Prime Partners

SINCE 1998

MARKET INSIGHT

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Market analysis

February 2022

The Federal Reserve (abruptly) shuffles the deck!

Market conditions deteriorated in January, with equities highly volatile.

Question marks left over the future of COVID-19 and the geopolitical situation (Ukraine) understandably made investors more cautious after a solid performance at the end of last year. However, the shock to the markets came from the US Federal Reserve.

seen their P/E ratio climb steeply in the previous 12 months.

Investors' rotation from growth to cyclical companies and/or stocks with a higher value was particularly swift. This move was not displeasing to us given our message encouraging a more cyclical bias in 2022.

"The readjustment of real interest rates is something that we absolutely cannot ignore in the coming months."

FRANÇOIS SAVARY, CHIEF INVESTMENT OFFICER, PRIME PARTNERS

By opening the door to tapering, as mentioned in the minutes of the December 2021 FOMC meeting, Jerome Powell and his colleagues caught traders off-guard, forcing them to revise their US monetary tightening expectations as a matter of urgency. The change was sudden!

Most investors are now expecting no fewer than four rate hikes in 2022, and some are even predicting as many as seven. The idea of tapering brings back some bad memories for traders; those of 2017-2018 when Powell took a similar course of action.

Pressure on US 10-year yields soon reflected the new monetary reality. However, it was the sharp upturn in real interest rates that inflicted the damage on stock markets.

While at first glance it may seem that equities were merely consolidating – with the fall in the main indices (Nasdaq excepted) being less than 10% at the time of writing – a closer look suggests a correction; some price drops were big (between 30% and 80%), and investors abandoned cryptocurrencies such as bitcoin en masse.

Generally speaking, the shift away from high duration stocks was significant, whether in technology (especially where profitability was uncertain), luxury goods or companies that had

The readjustment of real interest rates is something that we absolutely cannot ignore in the coming months.

It is probably linked to inflation and its likely normalisation. The Fed clearly realised its "failure" to limit price increases when it made a recent U-turn in its monetary policy management.

This change of direction did not surprise us. However, the scale and speed of the development are astonishing.

Despite investors' propensity to reconsider the number of rate hikes that lie ahead, we would prefer not to jump to any conclusions at this stage.

We remain sceptical about the idea of there being four Fed funds increases this year. As we said last month, it will depend on the extent to which inflation eases after the first quarter.

One thing is sure, though: real interest rates are set to rise further. That's an inevitability!

Basically, the markets had been under three major influences: a liquidity glut, strong earnings growth, and the ability to support high price multiples at a time of historically low real interest rates. In the space of just a few weeks, two of these pillars (P/E and liquidity) have been cast into doubt.

In other words, the markets are now depending on growth (economic and earnings) for prices to rise further.

We covered this extensively in previous publications. Equally, we noted that the risk of a monetary policy mistake would increase in 2022, as the United States adopted a less accommodative bias, creating more volatility.

This proved to be the case in January, with daily movements erratic to say the least.

As we said, the growth issue is now the keystone to any scenario that we could try to draw up for the international stock markets.

Should we forget the idea that, despite weakening, growth might be of good quality in 2022?

We don't think so given the recent data and leading indicators that we have at hand. However, we can't ignore the greater risk of a monetary policy error and all the consequences that this would have on the economy. The longer it takes for inflation to return to normal, the more serious this risk will become.

The monetary conditions in which we now find ourselves mark a new stage in the financial cycle and, in our opinion, are detrimental to fixed income assets. We have not changed our view, and recommend underweighting this asset class – government bonds in particular.

The best-rated corporate bonds are not attractive either given their lack of excess return and their duration risk. We are avoiding such investments.

Although the spread on high yield bonds has not come under any heavy pressure in recent weeks, which may offer some reassurance about the future of the business cycle, we decided to reduce our exposure in January. This reflects our efforts to manage overall portfolio risks the best we can.

Similarly, we reduced our inflation-linked bond positions given our expectations for real interest rates over the coming months.

As regards equities, we still think they have reasonable potential to rise from the levels at which they ended 2021. In other words, if we take these levels as a starting point, gains of 6–8%, in line with earnings growth, are foreseeable.

This upside is attractive relative to bonds, and justifies our preference for equities.

The heavy turbulence felt on the stock markets in January led us to adjust our portfolio's positions.

We eliminated exposure having too much dependence on growth, and invested in oil stocks. The latter choice partly resulted from the unrest in Ukraine but also enabled us to strengthen our cyclical bias on equities – another way of saying that we doubt a global recession is imminent.

We kept our exposure to emerging market equities, which proved more resilient than developed market equities in January. China's decision to loosen the monetary reins looks to be good news for these assets. Similarly, signs of an improvement in the pandemic situation should see trade return to normal over the medium term and this would theoretically support emerging markets, which are not expensive.

More generally, and given the speed of equity markets' fall, the basic question is whether we should buy on weakness again.

This answer is not a simple one. We think the most important thing is to avoid being motivated by ideas that may have been valid these past 18 months but are not necessarily relevant today.

The shock caused by the Fed is not trivial and, as mentioned earlier, we have entered a new stage of the business cycle due to the recent choices it has made.

For volatility (VIX) to approach 40 so quickly is rare and is not something that should be played down considering the reasons behind it.

With this in mind, we need to make a distinction between the short-term strategy applied to a diversified portfolio and the one to be followed on a 12-month horizon.

This choice is consistent with what we said last month about our determination not to extrapolate the situation beyond this year, partly due to the risk that the US monetary policy reversal could pose to the economy over the longer term.

Despite the recent dip, it doesn't seem right to be increasing our equity weighting for the end of 2022. We are sticking to the path that we set for ourselves, as uncertainty has increased significantly.

The volatility shock that the markets are experiencing must be taken in, and visibility over the outlook for the economy and for earnings must improve before we would consider any deviation. In other words, it seems unreasonable to assume that the shock inflicted by the Fed will be forgotten quickly, and think that the change of monetary direction will have no implications. Shockwaves are highly likely in the short term.

However, we still prefer equities to bonds given the economic and financial outlook for 2022. Moving the equity slider to the right in the current circumstances is something we are not prepared to do.

Does that mean we shouldn't be seizing any buying opportunities?

The sell-off these past few weeks means there is a serious temptation to reposition ourselves on the markets, at least to rebalance our equity weightings.

Following the path described above, we will buy as and when we see fit. We are getting ready for this.

In such a context, we had been focusing on cyclical stocks and some more defensive segments in recent months. The sharp fall in growth stocks could present us with some possibilities to rebalance our sector allocation somewhat, although a quality bias should remain the priority.

Our views on currencies and gold do not require any particular comment, as our mindset is the same as it was last month.

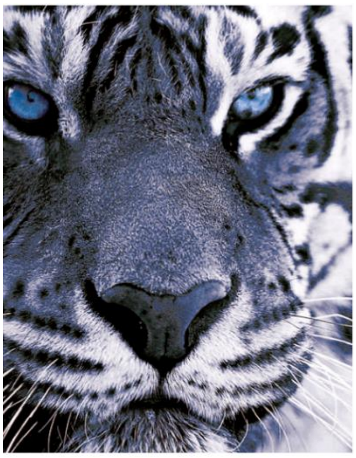
To sum up, January was a testing month. The markets' movement is not illogical given the Fed's decision to reshuffle the pack completely. It changes the deal for financial markets on a 12-month horizon, if only because equity volatility will probably be even higher than in the recent past.

That said, with earnings season having entered its most intense stage and results far from bad, we shouldn't think that earnings growth will be insufficient to give the markets some impetus.

Steering a path through such conditions is certainly not easy, but it's what we have to do.

Last month we stressed the fact that when markets are under the influence of a monetary policy shift, conditions are more volatile for investors. It's already clear that 2022 will be no exception to the rule!

Geneva, 30 January 2022



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