Monthly Commentary 5th of October 2021

September broke the upward trajectory of equity markets, with the US market falling especially hard (4.76%), and only the FTSE 100 being spared a more than 3% decline among major markets. The bond markets also fell by more than 1% while in currencies, the USD strengthened by a hefty 1.7%. Energy was up but most of the rest of the commodity complex fell. Bitcoin fell by more than 7% but has recouped all these losses in the first few days of October, as we write.

Walls of worry

It is natural that with the first decent drops in equity markets in more than a year, some clients have already started to voice their concerns. Is this the beginning of a much bigger downward move? After all there are a lot of negative news to consider, including inflationary pressures, an energy “crisis”, slower growth, supply chain issues, talk of stagflation, contagion from the potential default of China’s largest real estate company, a worsening of relations between China and the US, Covid fatigue, perceived overvaluation of equities, etc etc. Each one of these issues may indeed make matters worse for equity markets. But with the possible exception of the sudden rise in the cost of energy, the rest of the issues have been known for a while. Is it perhaps that markets need to exhale once in a while and get rid of some of the excesses that accompanied their relentless rise since March of last year? The markets have always needed a wall of worry to climb, and this time is no different.

We honestly do not know what effect all the separate moving parts will have on market direction. Many pundits have already decided that it will not be a good outcome. They might be right, and they might be wrong. Instead of trying to analyse each problem and its possible effects on markets, we would rather reproduce our commentary from mid September.

Commentary of 13SEP21

This commentary is prompted by the headline news on Bloomberg on September 10th, as shown below:

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Markets

More Strategists Say a Storm Is Brewing in the U.S. Stock Market

By Ksenia Galouchko and Joanna Ossinger
10 September 2021, 05:59 EEST *Updated on 10 September 2021, 14:54 EEST*

- 'Global stock markets may be entering a period of turmoil'
- Calls for market volatility are growing louder on Wall Street

I had written a client letter back in January, in which I wrote:

"*There have been an increasing number of articles on a probable and pending stock market crash due to the possible overvaluation of equities. Naturally, many clients have asked my opinion. I disappointed them by saying that I really don't know if one is coming*."

So here we go again, with the world equity markets up about 14% since January and not even a 5% market correction since then, the media is full of investment pros voicing their nervous outlooks. The Bloomberg article cites strategists from Morgan Stanley, Deutsche Bank, Bank of America, Credit Suisse, Goldman Sachs and Bank of America. The worry is common: that there will probably be a sizeable market correction as the stars are aligned for one. They refer to a number of reasons including high valuations, seasonality, the Delta variant, pending rise in US corporate tax, the ending of monetary stimulus, chilly China-US relations, peak globalisation, supply chain disruptions, peak corporate sentiment, inflationary pressures etc etc.

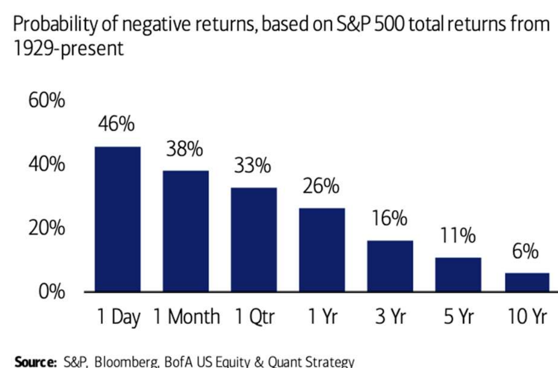
All of these are valid reasons to trigger a sharp fall in markets. And it may very well happen. But can we or anyone time this fall? After all, the old adage "***it's time IN the markets not TIMING the markets***" that has led to investment success over the years. Had we pared back our equity allocations meaningfully in January we would not have looked too smart today.

Even if we were to believe that a major correction is around the corner, all we would do is move from our current "overweight" equity allocation to "underweight". This means that for a "balanced risk" client we would reduce the equity component from circa 55% to 45%.

But we are not going to unless a client's time horizon and attitude to risk has changed. This is because we are in the camp that believes that a bear market happens only if a recession is to follow about six months down the line. And for now, the probability of a recession in the horizon is low.
Below are the reasons that we are still optimistic:

- Fiscal spending is still very strong in the US and Europe.
- Excess household savings are massive (about $3 trillion in the US alone)
- Major central banks are still dovish. It's one thing to remove stimulus and another to tighten.
- Major inventory replenishment is underway.
- Corporate capital expenditure is expected to grow at a huge 13% this year.
- Net margins are close to all-time highs in the US as productivity has risen.
- Bonds are a more expensive alternative for asset allocators.

So selling now in anticipation of a potentially meaningful fall in markets does not seem like the right strategy. And if we sell now, when do we choose to re-enter? Not that easy. Studies have shown that if one was to miss the 10 best days in the US markets each decade, their total returns from 1930 to 2020 would have been 28%. Had they stayed invested, these rise to 17,715%. The graphic below shows the probability of losing money based on the amount of time one stays invested:



Of course, all the above does not mean we should not stick to prudent risk management, buy only quality and not speculate. And yes, we are aware that the likes of Deutsche Bank and Merrill Lynch have recently said that their models based on long-

term valuations suggest zero or negative annual returns from US equities for the next 5 and 10 years respectively. This does not make their models infallible.
And yes, we are aware that market forward price earnings (P/E) ratios are at very high levels. But should reliably high-growth/high-profit companies be compared to market multiples which comprise of many companies that are growing at much lower rates? We do not think so. If anything, a high-growth company should be compared not with the market multiple but with its own historic multiple. While it might still look expensive, it is not nearly as much as many analysts think.

Another worry is that markets in the US have fallen only 2% from their all-time highs (as of 10SEP21), so surely, they have more to fall. Perhaps. But one should note that half of all companies in the market are about 10% below their highs already, so a "rotating" correction is already taking place.

In the end, we have no idea if a large correction is imminent, even if many investment bank strategists think so. If you are nervous about the markets and are not comfortable with the amount of risk you are taking, please let us know and we can change your portfolio accordingly. But please don't come back to us and ask why we did not sell before a 10-15% correction that might or might not happen now.

End of commentary from 13SEP21.

To be clear, we are not complacent, nor are we overtly bullish. We do make a reasonable assumption that we do not expect a recession looming, which would cause equities to fall hard. We are also concerned that with fixed income offering measly yields, we reluctantly limit risk in balanced portfolios by also having a cash component. Some might argue that with current inflation above 2%, the erosion of the value of cash is not helping portfolios. But at the same time, allocating more to equities will increase the risk. Here lies every asset allocator's conundrum, and we are no different. What we do not want to do is to try and time the downs and ups of the markets as it will almost certainly detract from long term performance.

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