GLOBAL EQUITY PERSPECTIVES 20 JUNE 2022

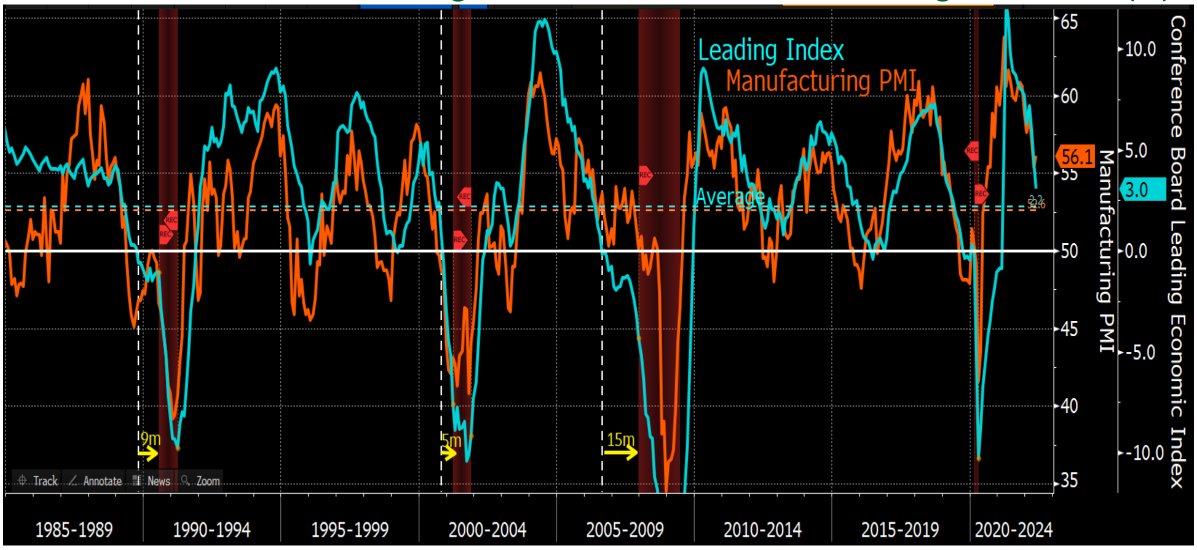
"We are made strong by what we overcome."

John Burroughs

1. US ECONOMIC OUTLOOK

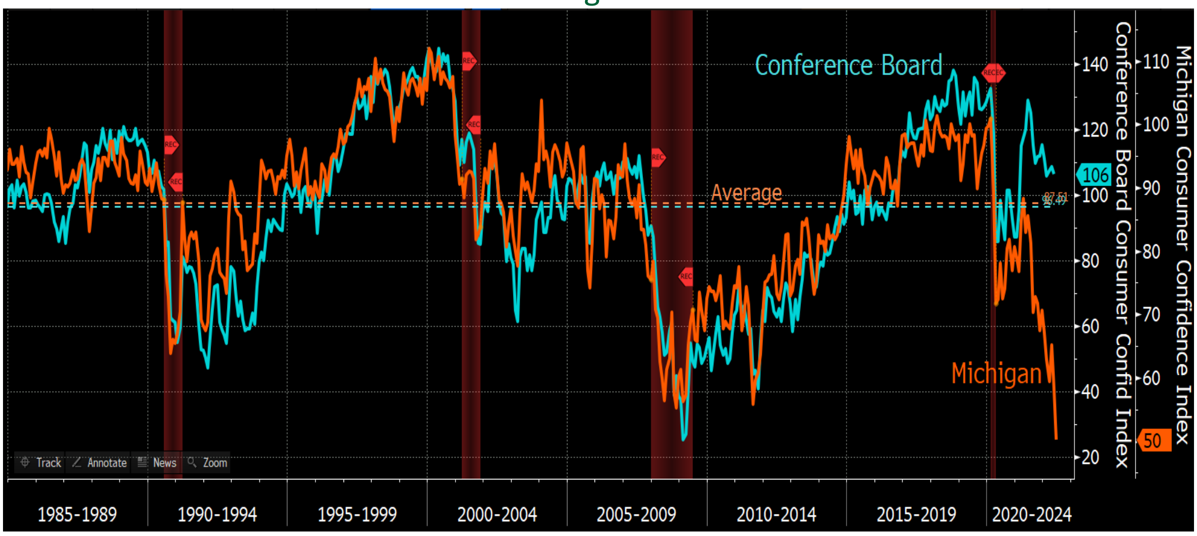
Many investors fear an imminent US recession, mainly because of the more aggressive stance the Federal Reserve has decided to take to cool inflation. The following charts provide some perspective in this context:

US – Conference Board Leading Economic Index vs Manufacturing PMI* Index (%)



Whilst both the above important leading indices (with very recent readings) are in a negative trend, their current readings still are above their respective averages. On this basis, it is too early to imply an imminent recession.

US – Conference Board vs Michigan Consumer Confidence Indices



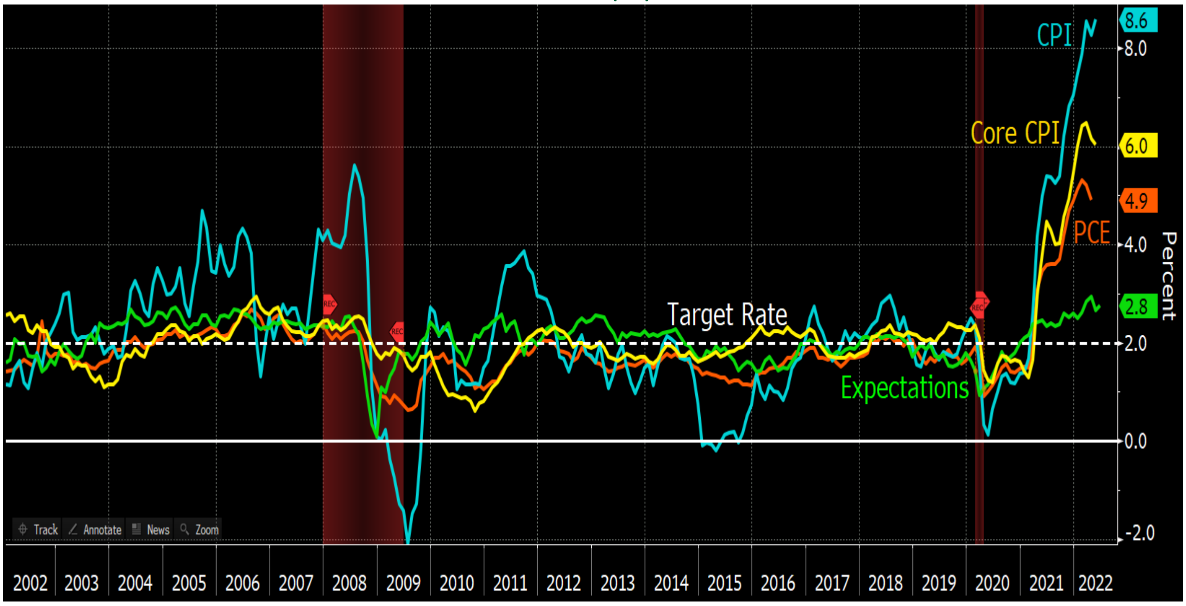
Consumer confidence, logically, is critical for the US economy. The difference between the current levels of the Conference Board and University of Michigan Confidence Indices is striking. The former is more strategic, and the latter more tactical in nature. This implies that the current high gasoline, food and inflation levels are foremost in consumer minds.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. June 2022. ***Past performance is not a guide to future performance. Future performance indicators are not a reliable indicator of future returns.*** ** Purchasing Manufacturers Index.*

2. US INFLATION

The US CPI inflation level of 8.6% for May 2022 was its highest since December 1981. This unsettled capital markets materially.

US – Consumer Price (CPI) and Personal Consumption Expenditure (PCE) Inflation Levels (%)



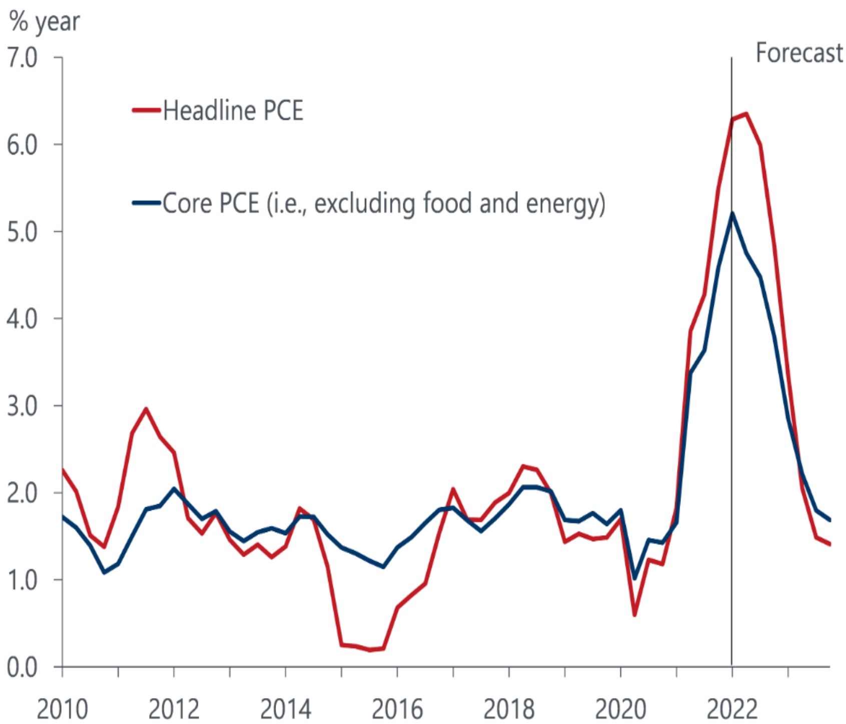
The Core CPI level of 6.0% is 2.6% lower than the Headline CPI level, reflecting the huge effect of rising Energy and Food prices. Importantly, the Core readings have dropped for two months in a row, reflecting the improving supply chain bottleneck issues. Along with this, the PCE readings have now also dropped for a second month in a row. The Fed usually focusses mainly on PCE to determine the course of their tightening pathway, but has for the moment taken the stance to lower the Oil price through economic means (we have since already seen the effect on Oil). Further to this, Inflation Expectations (the green line in the above chart) remain relatively muted and do not reflect views of huge structural changes.

US – Personal Consumption Expenditure Index Growth (%) *

** Source: Oxford Economics June 2022*

This chart reflects the views of the above economic experts. They believe PCE is probably at peak, and can continue to drop, returning to normal levels in around eighteen months.

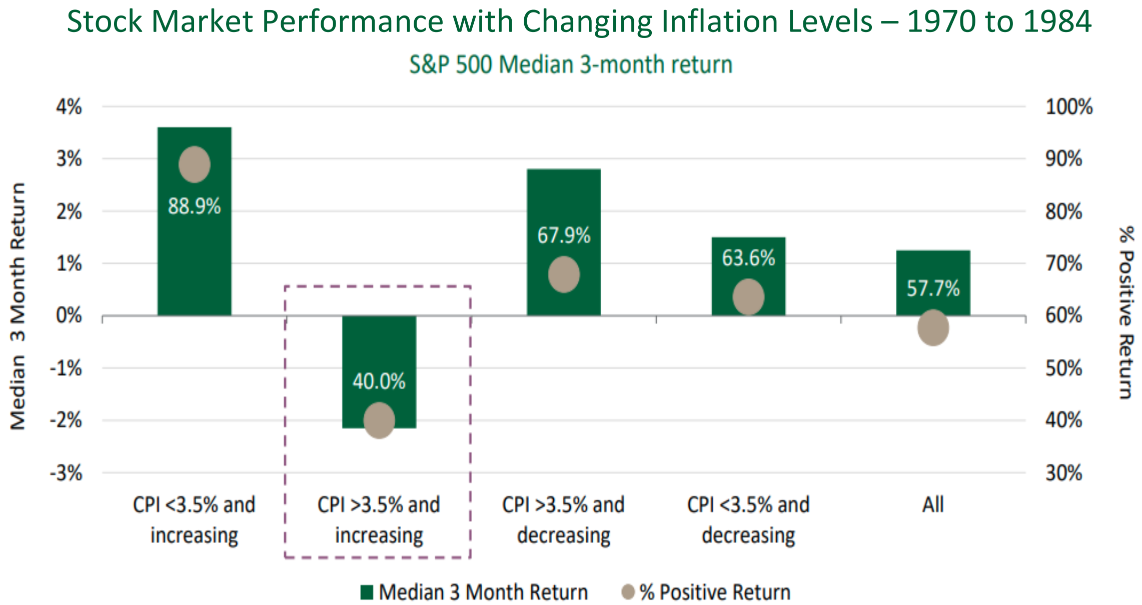
The wild card in this context is clearly the Ukraine war, affecting both the prices of Energy and Food. President Putin holds the answer to when Headline CPI inflation levels can also return to more normal levels.



Source: Bloomberg & Stonehage Fleming Investment Management Limited. June 2022. ***Past performance is not a guide to future performance. Future performance indicators are not a reliable indicator of future***

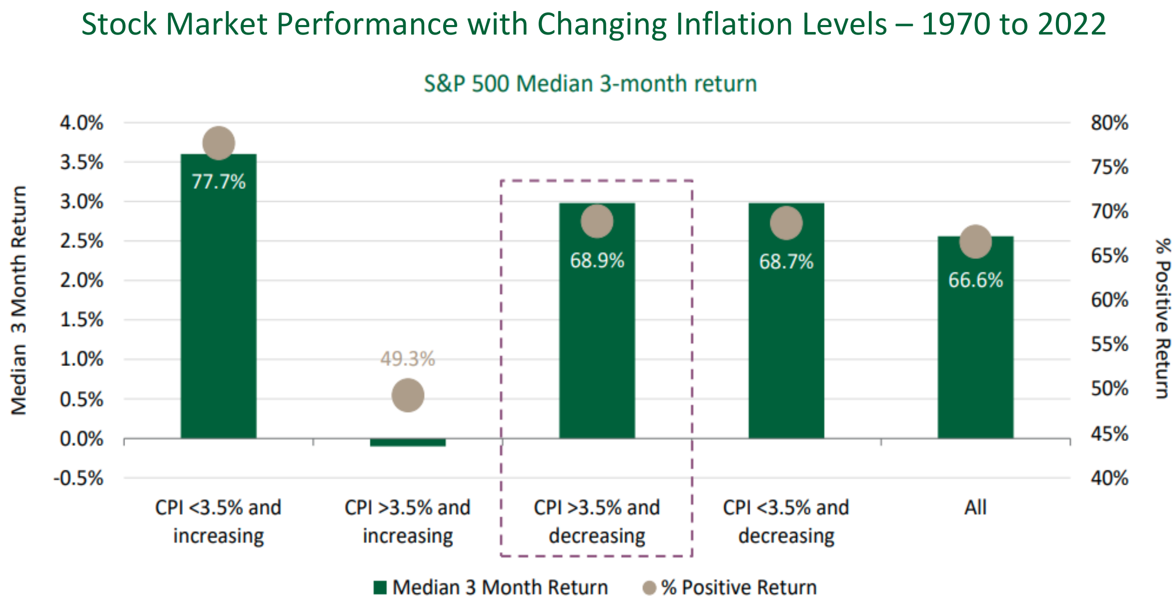
3. INFLATION EFFECT ON SHARE PRICES

The pivotal inflation level for affecting share prices is around 3.5% - beyond that level, the market takes a negative view on its economic effects. With the current uncertain inflation outlook because of Energy prices, the Oil shock of 1973 comes to many investor minds. Inflation then remained elevated for 14 years, going as high as 14% and averaging 7.6% over the period.



The above bars reflect stock market performances during the directional inflation level changes around the 3.5% level, whether increasing or decreasing. The overall return over the high inflation period was very pedestrian (far right bar), with a relatively low probability for positive returns (the brown dots). The best scenario was with inflation increasing, but staying below the 3.5% level (far left bar). The worst scenario was with inflation above the 3.5% level and continuing increasing. It delivered a negative return with a low probability of positive returns. This is, in essence, the scenario we are currently experiencing. The second-best scenario was with inflation still above 3.5%, but decreasing (the third bar). It delivered a +10% annual return, better than a normal long-term level of stock market return.

The following chart considers the same information, but over all of the past fifty years:



Source: BCA Research & Stonehage Fleming Investment Management Limited. May 2022. ***Past performance is not a guide to future performance.***

Our focus now moves to the third bar, with inflation still above 3.5% but in a decreasing trend. This scenario provided a strong outcome of +12% annual return and over a two-thirds probability of a positive return. Interestingly, this outcome continued also as inflation dropped below the pivotal 3.5% level and continued decreasing (fourth bar).

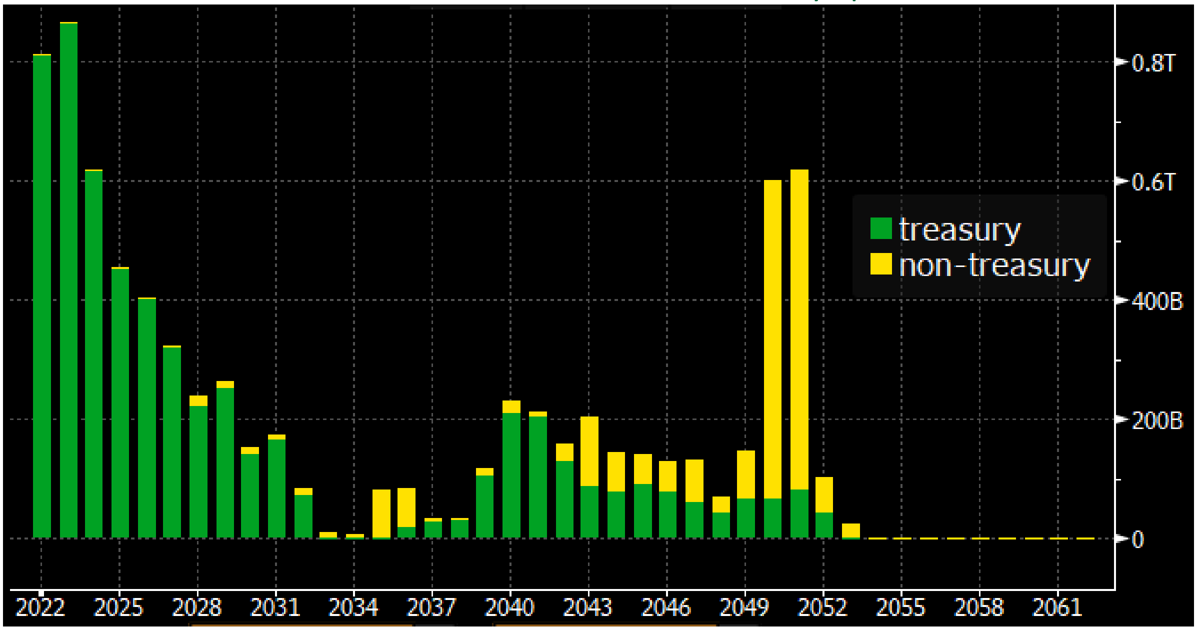
Based on the above, long-only investors look forward to a confirmed peak in US inflation levels.

4. QUANTITATIVE TIGHTENING (QT)

The runoff of the Fed's balance sheet starts this month. Many investors fear the reverse of the Quantitative Easing process that may drain liquidity in the capital markets with a potential dampening effect on investor sentiment causing higher interest rates and lower equity ratings.

The Fed indicated that they would like to halve their book from ~40% of GDP to ~20% of GDP. This implies a huge potential ~$4.5tn of debt potentially offered in the market.

Federal Reserve Balance Sheet Maturity Spread



The Fed indicated that they may be slow in reinvesting the coupon they receive, marginally diluting the overall potential QT effect. Furthermore, the maturity spread of the Fed's balance sheet provides some indication of how QT may be implemented. Over $800bn of debt matures both this year and in 2023. By doing nothing, the Fed can already achieve 17% of their QT target this year and 18% in 2023 (apart from the respective coupon effects).

The Fed has already indicated that they may not sell securities initially. They also indicated that they will monitor the QT effects and moderate the process if necessary, and also that QT can replace some rate hikes. It seemingly can be a tool for attempting to engineer a soft landing.

Because of the above, we conclude that QT may possibly not disrupt capital markets initially, especially seeing the short nature of their book. Nevertheless, until the process is completed, we believe QT will dampen a material potential rerating of the stock market. On this basis, shareholders will have to rely more on strong organic growth and dividend income or share buybacks. This brings us back to quality growing businesses with strong balance sheets that sustainably generate strong free cash flow and are attractively valued.

5. BEAR MARKET RETURNS

The S&P 500 Index last week entered a new bear market of -20% since its recent peak level, unsettling many investors. This last happened with the Pandemic, and before that with the Financial Crisis (middle chart below). Its RSI Overbought/Oversold Index dropped close to its 30 Oversold reading (the bottom chart).

S&P 500 – Index vs Maximum Drawdown and RSI* Overbought/Oversold Index

The following table summarizes returns following the crossing of the -20% threshold:

S&P 500 Performance Following Entering a Bear Market (%)

	S&P 500 Index Returns		
Date Bear Market Starts	3 Months	6 Months	12 Months
21 October 1957	5.2%	9.3	31.0
28 May 1962	7.3%	11.2	26.1
29 August 1966	7.9%	17.6	24.6
29 January 1970	-4.9%	-8.9	10.7
27 November 1973	0.7%	-9.2	-28.1
22 February 1982	3.0%	1.3	32.1
19 October 1987	10.9%	14.7	22.9
12 March 2001	6.3%	-7.4	-1.2
9 July 2008	-20.0%	-27.2	-29.1
12 March 2020	21.0%	34.6	59.0
Average	3.8%	3.6	14.8
Median	5.8%	5.3	23.8

The level to which the market drops further following the entering of a bear market is dependent on the depth of the economic recession at the time. Nevertheless, the above table shows a nearly +15% return a year after the event. Both the exceptions (1973 and 2008) were around material economic disruptions and financial imbalances - the Oil shock and 14-year high inflation era and the Financial Crisis.

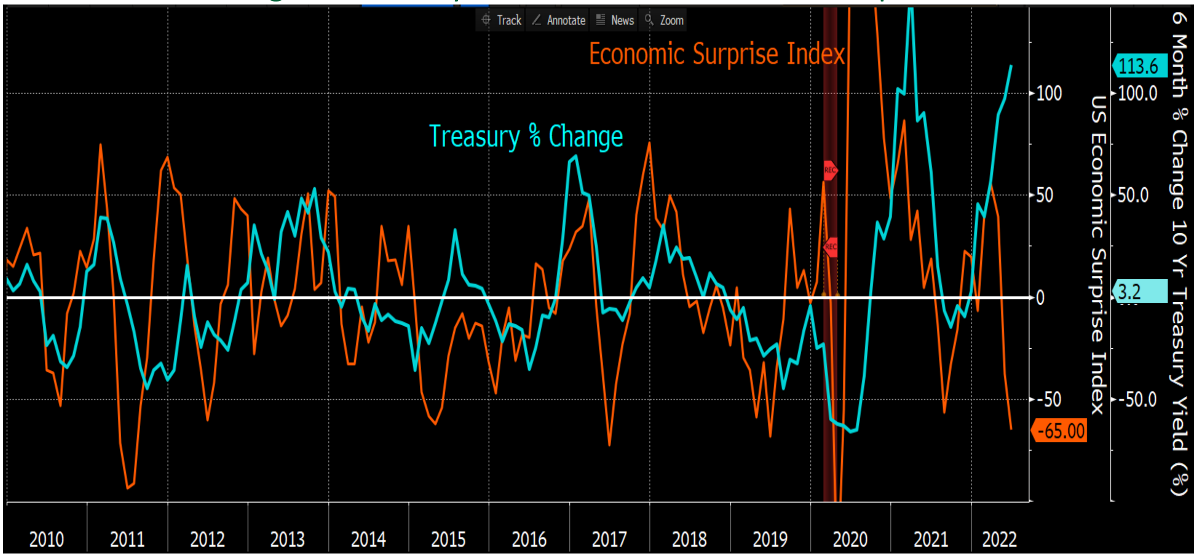
There are no material economic imbalances currently. The war remains the wild card on the duration of high inflation.

Source: Bloomberg & Stonehage Fleming Investment Management Limited. June 2022. ***Past performance is not a guide to future performance.***
** Relative Strength Indicator*

6. INTEREST RATES

The US 10-year Treasury Yield is already at a ten-year high. Logically, that it is rather because of inflationary risks than fundamental economic circumstances as the following charts confirm:

% Change in Treasury Yield vs Citi US Economic Surprise Index



Whilst the two series in the above chart historically correlated, they are currently at opposite extremes. We doubt the Economic Surprise Index will turn the corner anytime soon, possibly causing an even wider gap between the two series.

Copper/Gold Price Ratio vs Treasury Yield (%)

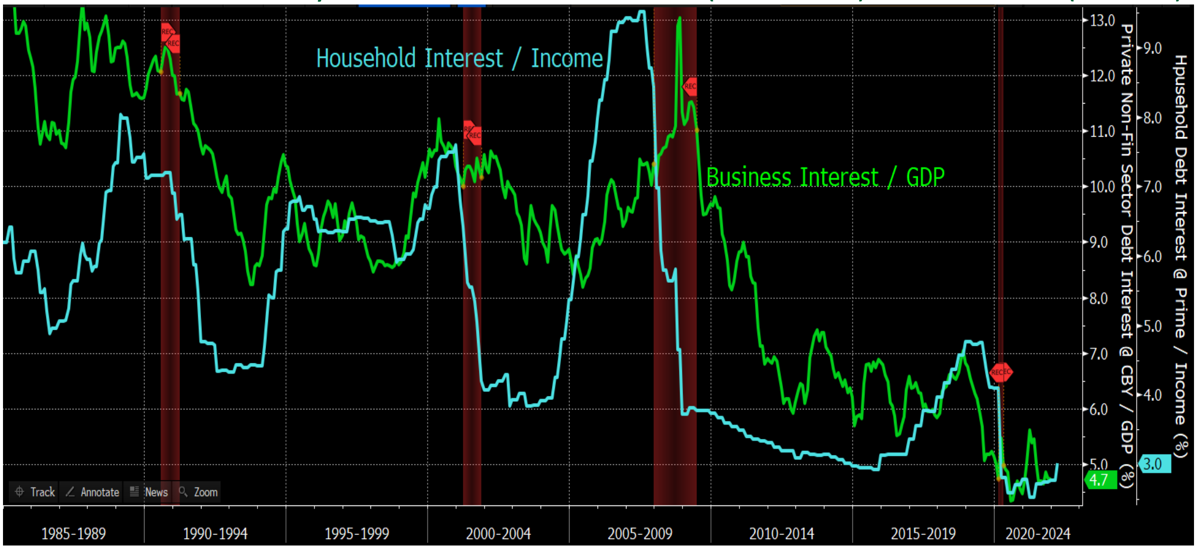
The Copper/Gold ratio has been flat for over a year, and currently seems to be rolling over. The Treasury Yield historically had a strong correlation with this ratio, but is currently following an opposite pathway.

On these fundamental bases, longer duration interest rates are currently too high. We realize the Fed will have to continue an aggressive tightening process to bring inflation under control. This has already lead to the yield curve to flatten, and chances are clearly growing for it to invert, indicating more difficult economic circumstances and slower company profits on their way.

Whilst this suggests an unexciting business outlook, we fortunately do not have major concerns about the direct interest rate effects on business and household income statements:

Source: Bloomberg & Stonehage Fleming Investment Management Limited. June 2022. ***Past performance is not a guide to future performance.***

Estimated Interest Payment Ratios – Households (vs Income) and Business (vs GDP)



Both the above interest payment ratios are currently close to historic lows, less than half their respective levels prior to the Financial Crisis. This may even be too conservative, seeing many personal mortgages and especially large portions of business debt have been fixed at rates much lower than current ones (we have merely used current interest rates in our calculations). It is rather the institutions that have provided the cheap finance at fixed rates that may suffer from the higher rates.

7. TECHNICAL PICTURE

S&P 500 vs 200-Week Moving Average and % of Stocks Trading above their 200-Day Moving Average

The S&P 500 is less than 4% away from potentially breaking its 200-week strong support level should we face an imminent US recession. Nevertheless, for strategically minded investors, the lower part of the above chart technically shows an oversold current situation.

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Source: Bloomberg & Stonehage Fleming Investment Management Limited. June 2022. ***Past performance is not a guide to future performance.***

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