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Investment Market Update

February 2022

Markets

Share markets were volatile during January and generally sold off by up to 10%. Particular market sectors including technology and healthcare sold off even more.

The ASX 200 Accumulation Index fell by 6.4% in January, with the speculative end of the market falling considerably more. In the US, the S&P 500 was down 5.2%, the Nasdaq fell by 9.0%, and the Dow Jones was lower by 3.2%[1]. Big falls were recorded by tech names, reversing large gains made last year. European and Japanese market returns were likewise weak, and bond yields rose as inflation pressures intensified. As we noted in our last update, *it is our view that the rise in interest rates will produce a significant test for markets over the coming year. However, it is well anticipated, and markets are already adjusting.*

Underneath the volatility, markets tend to be forward-looking. The path forward appears somewhat problematic, which is disturbing some market participants. Within 3 months, the US Federal Reserve (Fed) will commence its rate rising program. The pivot to higher rates could endure for the next 2 years or so. In the US, inflationary pressures have surprised on the upside and could worsen if energy costs, and wages continue to accelerate. Locally, the underlying rate of inflation – the Reserve Bank of Australia (RBA) favours the trimmed mean of the CPI – last printed at 2.6%, which was higher than anticipated.

Global institutions such as the International Monetary Fund (IMF) and the World Bank lowered their forecasts for global growth in January, with particular emphasis on falling rates of growth in the US and China, the world's largest two economies. Expectations are that US growth in GDP will fall from 5.7% in 2021 to 3.7% in 2022, and in China from 8.0% to 5.0%. In the US, forecasters have focused on the difficulty the Biden Administration is experiencing with passing further fiscal stimulation through Congress. In China, concerns hinge on problematic over leverage in the property and construction sectors.

It is now clear that the almost free money that has supported share markets, bonds, and property prices since the pandemic low in March 2020 is diminishing. Markets are nervous that corporate profits will be squeezed at two ends – from declining revenue growth in a slowing economy, and from rising wages and energy costs. As always, there are reasons to be wary.

Another concern is valuation. Parts of the share market do look expensive. A measure popularised by Robert Shiller of Yale University puts America's share market at more than 30 times their earnings, adjusted for the business cycle. That is significantly above the long-term average. Measured in a more conventional way, the S&P 500 index is at roughly 20 times its forward earnings (compared with its long-term average of 16 times). In Australia, following recent falls, our market at the end of January was trading at around 17 times forecast earnings, which is only slightly higher than the long-term average of 14.9 times.

[1] Factset

As often occurs during market corrections, some will overreact and make poor decisions. Yet it is worth remembering that pullbacks or corrections are a normal part of market behaviour. Indeed, the ASX has had intra-year falls of more than 10% in 16 out of the last 28 years. History shows that corrections typically last about 3 months and the median decline is about 17% outside of recessions.

Despite the uncertainties, there are several reasons to be reasonably positive with the current outlook:

- Interest rates will rise from almost zero, but they are not likely to go much above 2.0% with central banks expected to be extremely careful not to upset markets.
- Following the recent adjustment in prices, many quality companies/investments are once again offering sound long-term value.
- Even with growth slowing in parts of the world, there are few signs of recession, and re-openings post the pandemic will likely begin in earnest later this year.

For now, though, the focus is firmly on the Fed and other central banks, which want to ensure that inflation comes down in an orderly way. Much will depend on the course of the pandemic. On balance, we expect the global economic recovery will continue, albeit at a slower pace.

As we have previously noted, the outlook is challenging for highly priced growth assets and companies with good prospects but no current profitability; their values will be tested by higher bond yields. Solid businesses that benefit from inflation and moderate economic growth will continue to do well. With markets having pulled back considerably, these companies now exhibit attractive yields and sound prospects. Similarly, well-tenanted properties occupied by solid businesses will do well for their owners.

Increased volatility in markets is expected to be utilised to acquire appropriate high quality investments.

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