MERRION INVESTMENT MANAGERS | CANTOR Fitzgerald

Strategy & Outlook

MARKET UPDATE

FEBRUARY 2022

January: Global equities fell by 3.5% in euro terms to start the year, a rally in towards the end of the month meaning one of the worst January's in the history of the stock market was avoided. Various sentiment, positioning, and oversold measures we track are now at or through their March 2020 or even decade lows. The outperformance of value stocks vs growth hit a record for any single one-month period in history, the MSCI Value Index falling by 1.3% vs -8.6% for the MSCI Growth Index.

The sector rotation that we saw in December was followed with stark asset price corrections that began at the start of the year, prompted by minutes of the Federal Reserve's December meeting, which caused the biggest sell-off in the Nasdaq since March of last year. Bond yields had been quietly pushing higher in the aftermath of the December Federal Reserve meeting and extended that move in early January (although longer dated yields have since stabilised). There was little in the minutes that the Fed Chair Powell didn't explain to the market in December, but perhaps seeing it written in black and white brought home the fact that rates are going to rise, and not only will quantitative-easing end in March, quantitative-tightening is possible soon after the first hike in rates.

Inflation concerns remained front and centre as the month progressed, with hawkish Fed re-pricing pushing US real yields higher, weighing on the overall market and boosting low-multiple stocks. Fed chairman Jay Powell's press conference after the January FOMC meeting was interpreted as not only an abandonment of forward guidance but of any guidance for markets, admitting that the Fed didn't have clarity on how the rate path may develop over the year. The money markets are now pricing 4-5 quarter point Fed hikes for 2022, with some market commentators saying that won't be enough, calling for more than 5 hikes, or a 50bp hike in March. This expectation of impending tightening of financial conditionings has caused untold damage to certain areas of the market, namely growth stocks. With economic growth naturally peaking from the lofty reopening levels of 2021 however some in the market are seeing this move as policy mistake that will kill not just inflation but economic growth. This is evidenced by the continuing flattening of the yield curve i.e., short term interest rates up but long-term stable / down. This is now beginning to weigh on cyclical parts of the market which had up until now been performing better.

The chaos in markets is at odds with the solid results season we are seeing so far. Industry bellwethers Apple, Microsoft, Texas Instruments, Visa, and United Rentals all offered upbeat assessments of their businesses and the economy. Apple's comment on supply chains normalising were particularly important as inflation worries continue to be front and centre. Likewise, comments by McDonald's on labour issues abating dramatically also bode well for the long term. In November 10% of their stores were disrupted by labour shortages, that is now currently 1%. Given the main driver of the current bout of inflation is/was a one-off shift in spending to goods from services which is reversing and supply chain bottlenecks which will ease, albeit at a slower pace than anticipated, on balance it seems more likely than not that inflation expectations ease as we move through the year.

Much has been written about quantitative tightening, the previous episode in 2017/2018 having run into difficulties rather quickly - the excess liquidity in the system was quickly drained, and the resultant tight bank reserve environment caused significant disruption in dollar funding markets. There is much more headroom currently. With approximately $1.5tln sitting on reverse repo at the Fed, any reduction in the Fed's balance sheet should see a drain on this reverse repo rather than purely on bank reserves. Add to that the new standing repo facility, and confidence in the Fed's ability to implement QT without the issues we saw last time should improve.

Outlook and positioning

To summarise our views, the recovery was rapid, but has slowed, stimulus (both fiscal and monetary) is still there but fading. Although consumer demand will be weaker, low inventory levels globally should support growth. This may further pressure supply chains in the short-term, and while inflation is elevated globally, indicators such as the ISM Prices Paid suggests we are past the peak. This leaves us with very strong foundations for the equity bull market, with already strong earnings and margins accelerating through the rapid investment in technology. The US equity risk premium is just over 2%, so towards the lower end of the range of the last 5 years, but well above the levels that prevailed pre GFC, and significantly above the levels of the late 1990's (when it was negative). History suggests the secular bull market is far from over.

Despite a very bad month for our own performance, MIM funds continue to be sitting at the upper end of the asset allocation range. We continue to use this volatility to add to structural growth winners. Businesses that continue to deliver whilst being exposed to long term secular trends are on sale at incredibly attractive multiples. They will benefit from the slowing inflation and economic growth backdrop which we believe will become apparent throughout the course of the year. The best time to invest in our funds in the last 3 years has been after similar drawdowns were experienced in December 18 and March 20 where returns of 15%+ were achieved over the following 3-6 months (MMA70).

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