NORTH CAPITAL

Market Overview and Outlook

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July 2022

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Market Review and Outlook

Summary

The first half of 2022 has been a tough one for investors, as virtually all asset classes suffered substantial losses. Earlier in the year there were a few hiding places – largely in real (inflation sensitive) assets, such as commodities, infrastructure and property, as well as value stocks – however, these assets also suffered in the second quarter as investor anxiety shifted from inflation to increased recession risk. The result was a first half loss for equities of around 20%, which is the worst return for the period in 50 years. For investors in conventional portfolios, bonds tend to be the other main asset class held, and the picture here wasn't much better – with global bonds down some 10% in the first half of the year – again, one of the worst periods on record for the asset class.

For US investors, this has meant a particularly bleak six-month period. As can be seen below – during previous years where equities fell, bonds usually provided some protection. This year however has been very different with both equities and bonds falling in unison – which illustrates the extent to which markets have been distorted by central bank policy in recent years.

UK based investors have fared a bit better with the weakness of sterling and relative strength of the UK market providing some cushion to the equity component. We will discuss this more in this note, alongside providing a fuller review of various asset classes, outlook for the rest of the year and positioning in North Capital portfolios.

S&P down years (1976 - 2022):

Year	S&P Total Return (Stocks)	Bloomberg US Aggregate Index (US Bonds)	60/40 Portfolio (US Stocks/US Bonds)
1997	-7.2%	3.0%	-3.1%
1981	-4.9%	6.2%	-0.5%
1990	-3.2%	9.0%	1.7%
2000	-9.1%	11.6%	-0.8%
2001	-11.9%	8.4%	-3.7%
2002	-22.1%	10.3%	-9.2%
2008	-37.0%	5.2%	-20.1%
2018	-4.4%	0.0%	-2.6%
2022 YTD*	-20.0%	-10.4%	-16.1%

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Review of the period

The first six months of 2022 have all been about the macro backdrop (war, inflation, and central bank policy on interest rates). There has been a regime shift in the economic environment we experienced for most of the last decade to where we are now – notably on the inflationary backdrop and the corresponding effect on central bank policy. This has had a significant impact on all asset classes this year, described in more detail below.

Equities

> Global equities have seen some of their sharpest falls since the pandemic induced sell-off of 2020, falling 20% in the first six months of the year, in US dollar terms.

> There has, however, been differentiation in performance across geographies. The US market led the falls, down some 20%, whilst the often unloved UK market weathered the storm well, broadly flat for the year. Reasons for this are:

- Valuations were not as rich in the UK coming into this year, so were less sensitive to an increase in interest rates/central bank (monetary) tightening.
- US dollar strength – the pound has weakened some 8% against the dollar, helping boost UK listed companies with overseas earnings, as well as sterling denominated overseas assets in portfolios.
- Commodity exposure in the FTSE 100 has been a positive contributor.

> The equity growth style has come under extreme pressure, led by unprofitable technology, falling 28% this year, as central banks have looked to combat rising inflation by increasing interest rates, which tends to have a particularly negative effect on growth stocks.

> The energy sector is the only major industry which has seen positive movements this year. The sector has increased almost 30%, as oil and gas prices have remained elevated following the Russian invasion of Ukraine.

Bonds

> Fixed income, which often provides some protection when equity markets run into trouble, have also had a poor start to the year, with the global bond market falling 10% year to date.

> Bond yields, which began the year at record lows, have been pushed higher as inflation has caused central banks to reverse their quantitative easing programmes and increase interest rates (the price of bonds fall when their yields rise).

> Default rates remain relatively low amongst investment grade and high yield debt, however the uncertain outlook for the global economy may increase default rates, which has led to spreads (the difference in yield on US treasury bonds, relative to corporate bonds) to widen – negatively affecting the price of corporate bonds.

Commodities

> Commodities had a strong start to the year, which has fuelled inflation. In June, however, there was a significant retracement, as fears turned to recession and a demand shock for commodities.

> The oil price has risen by over 40% year to date, as the war in Ukraine has caused many countries to boycott the purchasing of oil from Russia – one of the world's largest oil producers. However, even before the war there were upside pressures on oil.

- OPEC, a group of countries which control most of the supply of global oil, has not bowed to pressures from the US to rapidly increase oil production, while years of underinvestment has left countries like the UK and the US struggling to cover the shortfall.
- Gold prices have remained stubbornly flat for the year in the face of higher inflation and macroeconomic uncertainty, largely due to rising bond yields offsetting the inflation and geopolitical tailwinds.

Currency

- The US dollar has had one of its strongest starts to the year for some time – driven by investor desire for safe haven assets (in the face of geopolitical tensions and increased recession risk), but more so due to the growing policy divergence between the US and other developed nations' policy on rates, with the Federal Reserve being more willing (finally) and (importantly) able to raise rates aggressively to fight inflation.
- The Japanese yen has dropped to levels not seen since the early days of the Asian financial crisis, as the Bank of Japan continues its accommodative monetary policy, in stark contrast to most other central banks.
- The pound and the euro remained relatively volatile over the period, as both have had their fair share of political and geopolitical risks to contend with. Both have fallen by around 10% against the US dollar.

Cryptocurrency

- Cryptocurrencies have failed to live up to their 'digital gold' tag with Bitcoin falling almost 50% this year. This fall has been mirrored by the broader crypto market which has fallen as much as 60%.
- This fall in cryptocurrencies has been further exacerbated by the rolling back of central banks' loose monetary policy, which had helped to propel speculative assets, such as cryptocurrencies, to stratospheric levels.
- Cryptocurrency exchanges have also come under pressure with Coinbase joining other major exchanges in aggressively cutting their workforce, as trading activity has cooled.

Hedge Funds

- Hedge fund returns have remained relatively volatile across this six month period and returns have differentiated significantly across investment approaches.
- Hedge funds whose strategy focuses on the equity market have had one of their worst starts to a year, while macro strategies which aim to capitalise on movements in interest rates and currencies have performed considerably better.

Private Equity

- As has been seen in public markets, there has also been a pullback in listed private equity markets. Discounts (share prices relative to net asset value) have widened to levels almost comparable to other notable market shocks, such as the pandemic.
- Deals within private equity have also decreased – admittedly from a high level – as managers take a more conservative approach and financing costs increase.
- Key will be the valuation updates in the mid-year point to gauge whether the severity of the sell-off in listed PE has been justified by lower net asset valuations. Early indications suggest the selling may be overdone.

Outlook for the remainder of the year

Regular readers of our periodic updates will know that our key call at the beginning of the year was that of inflation being substantially higher and more entrenched than both markets and central banks were anticipating – and the effects of which were going to be a primary driver of markets. At the mid-year point, that has indeed been the case. However, the rate of increase and the extent of inflation around the world has surprised even us. Furthermore, we did not believe, at the beginning of the year, that elevated inflation would be recession inducing. At the mid-year point, the outlook is decidedly more uncertain; and we cannot, with any degree of accuracy, forecast the landing point for risk assets yet – and it doesn't feel like we are alone in this view.

Take analysts' expectations for the oil price at the end of the year for example:

Citigroup: $65 per barrel

JPMorgan: $380 per barrel

As for equities – we arrive at the mid-year point some 20% down for global equities in dollar terms. A significant portion of this is the excess (valuations) that was built into stocks post covid – notably in the high growth areas of the market – coming out. Valuations of stocks are now just about at their long-term averages. In a recessionary environment, we would expect this element of a stock's price to fall further. In the absence of a recession, we believe multiples (valuations) are now fair. So, then it comes to the earnings component of a stock's return – and that is where we believe the market is being a little too optimistic. There has been little in the way of downgrades of earnings for companies. In a recession, earnings fall on average by around 20%. At present, analysts are still forecasting high single digit growth over the next 12 months. We would say there is risk to the downside here.

So, our outlook for the remainder of the year is cautious. Now that inflation, in the short-term at least, appears to have peaked – helped by the fall in commodity prices in June and alongside a dip in market which implied future inflation expectations (also known as breakeven rate) – attention will likely turn to company earnings in July. A relatively solid earnings season, and not too pessimistic outlook from management, would do a lot to put a floor on the recent market sell-off. However, if earnings come in a bit weaker, and there is a notable deterioration in outlook statements, a further leg down for stocks could be on the horizon.

North Capital portfolio positioning

Our current cautious stance is reflected in our discretionary portfolio positioning. However, rather than reduce equity allocations further (after such a big fall), we have moved our risk exposure further into defensive equity styles of quality and low volatility. We have also reduced our exposure to smaller companies, which typically fare poorly in periods of economic slowdown or recession. Furthermore, we have increased our exposure to Japanese equities, at the expense of European stocks. A net benefit here is gaining more Japanese yen exposure, which is looking very cheap and historically a good haven exposure to hold. Should we get a bounce in equity markets over the summer, but no real change in the economic backdrop, it is possible that we would lighten our risk allocations below neutral – we will consider that when the time comes.

We are maintaining our overweight exposure to real assets – commodities, infrastructure, property and gold – as we do expect inflation to be persistently higher over the medium term, albeit come off its high in the short-term. These assets have historically acted as good inflation hedges over the medium term.

For portfolios that hold a portion of defensive assets, we have slowly been increasing our fixed income allocations back to neutral weighting, as yields have risen. Despite being at our maximum underweight at the beginning of the year, US treasuries (government bonds) hitting 3.5% and yield spreads widening on credit, was a catalyst for a move back to neutral.

Clearly, the short-term picture is unsettling for investors. And whilst we have a cautious tone to this note, it is often during the difficult periods, when the backdrop feels very uncertain and uncomfortable, that superior long-term returns emerge – rather than during times when all appears calm.

Finally, on inflation – we can look back to a few inflationary periods in the past 50 years, none more pronounced than the 1970s – holding a diversified blend of equities, bonds and real assets served investors well in providing inflation beating returns over the long-term. But it certainly wasn't smooth sailing year-on-year.

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