October 3rd, 2022

A Furrowed Brow and an Eagle Eye

- **Tough times still ahead as the tightening causes trouble in places you might not have expected**
- **In terms of news flow and market action it feels like Q1 2008**
- **We are also mindful that asset prices have adjusted already, some more and others**
- **We have an eye on those assets that are getting closer to distress levels**

Investors often ask how close we are to the bottom. Our immediate answer is that it is far too early in this down leg of the global economy to believe that a significant buying opportunity is at hand. After all, we have yet to see the recession that central bankers are seemingly trying to create. In terms of market psychology, we are probably in the first quarter of 2008. We are aware of the issues; we are seeing the tightening, but we have yet to see the full consequence of the tightening. However, investors still hope we can avoid a further significant setback in asset prices.

The recent mess in the UK is probably the most significant manifestation of unpredicted trouble so far. Commentators are quickly lining up to forecast the next weak link in the global economy. Even the gold price is starting to stir, up 2.5% in the past week.

This is not the global financial crisis of 2007-9, but a massive economic regime change - deflation to inflation. If we take central bankers at their word, their primary focus is squeezing inflation out of the system. At this stage, they are asking investors to take the rise in interest rates and consequent drop in asset prices in their stride, as this will help us provide a sustainable economy in the future.

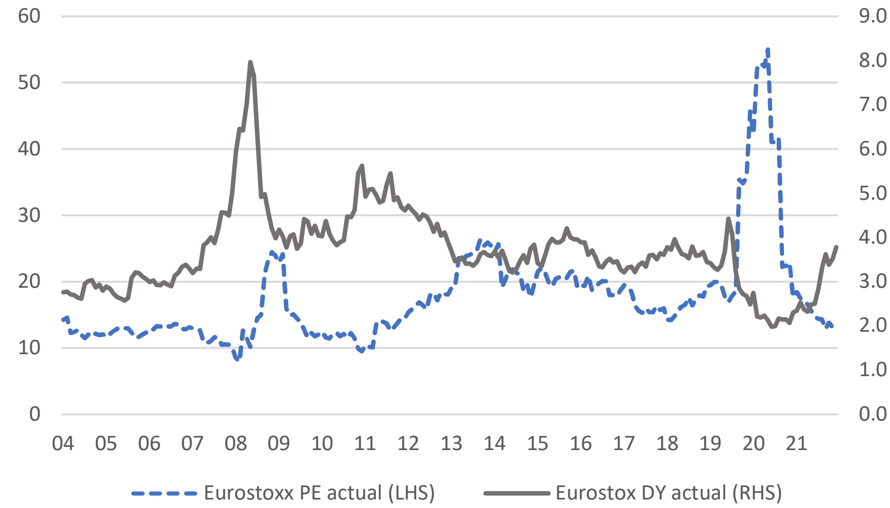
As ever, some asset prices run quicker than others to discount the bad news. Below we highlight a few where the markets are at least halfway to discounting the challenges ahead.

Don't get us wrong, but we still see trouble ahead. Nevertheless, as we reflect back on the weaknesses that characterized the third quarter, we acknowledge that we see opportunities emerging in some asset classes. We may still be some distance away from hitting the rock bottom that we have long been talking about, but we suggest keeping a close watch on assets that are near or nearing their extreme historical valuations.

European Equities

Eurozone equities have had a torrid time, but the valuations are now approaching the previous buying territory. The dividend yield of the market is close to 4% and the P/E of the market close to the 10x multiple low of previous cycles.

Chart 1: European equity valuations approaching historically low (buying) levels



Source: Bloomberg

Japanese Yen and asset markets

The yen may be another asset class that is approaching that buying opportunity. The recent selloff has been brutal as the Japanese central bank made it clear that it wished to leave the monetary policy loose even in the face of a collapsing currency and higher interest rates abroad. There is, however, the glimmer of hope of a change in policy at the central bank level considering inflation has picked up and activity is set to accelerate as the re-opening of the economy post COVID boosts growth.

The Yen's correction has been brutal in recent months. Few commentators have had the risk appetite to call an end to the weakness. However, at the margin, the news flow is improving. Policymakers finally look likely to provide support for the currency. The BoJ did intervene recently and may be more likely to revisit their 'no change' to interest rate policy now that the economy is displaying a greater ability to generate inflation and growth. Economists are pencilling in around 3.5% annualised growth this coming quarter as the economy re-opens. Inflation is already at 3.0%.

Chart 2: JPY vs USD

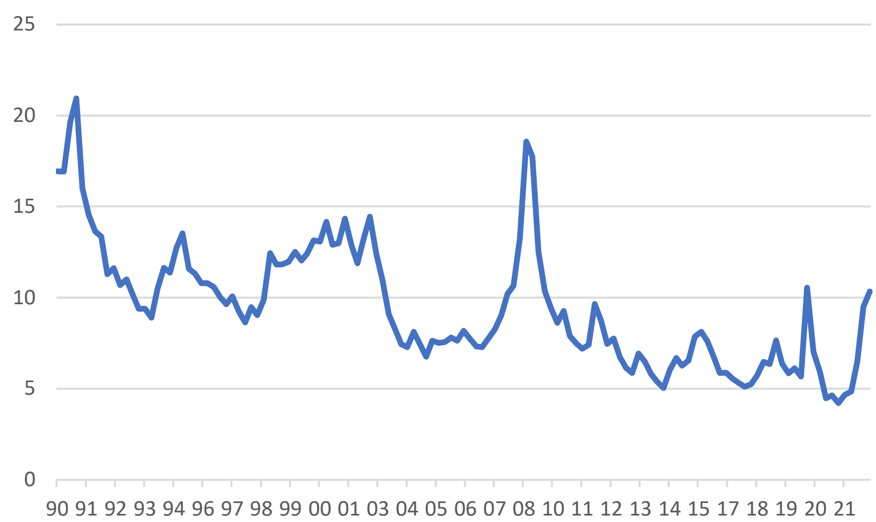
Source: Bloomberg

A stable Yen and a vibrant economy, with strong nominal growth should provide help the equity market. In local currency terms Japanese equities have been one of the most stellar performers among global markets over the past twelve months. Foreign investors which have been net sellers through September, may return to the market and help to make this one of the more defensive markets even in dollar terms in coming months.

Global High Yield – too early but well on the way to value

Yields have moved out spectacularly since the mid-last year lows of 4.2%. Undoubtedly, bond investors are still concerned about the scale of the likely defaults as we go through a (technical) recession. We can only hope that the global financial crisis would not be repeated. But, central banks now have more tools at their disposal to save the situation compared to the early days of the GFC. Hence, we are targeting an extreme yield of around 14-15%, which also implies we are already over half-way there. On a spread basis, the current 650bps is around 50% of the level of the GFC.

Chart 3: Global High Yield (YTW %) moving quickly towards (but not at) value territory

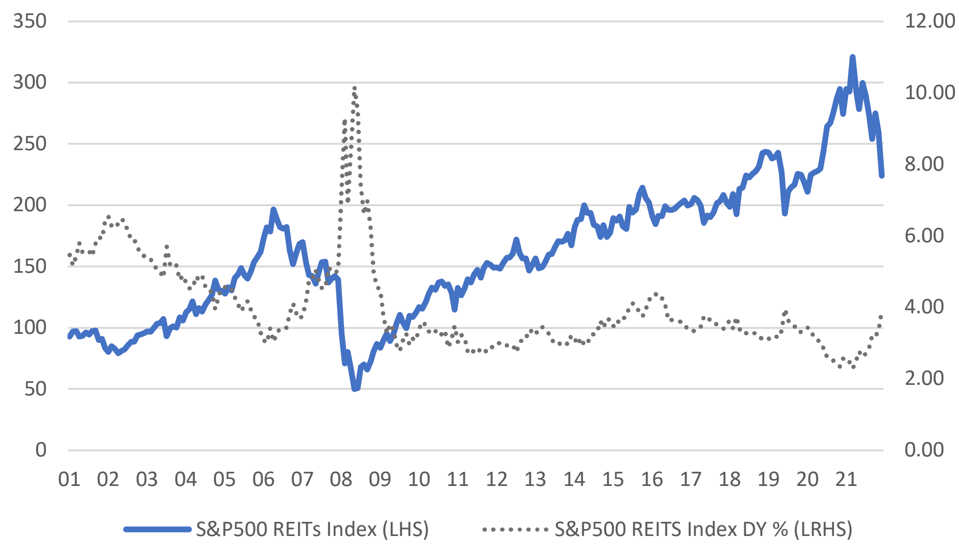


Source: Bloomberg, Note YTW = Yield to worse

US REITS – yielding more but maybe not quite enough

The US REITS price index has fallen around 30% from its peak, about 5% ahead of the drop in the S&P500. The level of the index takes us back to a price index level of about halfway through the early phase of the COVID crisis. Undoubtedly the sector gets hurt by a rise in both short and long-term interest rates. However, the sector dividend yield is now very close to 4%, double the level at the start of the year. This is not the REIT sector of the global financial crisis. In sectors such as multi-family homes, there are still severe property shortages. And as families can't afford the high-interest rates, they are more likely to want to rent. Several stocks in the more cyclical sectors are down more than 50% and trading on yields close to 10% or above. At least that starts to sound like value, even if we would warn investors off investing for the moment and wait for real distress to hit before jumping in.

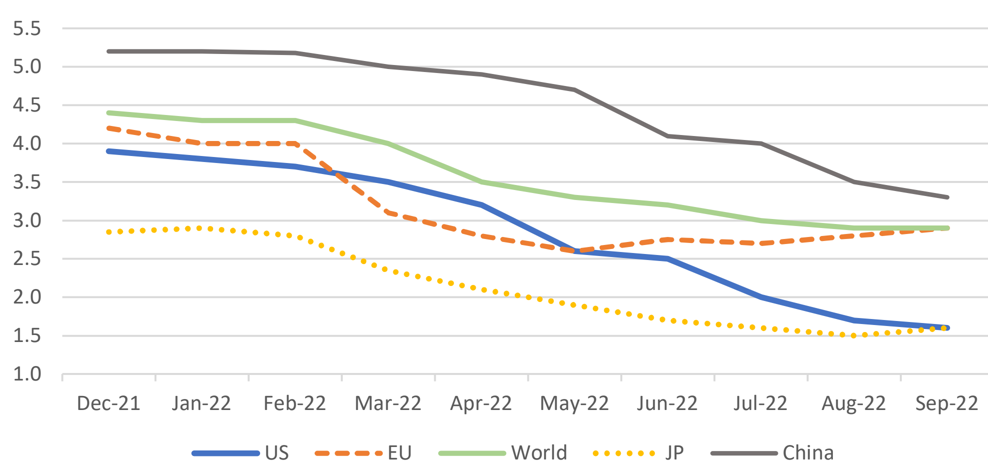
Chart 4: US REITS sector – yields nearly double



Third-Quarter Markets Review

Growth forecasts are down (Chart 4) and interest rate forecasts have shot up (Chart 5). Global growth forecasts have slipped by 150bps since the start of the year. Consensus forecasts for US GDP growth are down to about 1.5% while forecasts for EU have improved modestly after governments capped the impact of higher energy prices. However, next year could be much more difficult.

Chart 5: 2022 GDP forecasts are declining in most parts of the world



Source: Bloomberg

Market expectations of central bank tightening have moved up another notch since mid-August as the market realised that core inflation was going to be more of a problem than previously thought. German headline inflation hitting 10% and a surprise on US core inflation data both hit the market hard.

Chart 6: Market expectations for December 2022 Fed funds rate

Source: Bloomberg

Equities

Equity markets had another tough quarter. Although seen through the prism of the year-to-date performance, it was more of the same. In fact, the aggregate equity returns for the quarter hide the fact that global equities dropped 17% from their quarterly peak in mid-August. The S&P500 volatility index shot up to 30% from 20% over those six weeks. For a month and a half, investors had built up their hopes that they could escape from the major down-leg in equities. However, the positive sentiment evaporated as inflation rose sharply, forcing central banks to promise – and execute – far greater tightening than the market had previously expected.

Table 1: Equity Market Returns

Total Returns	**1H**		**3Q**		**YTD**	
	Local	USD	Local	USD	Local	USD
MSCI World	-20.5%	-18.3%	-6.2%	-4.4%	-25.4%	-21.9%
MSCI US	-21.3%	-21.3%	-4.8%	-4.8%	-25.1%	-25.1%
MSCI Europe ex UK	-11.9%	-20.8%	-5.9%	-10.1%	-17.1%	-28.8%
MSCI Japan	-5.9%	-20.3%	-1.6%	-7.7%	-7.5%	-26.4%
MSCI UK	1.7%	-8.8%	-2.9%	-10.8%	-1.3%	-18.7%
MSCI Asia Ex Japan	-11.6%	-16.3%	-9.0%	-13.8%	-19.6%	-27.9%
Emerging Markets	-13.7%	-17.6%	-8.2%	-11.6%	-20.8%	-27.2%

Sectors	1H	Q3
Energy	24.0%	-1.4%
Consumer Discretionary	-31.9%	0.2%
Banks	-18.6%	-5.8%
Tech	-29.7%	-6.3%

Source: Bloomberg

Bonds

Bonds – like equities – were quite volatile through the quarter, with a significant rally early in the quarter and a dismal drop in the latter half. In the early part of the quarter high yields did well largely following the strong recovery in the equity markets, before retreating by about 10% from their peak levels. Nevertheless, global high yield quarterly losses look modest.

UK gilts stand out for their extremely dismal performance during the quarter. The UK government's mini budget was anything but mini. The implied extra burden of debt put the skids under the gilt market, creating circumstances where the Bank of England had to step in to stabilise the market.

Table 2: Bond market
Total Returns (%)

	1H	**3Q**	YTD
Global Aggregate	-9.1%	-3.3%	-12.1%
US Aggregate	-10.3%	-4.8%	-14.6%
Global High Yield	-15.2%	-1.4%	-16.4%
China Bond Index	-3.1%	-4.1%	-7.0%
UK Aggregate bond	-12.7%	-10.2%	-21.6%
EM Debt	-18.8%	-4.2%	-22.2%
Change (bps)			
US 10 year (currently 3.8%)	150	82	232
US 2 year (currently 4.3%)	222	77	228

Source: Bloomberg

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