Monthly Commentary 4th of July 2022

A horrible June ended a horrible first half for the year in financial markets. Negative records were broken as there was nowhere to hide with red ink covering every asset class. World equities were down more than 7.5% in June, with the US and Europe falling even more. Investment grade corporate bonds were hit very hard while government bonds were not far behind. Commodities joined the selloff for the first time this year (- 8%) as recession worries pointed to demand destruction. The USD was up (a very strong) almost 3%. Finally, Bitcoin was taken out and shot, falling 41%.

Are we back to the Seventies?

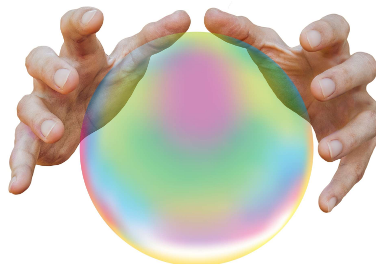
For those of us old enough to remember the 1970's: High inflation, slowing growth, recession worries, geopolitical turmoil, higher interest rates and supply chain issues are some of the similarities with today.

Throw in the various threats of industrial action and travel chaos and it's very easy to imagine platform shoes and flared trousers listening to the latest hits from David Bowie and T.Rex.

It's not all bad though, as today's market environment has high levels of employment, healthy consumer & corporate balance sheets, as well as strong tech-enabled productivity growth across all sectors. Additionally, energy is now a much smaller part of US GDP than it was in the 70's.

But there is no denying that the world economy is facing major challenges.

The Crystal Ball



One of the main expectations of investors from their portfolio managers is how they see the future of world markets and of their own portfolio. Below are 10 points that highlight why predictions are almost useless but people insist on making them and listening to those that make them. The below was from an article on Bloomberg.

No. 1. Not everything is a forecast*: This is especially true in terms of markets and the economy, and so a reasonable definition of a forecast is as follows: It pertains to a specific asset or asset class and/or economic data series, at a given price or level and a specific time. It also must be disprovable. Making a statement that can't be proven or disproven is not a forecast; it's a theoretical academic debate. Consider the following statements: "Stocks tend to go higher" or that "recessions are cyclical." These are not forecasts because they lack specifics.*

The statement, "The S&P500 will hit 3000 by the end of the year," on the other hand, has all the elements of a forecast and it will either be proven right or wrong.

***No. 2. We are very bad at forecasting**: Examples are everywhere: Economic forecasts, earnings estimates, market forecasts, expectations of future technologies, not to mention election predictions. The data overwhelmingly show that as a species, we are simply awful at this.*

***No. 3. We are even worse at predicting our own behaviour**: I have been highly critical of those surveys that ask people to describe what they plan to do in the future. Whenever you see someone forecasting their own behaviour, what you are getting is a read of their emotional state. Whether it's holiday shopping, company hiring plans, voting intentions -- people say what they are feeling at the time the question is posed, and it is not predictive of what they are actually going to do.*

***No. 4. Random and unforeseeable events ruin forecasts**: Try going back and looking at the record of forecasts made years or decades ago. Most of them are inaccurate for the simple reason that they were overtaken by random or unforeseeable events.*

***No. 5. Technology is tricky**: We are particularly bad at making predictions about technology. This goes back a long ways, to claims in the late 19th century that no one would ever need or want a telephone, or that cars would never replace horses and buggies. And folks are still at it, despite their inability to get it right. Check Microsoft ex chief Steve Ballmer's 2007 prediction that Apple's iPhone would never catch on.*

***No. 6. Forecasts are marketing**: If forecasts are so useless, why are they so prevalent? I don't know of a clearer way to say this: A forecast is usually accompanied -- directly or otherwise -- by an effort to sell something. Predictions are inherent in marketing campaigns. It's as simple as that.*

***No. 7. Random luck**: People tend to overfocus on the outcome rather than paying closer attention to the process. This leads to an overemphasis on guesses that were merely lucky and therefore cannot be replicated.*

***No. 8. Asymmetric risk**: Bad forecasts are quickly forgotten, while those who make accurate predictions that are nothing more than the result of luck or random chance get elevated to stardom. This is the entire underpinning of why people make forecasts -- and especially radical scary ones -- in the first place. The potential rewards for being right can be significant, while being wrong has little downside.*

***No. 9. Failing to acknowledge a mistake**: Many people engage in the sort of ego-driven decision-making that leads to bad outcomes. Rather than admit error, they prefer to stay invested based on their predictions rather than do what's best as an investing strategy. Renowned technician Ned Davis literally wrote the book on this and the title says it all: "Being Right or Making Money. "*

***No. 10. Making better predictions**: There is some hope for improvement in forecasting: Phillip Tetlock, author of "Super forecasting: The Art and Science of Prediction," explored how forecasters can use data and logic to improve the probabilities of reaching a desired outcome. Note the word "probability" instead of prediction.*

To highlight the above, take an article from Bloomberg last week:

19/06/2022, 13:50 Nearly All of Wall Street – and the Fed – Botched Calls for 2022 - Bloomberg

Markets

Nearly All of Wall Street – and the Fed – Botched Calls for 2022

- Selloff defies year-end predictions by strategists, economists

Last December, every major bank on Wall Street, as well as the chairmen of the world's largest Central Banks predicted that 2022 would be year with decent equity market returns and controlled inflation. I..e they were ALL wrong. These institutions have thousands of very bright economists and strategists that are much smarter than me, and they still got it wrong.

So if we are not good at predictions how do we make investment decisions? Investment decisions should not be based on predictions. Rather they should focus on a long-term plan based on your investment goals and tolerance to risk. Recessions will inevitably come and they have come in the past in different forms and shapes. In the end they pass, leaving many investors who have tried to time the markets licking their wounds. Equity market recoveries are often "V" shaped meaning that when they bounce back, they do so very fast. Only those who manage to stick to their plan can navigate recessions and market corrections with success. Take as an example the pension funds that have very strict investment guidelines and are always fully invested. They did not panic and sell. They account for more than 65% of US markets!

The below are our views for investment success in any environment.

- **Invest according to your risk profile**. Whether you are cautious, balanced or growth, oriented it is very important that you are aware and have accepted how your portfolio will behave in different market environments.

- **Diversify**. Diversification into different asset classes is key for investors who cannot withstand equity market volatility. However, diversification is also key for an all-equity portfolio. In general investors should avoid large concentrated bets in specific sectors and specific companies. In a stagflationary environment energy, commodities, consumer staples, and health care are expected to do better than technology stocks. Do we completely move out of technology and overweight these sectors? The answer is no. Note that MSCI World, has only 3% energy, 4% materials, 7% consumer staples and 12% health care. On the other hand the technology and communication sectors alone are 1/3 of the index. Our equity allocation should fairly be diversified in all sectors. Yes, in this environment we need to have commodities and energy but at reasonable weights and not go overboard.

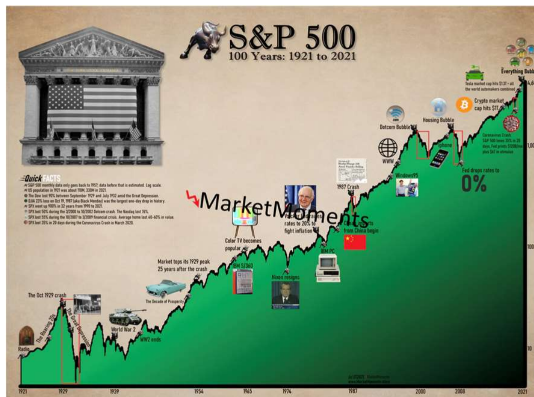
- **Invest in Quality**. Invest in quality and not in fads. It is ok from time to time to make some speculative bets if your risk profile allows, but that should be a small part of your portfolio.

We like companies that have growth characteristics but also with solid balance sheets, relatively good valuations, high barriers to entry, large TAM (Total Addressable Market) and good management. If you cannot find such companies, better to invest in broad market ETFs and quality funds.

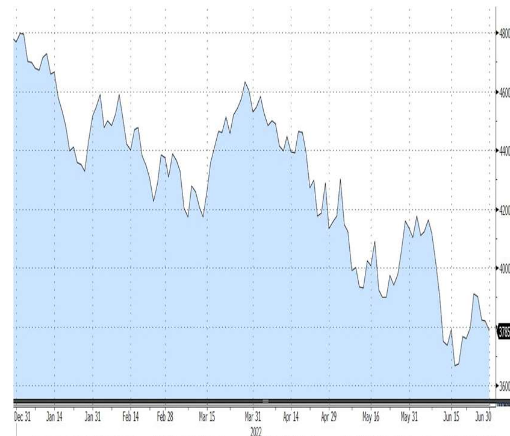
- **Minimise Fees.** Fees are an important element in portfolio performance. These should be kept as low as possible.

- **Stick to the plan.** Most investors fail to meet their investment goals because they are constantly changing their portfolio based on their feeling or view on the markets. As a cliché says, “the hardest thing in investing is doing nothing”. Although it might sound as bad advice, successful long term investing is about managing your emotions and following your plan according to your attitude to risk.

So, depending on your disposition, you may view the world with the glass half full (100 years of equity market returns – left chart) or half empty (Year-to-date returns – right chart):



100yr returns to December 31, 2021 circa 60,000%



6mo returns to June 30, 2022 circa -20%

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