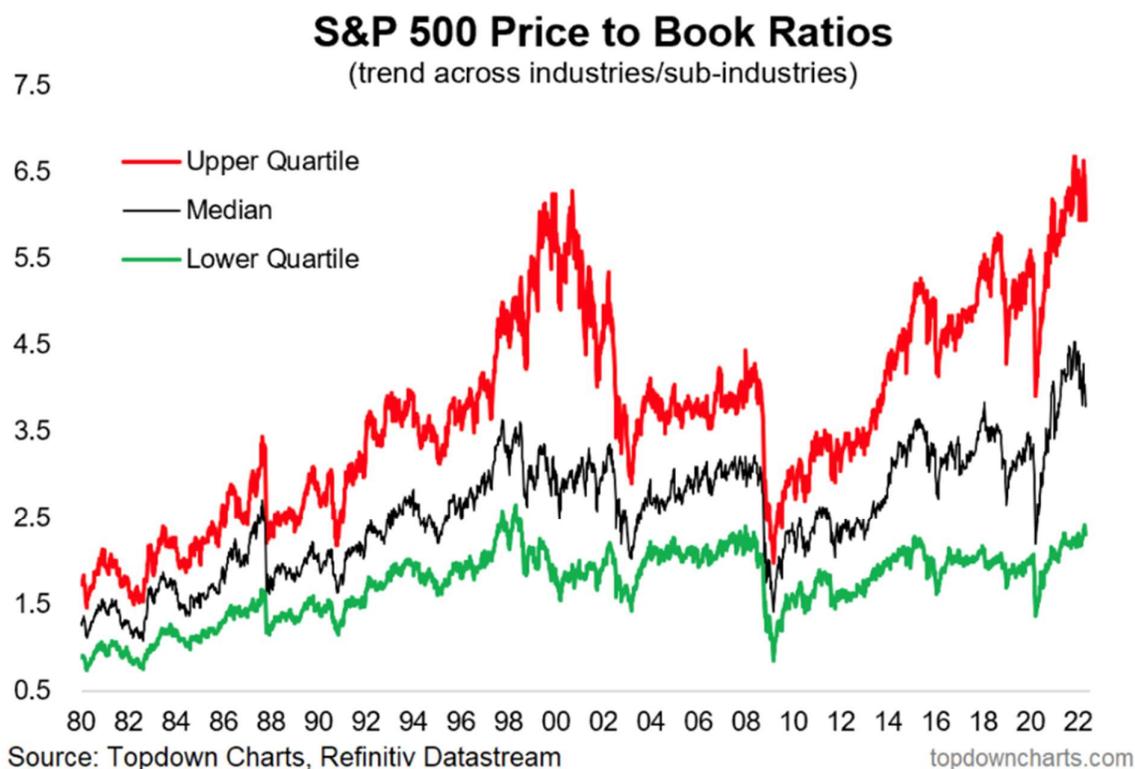
We would reiterate here that a lot has changed in the past six months. Higher interest rates, profoundly high inflation, and a war in Europe are all undermining any investor optimism that somehow the bull market of the past 20 years will persist.

The profound re-rating of growth stocks that took place during the previous equity bull market appears to be unravelling. The demise of the ARK Innovation ETF (ARK), the Kathy Wood vehicle that did so well during the COVID crisis, is symptomatic of the de-rating of growth companies that were highly overvalued. The latest blow to the fund was the 80% plunge in Teladoc Health, one of the key holdings in the fund. Teladoc announced results that were worse than expected and had to take a massive charge on an investment made in 2020 at the peak of the frenzy in the tech sector. The stock is down 50%. In turn, investors found the ARK fund wanting by overpaying for its initial investment in Teladoc. Indeed, Morningstar recently downgraded the fund questioning its risk management.

Events at ARK are playing out in the broader NASDAQ index, which is down 16.9% year to date, with the seven largest tech stocks down on average 30%. The sell-off in Amazon last week on disappointing profits prompted a broader sell-off in the tech-heavy NASDAQ index; Amazon announced its first quarterly loss since 2015. Apple also sounded cautious about supply chain problems. Meta meanwhile reported its slowest revenue growth in a decade. In aggregate, the total Q1 earnings for the 'Big 5 Tech' players are down 8.4% from the same period last year on 11.4% higher revenues, with a 421bps compression in net margins.

To reiterate the point about the broader headwinds to equities stabilising, Chart 1 shows that there is still a large body of stocks trading at high multiples. As the chart shows, both the top quartile and the median companies in S&P500 are at the top end of recent ranges in terms of valuations.

Chart 1: Valuations in the S&P500 still scream trouble



It won't get any easier for the markets in the coming week, with a significant risk that central bankers will spring a negative surprise. Several major central banks have policymaking meetings. Last week's announcement from the Riksbank was clear evidence of the panic among central bankers to address the inflation pressure at hand. By raising the rates by 25bps, the Riksbank did an about-face from its view less than three months ago in February that rates would only rise in late 2024.

The Reserve Bank of Australia looks likely to increase interest rates after last week's inflation report overshoot market estimates by 50bps to hit 5.1%. Then there's all likelihood that on May 4th, the Federal Reserve will raise rates by 50 basis points and announce plans for a rollback of quantitative easing. We find it interesting that more market commentators are aligning with the view that the Fed may have to manufacture a recession to bring inflation under desired levels. Last week's first-quarter US GDP report showed negative growth. Although final domestic demand was strong, a draw on inventories and exports was weak. We are not sure that companies can replenish inventories that give supply line problems. With the war in Europe and surging COVID cases in China, export markets may remain weak in a mini-lockdown.

The Bank of England is expected to raise rates for the fourth time since December last year. They are likely to indicate that further rate increases will be needed if only to stem the recent slide in sterling versus the dollar, which only adds to the inflationary pressures.

If you are looking for positives among the central bankers, Latin America may be about to provide better news. They started their tightening cycle much earlier than other central banks. Hence, the central bankers in Brazil and Chile should be raising rates to almost complete their tightening cycle – a positive that hasn't been lost on their asset markets.

Asia needs better news, and there are signs that China **may** provide that much needed boost. Although we have been impressed with the post-lockdown trading in some ASEAN countries, getting back to normal, everyday life will remain somewhat difficult without China. We would note the recent weakness in Asian currencies as evidence that investors are concerned. In April, the laggards included the Japanese yen, down 6.2%; the South Korean won, -3.5%; the Malaysian ringgit, -3.5%; the Thai baht, -2.9%; the Taiwanese dollar, -2.9%; and the Singapore dollar, -2.1%. Last week, the Chinese authorities committed themselves to the economic growth targets for the year. However, economists still fail to see where sufficient stimulus will come from to offset the challenges of the COVID-related lockdowns in Beijing and Shanghai.

The initial impact of the Chinese authorities' announcement of a commitment to growth targets was to stabilise the Chinese asset markets – and it appeared to have worked. Equities ended the week slightly higher after a rollercoaster week. Investors accept that valuations are in cheap territory; however, they may wait for proof of policy stimulus before committing investments. That said, the slide in the Chinese equity market began when the rest of the world was doing much better. That is no longer the case; hence the relative argument for substantial underweight in the Chinese equity market is weakening.

Gary Dugan

Johan Jooste

Bill O'Neill (Consultant)