Market intelligence update…

This week there has been a flurry of central bank activity and sharp market moves. Given the general level of market and economic volatility, I thought you might appreciate a more in-depth update.

There is talk of a similar situation to the inflation crisis of the 70s so I thought a look at what happened then might be useful:

In 1970 the market fell (3.8%), in 71 it rose 44.7%, 72 rose 17.9%, 73 fell (27.0%), 74 fell (50.4%), **75 rose 145.1%**, 76 rose 2.6%, 77 rose 48.8%, 78 rose 10.4%, 79 rose 12.3% and in 80 rose 33.9%

Source: Dimensional UK Market Index total returns.

Warren Buffet (the Sage of Omaha) once said: "it is wise for investors to be fearful when others are greedy, and greedy when others are fearful."

The past week, since the US inflation print last Friday, has quickly reversed any gentle rebuilding of markets that was occurring. The higher-than-expected monthly inflation number re-opened the debate around where interest rates will rise to this year and next, with significant impacts on both equity and bond markets. The spate of key central bank meetings this week has ensured market volatility remains elevated.

At its core, we believe this is a cyclical market de-rating rather than a deeper and more worrying corporate solvency issue as we saw in 2008 and 2020, and as such equities look more attractively priced now in relation to long run averages**.** The difficulty is in calling exactly how low markets may go. There is consensus that markets now price in a lot of pain: higher interest rates, high inflation, the withdrawal of Covid fiscal and monetary stimulus, the Ukraine conflict and the impact of Chinese lockdowns. In particular, the recent move down has been a result of pricing in higher inflation still, and at least an extra two or three interest rate rises. That does give comfort that we have seen much of the worst here. It is also likely that current market levels are pricing in slower growth and to some degree a recession. What is not yet certain is the degree to which that recession may extend, if indeed it occurs, and also the degree to which markets may overshoot on the downside, if they do.

That is the bad news, and in the short-term markets may be subjected to more weakness. But as long-term investors working with investment houses that target good quality businesses and substantial global diversification, the key point to reiterate is the inherent value that will be realised in time by the ability of these companies to grow their earnings. After all, the ability to grow earnings is one of the best predictors of share price performance over the medium-term. As such, the upcoming second quarter earnings season should give us plenty of opportunity to assess the impact of inflation, and we expect that quality businesses with adaptable business models and strong balance sheets will be better placed in terms of pricing power and recessionary risks, to prosper. At current levels, the valuations of companies as measured by their price to earnings (P/E) multiple is at or below long-term averages. For example, the forward P/E of the S&P 500 index in the US is 15.5x, now below the long-term average. Assuming no change in the multiple the market ascribes to such businesses over the long run (i.e., the average over 5-10 years stays roughly the same as in the past), then returns over any reasonable time period from hereon should be healthy.

This year has been painful on multiple fronts, exacerbated by the concurrent large falls in bond markets which have removed the protection element that they provide to balanced portfolios. The twin fall is something that is thankfully all too rare (only four occurrences in ninety whole years), but underneath the headline moves, the performance of most companies remains strong. As such, with earnings growing and prices falling, we have seen a painful adjustment in short term economic expectations, that ultimately represents a hiccup in the long term returns from the markets.

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