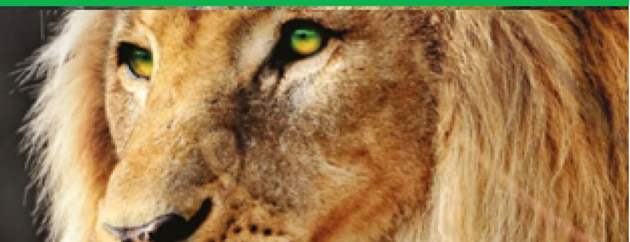

LIONTRUST

MULTI-ASSET PROCESS

Market review: May 2022

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- **Several markets dip into 'bear territory' but how useful are these arbitrary definitions?**
- **Peak hawkishness from central banks could stir a rally, as long as it comes with peak inflation**
- **Opportunities emerging in heavily sold-down quality companies**

The financial press has never been known for moderation and at a time when volatility is already rife, headlines proclaiming the 'everything bubble has burst' and 'Wall Street is heading into a summer of hell' are adding to the wall of noise.

We have seen the US Federal Reserve in whatever it takes mode before, notably amid the Global Financial Crisis and Covid pandemic, but the adversary has not been runaway inflation since the early 1980s. Fed chair Jay Powell made a couple of telling statements at the *Wall Street Journal's* Future of Everything Festival during the month, signalling the Federal Open Market Committee's resolve to use rates aggressively. First off, he said policymakers will remain unflinching in combatting the highest inflation for 40 years, even if it means pushing up unemployment, and second, that the stopping point for rate hikes is not certain and they could rise as high as 4% over next 12 to 18 months, rather than the predicted 3%. This almost guarantees the Bank will push through 50 basis point (bps) rises at its next two meetings and a 75bps hike is on the table if needed.

Minutes from the May session showed the Fed recognises policy may have to move past 'neutral', where it is neither supportive nor restrictive of growth, which could ultimately echo through the economy. More reassuringly, Powell expressed confidence that inflation control need not be at cross purposes with a soft landing and, if things come in better than expected, the Bank is prepared to do less on the tightening front; as a counterpoint, it is prepared to do more if things come in worse. Whatever happens, it will be Powell at the helm, with the Senate confirming him for another four-year term, and he will be keen to eradicate any 'Fed that failed' narrative.

Elsewhere, the Bank of England announced its fourth hike at the start of May and the European Central Bank, among few remaining policy doves, is also expected to join the rate-rising ranks as early as July.

With central banks facing such a tough balancing act, also coping with the impact of war in Ukraine and ongoing Covid outbreaks, concerns are escalating around potential recession, with the S&P 500 and Nasdaq also dipping into bear market territory (a fall of 20% or more, on which more later) over May. Meanwhile, the Dow Jones Index also posted its eighth consecutive weekly decline over the month, a spate of losses not seen for 99 years. As always in such circumstances, investors look to history for guidance and numbers make for troubling reading: Bloomberg figures show that on the 14 occasions over the last century when the S&P has gone into bear territory, in all but two of these – 1966 and 1987 – the economy had also shrunk within a year.

Before Covid and inflation, trade wars served as the economic bête noire for much of the latter part of the 2010s and the month did serve up potential good news on this front. President Biden announced discussions around tariffs imposed on China by the Trump administration, with investors seeing this as a de-escalation of the trade war between the economic superpowers and therefore helping revive some optimism towards riskier assets later in May.

Within the Liontrust Multi-Asset funds and portfolios, we have moved our overall target tactical asset allocation score down from four to three (on a one to five scale, where five is most bullish) but would say we are actually more at 3.5. This reflects the fact that navigating higher inflation and slowing growth calls for slightly more defensive positioning and risks to the downside are more prevalent. That said, we feel a technical, 'small R'

recession (two consecutive quarters of negative growth) is more likely than a 'real' recession, where a protracted slowdown emerges.

Satisfyingly for economic historians – perhaps less so for more pragmatic market watchers – this would be yet another successful recession prediction for the so-called 2s10s yield curve, which shows the relationship between 10-year and two-year US Treasuries. The yields on the former are usually higher, and when the curve inverts, recession has followed a year to 18 months after. Such an inversion happened in March as two-year yields climbed above 10, albeit for a matter of days, which has presaged each US slowdown since the 1970s.

Every American recession for the last 80 years has also been preceded by the Fed starting to tighten policy and the evasive action necessary to curb inflation is already triggering bearish conditions in markets. But every bear period is not the same and history suggests three possible phases: a liquidity-based sell-off on expectations of policy tightening, an imminent recession sell-off, and a credit crunch sell-off. We are currently in the first stage but there is no guarantee the others will automatically follow.

Expanding on this, I read some interesting analysis over the month (courtesy of Hawksmoor), making the point that accepted wisdom on what constitutes a bear market (again, down 20% from a previous peak) is fairly arbitrary: by definition, a market down 19.9% is not technically in bear territory but, in reality, the feeling for investors is no different. A bear market is ultimately one where momentum is clearly downward and while we do have that in most regions across the world, current conditions say more about the make-up of many headline indices rather than overall equity health.

As we have stressed over recent years, the S&P 500 and Nasdaq are dominated by a handful of mega-cap tech names and as some of those have started to struggle, so have overall indices. Likewise, the FTSE 100 Index is heavily weighted towards more 'value' companies in the energy and finance sectors, which has led to underperformance during several years of growth ascendancy but means our home market is performing well so far in 2022 on a relative basis.

In our funds and portfolios, we continue to hold a blend of asset classes and styles rather than relying on any one element and believe this will help us deliver suitability over the long term. This diversification, however, (including small caps as part of equity exposure, for example) is a key reason why our performance will not move in lockstep with 'headline' indices. In the long term, diversification is integral to strong returns but our portfolios will have a different performance profile to headline equity indices, especially over short periods.

Beyond arbitrary bear definitions, we feel more detailed analysis is needed to prepare for the rest of this year and beyond. Apart from geopolitics, the key question is when we might see peak hawkishness from central banks, and this could ultimately trigger a rally in markets (and prevent those further bear stages), as long as it is supported by peak inflation. We continue to believe inflation should start to fall in the second half of the year as rolling base effects from Covid shutdowns work through the system, although – to state the obvious – the higher it climbs, the longer it could take to fall. Softening levels as Covid effects diminish should allow central banks to be less aggressive on the hiking front than markets are predicting but there remains a risk of policy mistakes or unintended consequences.

While current newsflow is broadly negative, equity markets remain attractively valued, particularly after recent indiscriminate selling, and there is growing chatter about opportunities to buy the dip. The UK is still cheap despite the recent energy rally and value rotation, for example, and even the US is less unattractive after falls.

We would suggest a few points to consider for potential dip buyers. First is whether or not robust earnings will be enough to help companies weather this year's turbulence, with several US consumer titans highlighting the impact of inflation on margins and consumer spending. Target shares have plummeted, for example, as the retailer said supply chain costs and inflationary pressures had cut into its profits and customers are buying fewer higher-margin items.

Second, after a decade-plus of growth ascendancy, the value rotation is an early sign the backdrop may be changing and uncertainty around inflation and interest rate rises support our view that returns from stock markets, particularly the US, will be lower this year. Higher rates typically present a more difficult situation for

long-duration growth companies and if we are set to be in a hiking cycle for a couple of years or longer, we would suggest the environment for value could be favourable.

Recent selling, however, has left growth and quality companies on more attractive valuations and we expect to top up our weighting over the coming months. We continue to believe that multi-asset portfolios able to tilt between growth, value and quality, while keeping a foot in all camps, offer the optimal risk/reward balance.

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