



24th January 2022

Is It Really that Bad?

- **US equity market sell-off shouldn't be taken a marker for all equity markets**
- **US equities, particularly tech was very fully valued**
- **Netflix share price drop fully justified**
- **Asia, in particular, could do well if the re-opening trade takes hold as countries follow the UK's lead of no masks and no social-distancing**
- **Ukraine is a key geopolitical risk that could hold Europe in check**

The US equity markets witnessed one of the worst weekly declines in recent times with the S&P500 dropping 5.6% and NASDAQ plunging 7% to leave the markets down 7.7% and 12.0%, respectively, for the year. However, while US equities had a rather dismal week, the experience was not as uniform across other global equity markets. European equity markets fell sharply on Friday, but the UK equity market is still up for the year. Europe overall is down less than 2%.

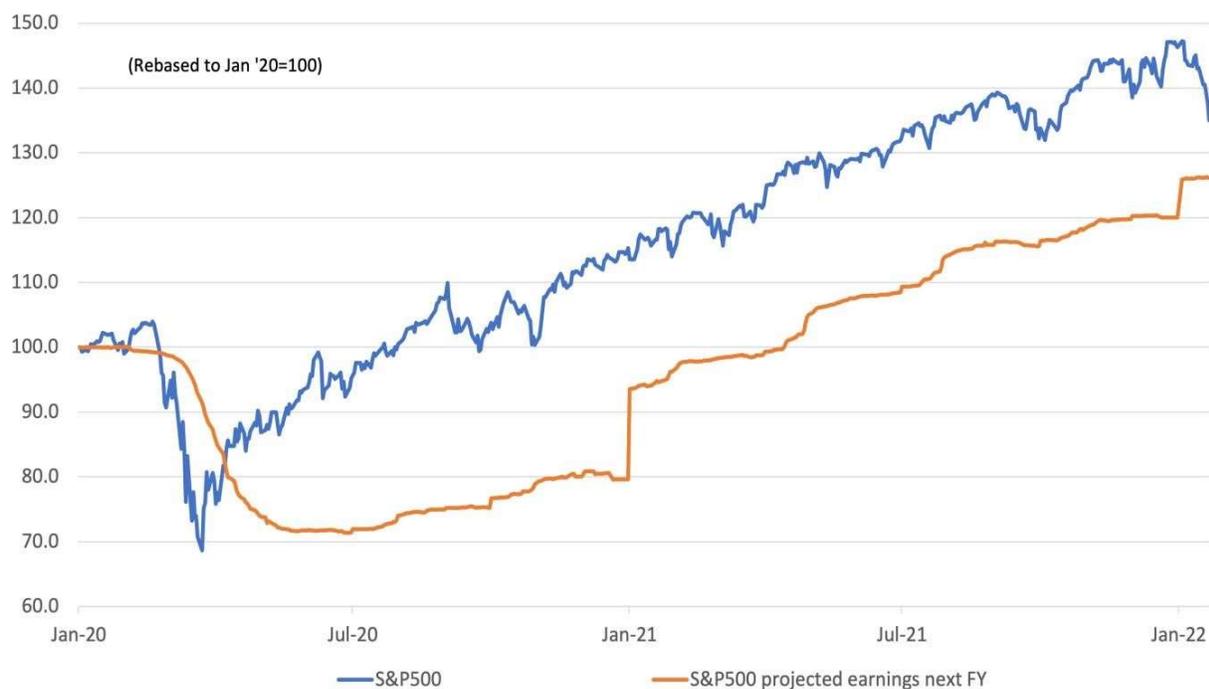
We are seeing a slow but steady unravelling of part of the overvaluation and overexuberance that the US asset markets have come to see over the previous two years. Indeed, we have emphasised earlier that recent asset manager studies of future 5- to 10-year returns have shown that US equities would likely trail Global ex UK equity market returns by two to three percentage points per annum. In other words, US equities were simply seen as overvalued.

The steep selloff that the Netflix stock witnessed last week is quite a salutary lesson for investors about the issues now confronting the US tech sector. Netflix's shares plummeted over 20% in just one day last week as the company guided analysts to cut back their sales forecasts. Once a growth stock disappoints investors, a sizeable stock price downside becomes inevitable. Netflix appeared vulnerable, too. Since the beginning of 2020, the consensus 2022 earnings estimate had only risen 22% – to \$11.25 from \$9.25. However, until the last week's battering, Netflix's stock had almost doubled during this period – to \$690 from \$350. The 97% surge in the stock price implied it was enjoying a sharp 75% rerating. The hammering, therefore, was long due, since it is common wisdom that at the first sign of trouble stocks with huge rerating get hammered. In fact, the stock had already been falling as the market fretted about higher interest rates. On pure maths, the stock price fall looks about complete. Since the start of 2020, Netflix stock is up more in line with the trend in earnings.

At the aggregate US equity market level, after the sell-off, the S&P500 index appears more in sync with the trend line denoting corporate earnings estimates since 2020 (Chart 1). At its peak, the equity market had surged 47% from the start of 2020, while earnings were only up 26%. The recent sharp correction in share prices has brought the two lines closer together. Another 6% fall in the S&P500 would bring the rise in the index in line with the increase in estimated earnings over the same period. Part of the rerating of the market over the past two years was due to the fall in the

discount rate for corporate profits growth – the 10-year bond yield. However, as a positive factor that has since waned; the US 10-year bond yield at 1.75% is just 15 basis points below where yields were at the start of 2020.

Chart 1: Rise in US equity index had outpaced corporate earnings



Source: Bloomberg

Falling markets can further reinforce negative sentiments. Nevertheless, while we worry about many overwhelming factors in the market, we should not lose sight of the positives.

For the past two years, news flow on COVID has been universally negative. But two messages from the early days of COVID 19 still stick in my mind: first, the majority of the global population would end up contracting the virus. Secondly, the virus would gradually weaken until it eventually dies out. I believe people realise that contracting COVID is no longer the health worry that it was once and while vast numbers of people are contracting Omicron, many don't even know they have it. For those that do have symptoms, they are much milder than the previous variants.

Last week, the series of announcements from the UK government could presage a broader re-opening of the global economy that allows for excellent mobility and a consistent return to something approaching normal. The UK has scrapped work from home, mandatory face masks, and COVID passes have been axed. Self-isolation will be dropped altogether from March 24th. Banks have been busy telling their staff to get back to work in the City of London. Social distancing gone!

If Asia follows the lead of the UK, even in part, it could reverse a lot of the poor sentiment that has surrounded the markets and allow for broader and more consistent outperformance. We doubt China will be as flexible, but economies such as Thailand, Malaysia, Indonesia, and the Philippines are obvious beneficiaries.

Ukraine remains a worry. The Trump presidency's breast-beating and global antagonism was only part of a marked increase in nationalism that has transcended both the East and the West. A Russian invasion of Ukraine is not something anyone in the markets wants to see. But there is equally no clear view of what it would mean for markets over the long term. It may be clear that Russia will not be wholly ostracised by the international community as there are significant gaps between the thinking and position of major European countries.

As a last thought and reverting back to the noise from Netflix last week, inflation is still alive and kicking. Netflix announced a 10% increase in subscription rates. We note that companies seem to increasingly calibrate their price increases to double-digit percentage increases. No longer are prices held in check or just squeezed up one or two percentage points.

Gary Dugan

Johan Jooste

Bill O'Neill (Consultant)