Equity markets sold off aggressively in January as intraday volatility in bond and equity markets spiked. Investors were forced to rapidly alter their interest rate expectations on the back of sustained higher inflation and more hawkish messaging from the US Federal Reserve that it is likely to adjust monetary policy more quickly than markets had priced. A significant rotation occurred from growth to value.

Policy Watch: Central banks have now largely acknowledged that some components of inflation are likely to be more persistent and have signalled that monetary policy is too stimulatory for the current climate and needs to move to a more 'appropriate stance'. The ECB is still clinging to the view that higher prices are more transitory and is resisting the urge to unwind stimulus. The RBA continues to flag 2023 as the likely time for a lift off in interest rates, despite higher inflation.

Vaccine Update: The Omicron variant has played havoc with communities over the past two months, with the supply of labour and goods being heavily impacted. Anecdotal evidence is suggesting that the current vaccines are quite effective against this new strain – and hospitalisation rates have remained relatively low. Governments are increasingly pivoting to the view that lockdowns are a thing of the past and we are moving into the phase of living with Covid. We believe that a pivot to a wider use of Rapid Antigen Tests and shorter periods of self-isolation will be the norm for 2022.

Inflation Watch: Inflation data points across the globe are setting multi decade records. Goods inflation is being heavily impacted by supply chain disruption – mainly caused by manufacturing and distribution hubs being forced to close or operate on limited workforces due to Covid related staff shortages. Services inflation is also high as many workers have 'voluntarily' removed themselves from the workforce – due to having covid, caring for someone with covid, or being fearful of catching covid. Goods inflation is expected to moderate as these industries tend to be populated by younger people while there is some concern that elevated services inflation may persist as participation in the work force among older workers may be permanently lower. Income inequality has increased during Covid, and we are starting to see a more organised effort for workers to regain some lost purchasing power through real wage rises.

Risk Budget: The severity of the market fall in January caught many off guard. Allocations to non-correlated and liquid alternatives helped smooth out this volatility. Interestingly the bond yield curve has been relatively stable and suggests that markets think the terminal cash rate is likely to be much lower than previous cycles. If US 10 Year bond yields stabilise around or a little below 2 per cent, equity valuations can recover quickly.

Call to Action: We have maintained our more neutral stance on risk for the time being but have taken some smaller decisions to pivot our underlying positions to reflect a slightly different factor exposure stance. We think the strong value outperformance over the past few weeks will dissipate and momentum and growth will outperform. We expect to see Quality recover from the recent sell-off quickly. With a solid backdrop of strong economic growth, margin expansion, easing supply chain and inflationary pressures we remain constructive on risk assets.

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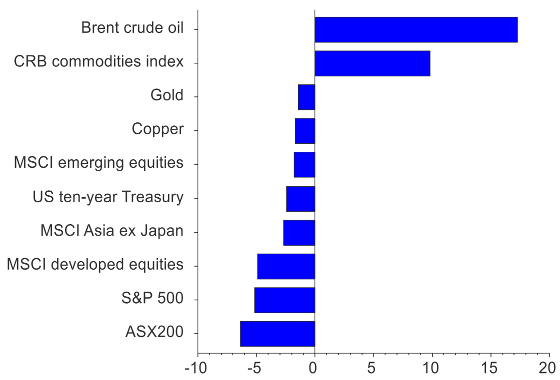
January Review

Volatility spiked in January with markets increasingly concerned about how the US Federal Reserve may respond to higher and more persistent inflation data. While markets rallied strongly at the end of the month the S&P500 ended January 5.2% lower, the index's worst month since March 2020 (-12.5%). Technology shares were hit particularly hard with the Nasdaq Composite down 8.9% for the month. The S&P 500 is 6.3% from its all-time high. The Nasdaq Composite sits 12% from its all-time high, firmly in correction territory.

Chart 1: January Asset Class Performance
Percentage Change (total return in local currency)

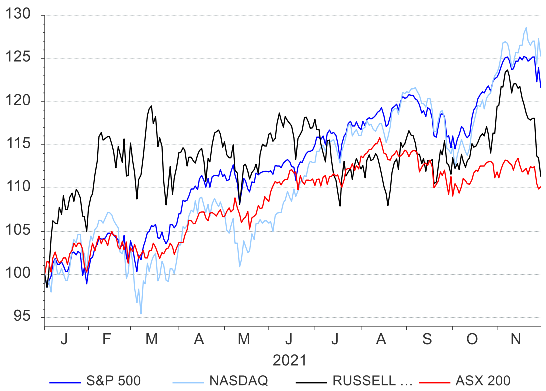


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The ASX 200 also suffered its worst monthly decline since March 2020, losing 6.35%. Emerging Markets outperformed developed markets while Oil and Commodities were standout performers. The oil price rise is likely being driven by optimism around the Omicron variant subsiding in many countries very soon and following the trend already evident in the likes of the UK and South Africa. Geo-political concerns are also having an input on energy pricing more broadly.

The US Consumer Discretionary Sector (-13%) was the worst performing sector in January, while loses in Real Estate (-9.6%) and Technology (9.3%) were also heavy. Energy stocks roared higher (18.9%) on the back of a rising oil price and positive US economic data. The rotation away from small to large continued with the Russell 2000 (-9.66%) underperforming other major US indices. European markets fared better with the Stoxx 50 down just 1.8%, benefitting from the shift to large caps and value stocks (away from growth).

Chart 2: US and Australian Equity Markets YTD Relative Performance (100 = 1 Jan 2021)

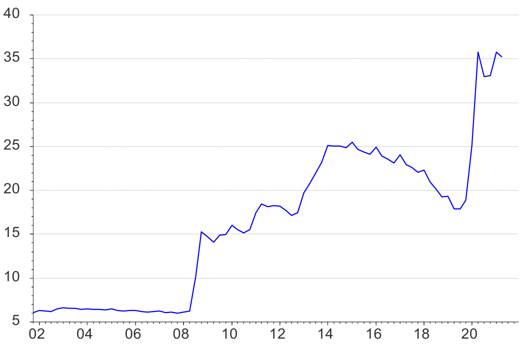


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

January's pullback has left the ASX200 almost unchanged in 2 years. The heavily concentrated IT sector lost 18.4% and healthcare fell 12.1%. Resources (2.9%) and Energy (7.8%) followed global peers higher on the back of strong commodity and energy price rises.

Markets were firmly focused on how quickly and aggressively central banks, in particular the US Federal Reserve, would need to tighten monetary policy in the face of persistently high inflation data. The release of the Federal Open Market Committee (FOMC) Meeting Minutes in early January revealed that "run off" of the Fed's balance sheet is likely to happen soon after or at the same time as the first interest rate hike. Previously, the market had expected that the Fed would halt its bond purchasing, then subsequently begin raising interest before running down the balance sheet later. The RBA has delayed a decision on run off until is May board meeting.

Chart 3: Federal Reserve Balance Sheet



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

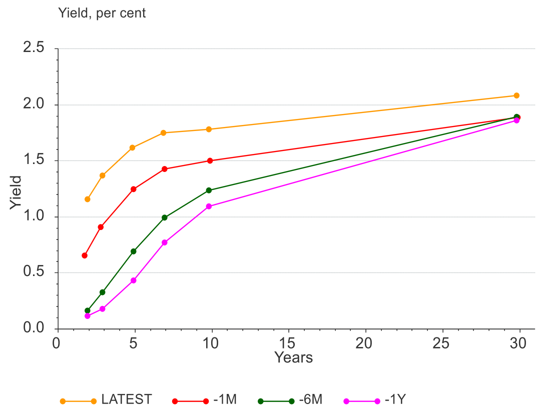
It was this event, early in January that provided the first catalyst for the increase in equity and bond market volatility that set the tone for markets for the remainder of the month. Bond yields headed higher, particularly at the short end of the US curve as a larger number of interest rate increases for 2022 was progressively priced in.

Chart 4: US and AU 10 Yr Bond Yields

Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The FOMC met later in January, and while rates remained on hold, Fed Chair Powell's statement and responses in his press conference following the meeting were interpreted as hawkish. He noted that "there's quite a bit of room to raise interest rates without threatening the labour market". That comment was taken in the same light as his 2018 words of being a long a way from neutral and suggests the Fed thinks it can raise rates substantially. He hinted that asset prices are "moderately elevated" suggesting that the Fed is not concerned with equity market volatility. And finally, while he did not answer directly, he left the door open for rate hikes larger than the traditional 25bps – this was interpreted as 50bp being a possibility in March.

Chart 5: US Bond Curve Flattens

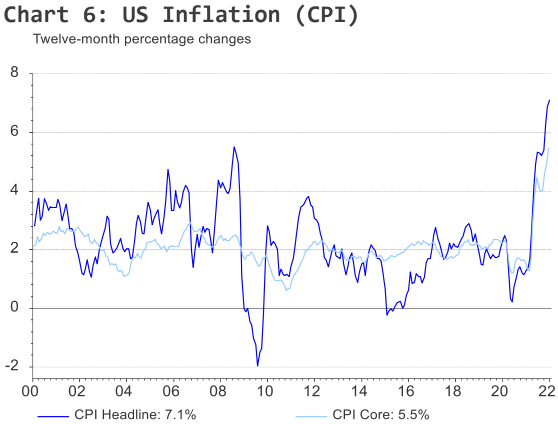


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Throughout January short tenor bond yields rose faster than longer dated bonds, pushing the US yield curve to flatten further. Suggesting that the bond market doesn't see the terminal cash rate (longer run cash rate) reaching any higher than about 2%, despite the aggressive tone from the Fed Chair.

Inflation continues to be closely watched and feeds into the narrative around rising interest rates. The annualised rate of headline US inflation hit its highest rate since 1982 at 7%. While the December rise in the headline CPI was still substantial, it marked a continuation of the slowdown in monthly price changes from the October and November readings.

Chart 6: US Inflation (CPI)

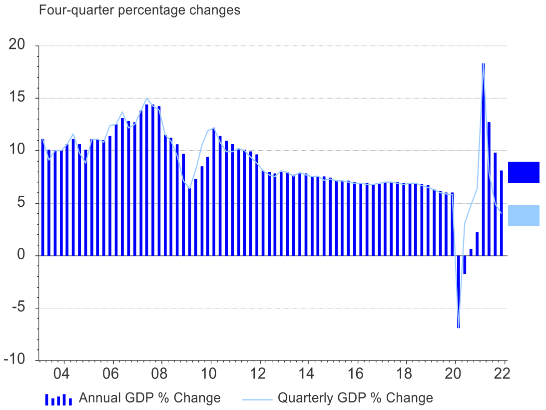


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

UK headline inflation hit its highest level since the early-1990s, at 5.4% p.a, while core inflation picked up to 4.2%. In Canada, headline inflation hit a 30-year high of 4.8%, matching expectations. Both central banks are expected to lift interest rates in the near future. In Europe however, the European

Central Bank continues to push back on inflation, believing it is transitory and will moderate soon.

Chart 7: China GDP



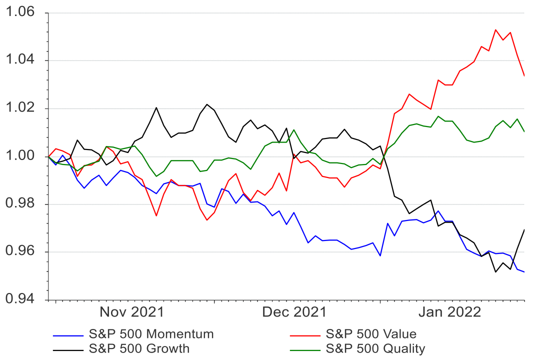
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Chinese data continues to be mixed and the outlook uncertain. GDP surprised to the upside with quarterly growth of 1.6% q/q against 1.2% expected. That takes 2021 full year growth to 8.1%. However, retail sales for December missed expectations, growing by 1.7% y/y in December from a year ago against 3.8% expected – this number typically recorded 8%+ pre-covid. China's zero-COVID policy appears to be dragging on the economy and adding to woes in the property sector.

On the back of this weakness the People's Bank of China cut interest rates during January, the PBOC's Deputy Governor confirmed that they are now in an easing cycle. There though was limited market reaction to the rate cuts or to the Chinese data. China's zero-COVID policy continues to be tested ahead of the Olympics and Lunar New Year.

There was a substantial rotation out of Growth into Value through January. In times where inflation is more prevalent investors prefer companies with strong cash flows and profits now, with strong balance sheets, rather than growth companies with long dated future earnings.

Chart 8: S&P500 Equity Factor Relative Performance (3 months)

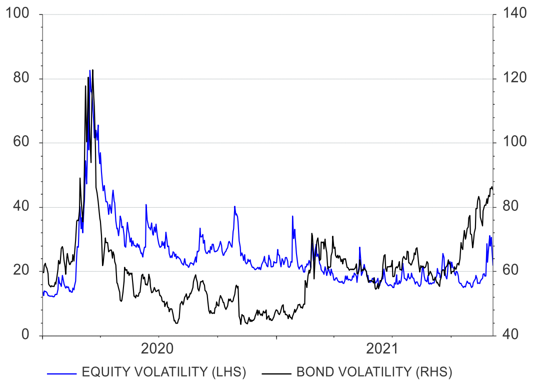


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Risk

Equity volatility spiked dramatically during January with large intra-day swings in equity markets driving the VIX to its highest level in over a year.

Chart 9: US equity & bond Volatility (MOVE)



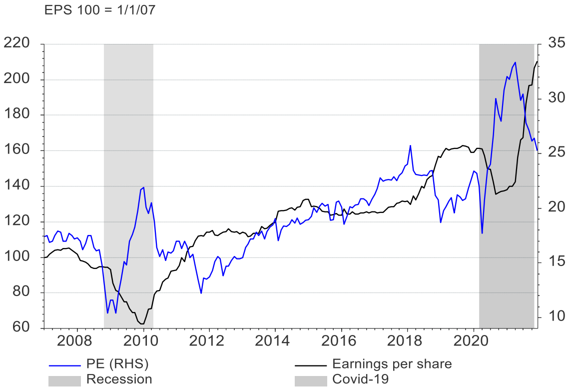
Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Outlook

Underlying economic data in the developed world remains solid and bodes well for developed market equities. US GDP accelerated at a 6.9% annualized pace in the fourth quarter, well ahead of the 5.5% estimate. Consumer activity and business spending led the gains, which propelled the U.S. economy to its strongest full year since 1984. In Australia unemployment rate fell to 4.2% for December, its lowest since August 2008. Should it continue to decline, it will be at levels not seen since the 1970s.

Despite increasing costs, companies have been able to defend and expand profit margins. We expect profit margins can rise further in 2022. Over the past month, in the background US companies have been providing 4th Quarter earnings updates, at the time of writing, of the 172 companies in the S&P 500 that have reported earnings to date, 78.5% topped analysts' estimates, according to Refinitiv.

Chart 10: S&P500 EPS, P/E

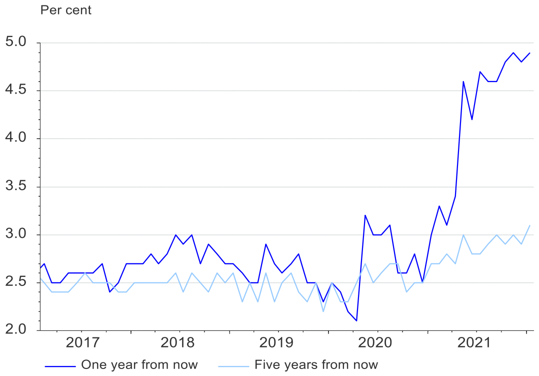


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Earnings remain solid and we believe are likely to support equity markets, the key, in our view, is whether increasing interest rates continue to put pressure on valuations, as they have in January.

We believe that supply chain disruptions are likely to ease as global shipping and manufacturing return to more normal patterns, especially if China moves away from its Covid zero approach post the Winter Olympics in February. However, the current disruptions and tight labour markets have the potential to maintain inflation at elevated levels for longer than first thought. As both inflation and wage data come in, we believe bond and equity markets are likely to remain volatile as investors second guess what more data dependent central banks may do.

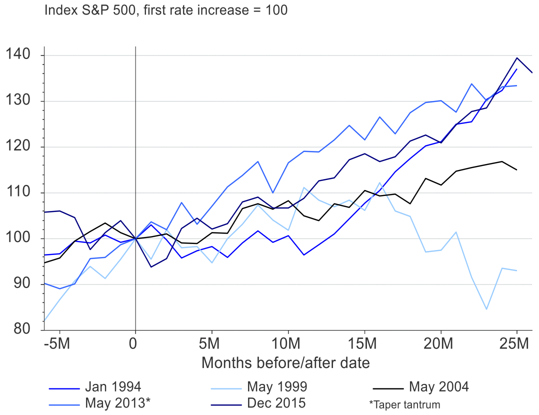
Chart 11: US, Uni of Michigan Inflation Expectations



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Equity markets have endured hiking cycles before and have risen following short-term sell offs. History suggests that it is further into hiking series as the economic cycle cools in response to higher rates, when equities start to struggle. We believe that underlying fundamentals are still very solid, and the Federal Reserve feel comfortable to start normalising monetary policy because of this economic strength. However, we do expect that gains this year may be more modest than previous years.

Chart 12: S&P500 and Hiking Cycles



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Geopolitical concerns remain front of mind, with the tension on the Russia/Ukraine border being a particular focus. The build-up of Russian forces at the border has led to NATO putting military forces on standby. As a result, gas prices in Europe were again on the rise in January, albeit lower than their 2021

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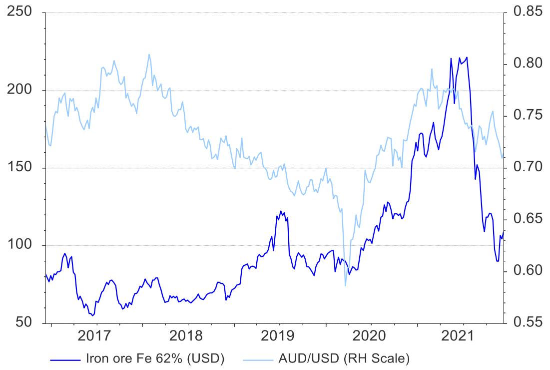
peaks. Additionally, recent reports of an incursion by 39 Chinese military planes into Taiwan airspace reminded markets that Eastern Asia remains a potential flash point.

With a solid backdrop of strong economic growth, margin expansion, easing supply chain and inflationary pressures we remain constructive on risk assets for the remainder of the year. We believe that offshore developed market equities will produce greater earnings growth than Australian equities and continue to position our portfolios accordingly. Alternative and non-correlated assets will continue to be critical tool to smooth out volatility.

In our opinion, bond yields need to rise further before Fixed Income becomes more attractive versus other asset classes.

Chart 13: AUD & Iron Ore Price



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The Australian Dollar briefly traded below 70 cents at the end of January. Despite rising commodity prices, the AUD is likely to remain under some pressure given the RBA appears reluctant to adjust interest rates in the short term.

James Wright and Luke Hansen
Sayers Capital Solutions Group

2 February 2022

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