

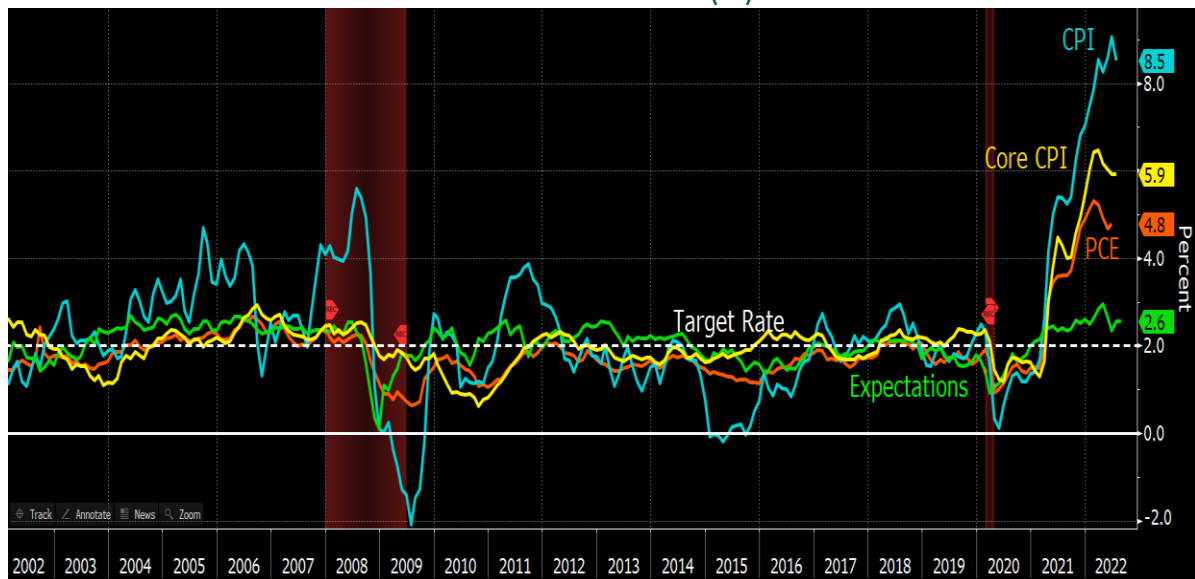
*"If you have to ask what Jazz is, you'll never know."*

Louis Armstrong

## 1. FIRST 'SWALLOW OF THE SUMMER'

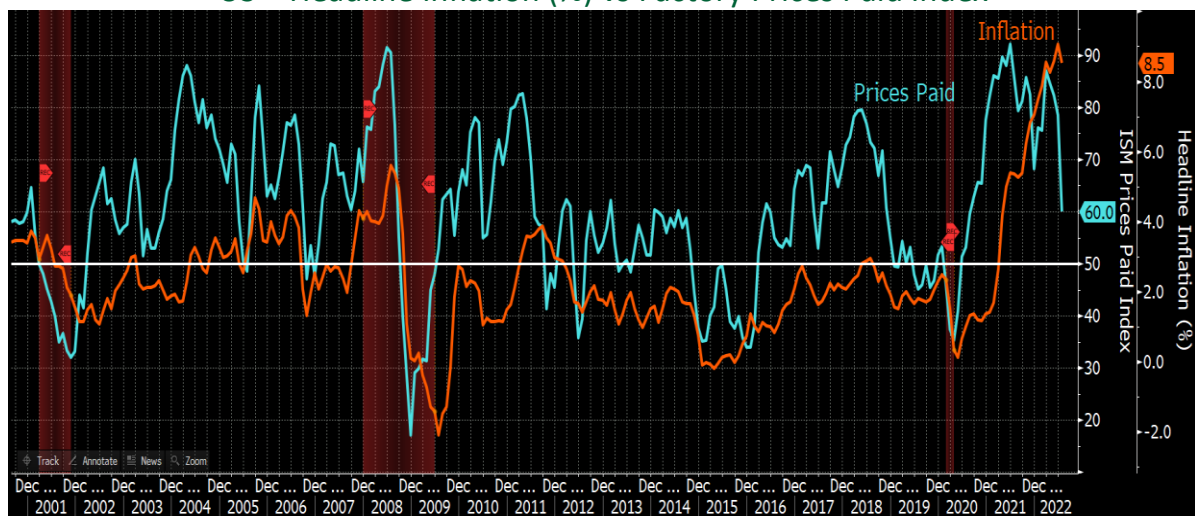
With huge relief to the capital markets, US headline inflation registered a 0.6% drop on 10 August:

US – Inflation YoY (%)



Core inflation has been in a negative trend for four months already, but the cost of energy specifically, and to a lesser extent food, have been boosting headline inflation to the recent peak level of 9.1%. Capital markets reacted enthusiastically on the news. It currently seems that inflation expectations have already peaked along with core inflation, with the former currently not far from the Federal Reserve (Fed)'s 2% target rate.

US – Headline Inflation (%) vs Factory Prices Paid Index



The Pandemic-induced inflation effects are now in a firm process of reversing and reducing inflation. This is well reflected in the Prices Paid Index in the chart above. Apart from Energy, Rent of Shelter seems to remain the main risk factor in this context.

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

## 2. MACRO RISK FACTORS

The stock market has had to deal with enormous macro risks this year. This has had a clear effect on share prices:

S&P 500 Price Index (since Jan 2021)



The S&P 500 Index peaked on the first trading day of the year. It then took a -10% adjustment in January alone and had lost -24% for the year by 16 June.

As we all know by now, a sequence of macro risk factors quickly evolved over the first half of the year, starting with the Pandemic-inflicted supply chain complications and its severe effects on inflation. This was followed by the Fed having to start raising its target rate from extremely low levels, which was followed by Russia's invasion of Ukraine, and then by China implementing a zero-COVID policy and placing many cities in renewed lockdowns, etc, etc. All-in-all, investors have had to contend with a sequence of seven major risk factors in the first half of the year, with geopolitical uncertainties around Taiwan becoming an eighth factor more recently. This potent combination of such material risk factors is the most severe investors have had to deal with in probably all of their careers.

We have tried to quantify how investor perceptions around this combination of risk factors may have evolved since the last quarter of last year. It is presented in the following table:

| Investor Perceptions of Macro Risk Factors |                                   |        |            |      |      |      |             |      |      |      |
|--|-----------------------------------|--------|------------|------|------|------|-------------|------|------|------|
| Risk #                                     | Risk Factor                       | Weight | Risk Level |      |      |      | Risk Impact |      |      |      |
|  |                                   |        | 4Q21       | 1Q22 | 2Q22 | 3Q22 | 4Q21        | 1Q22 | 2Q22 | 3Q22 |
| 1  | Supply Chain Effects on Inflation | 20.0%  | 6          | 8    | 10   | 3    | 1.2         | 1.6  | 2.0  | 0.6  |
| 2  | Fed Tightening                    | 10.0%  | 3          | 10   | 7    | 4    | 0.3         | 1.0  | 0.7  | 0.4  |
| 3  | Ukraine War                       | 15.0%  | 1          | 10   | 6    | 4    | 0.2         | 1.5  | 0.9  | 0.6  |
| 4  | China Lockdown                    | 7.5%   | 2          | 4    | 10   | 5    | 0.2         | 0.3  | 0.8  | 0.4  |
| 5  | Quantitative Tightening           | 10.0%  | 2          | 8    | 10   | 6    | 0.2         | 0.8  | 1.0  | 0.6  |
| 6  | Dollar Strength                   | 12.5%  | 3          | 5    | 10   | 7    | 0.4         | 0.6  | 1.3  | 0.9  |
| 7  | US Recession Fears                | 15.0%  | 2          | 4    | 9    | 6    | 0.3         | 0.6  | 1.4  | 0.9  |
| 8  | Taiwan Risks                      | 10.0%  | 1          | 2    | 4    | 4    | 0.1         | 0.2  | 0.4  | 0.4  |
|  |                                   | 100.0% | 20         | 51   | 66   | 39   | 2.8         | 6.6  | 8.4  | 4.8  |
|  | QoQ Perception Change             |        |            | 155% | 29%  | -41% |             | 139% | 26%  | -43% |

Source: Stonehage Fleming Investment Management Ltd. August 2022.

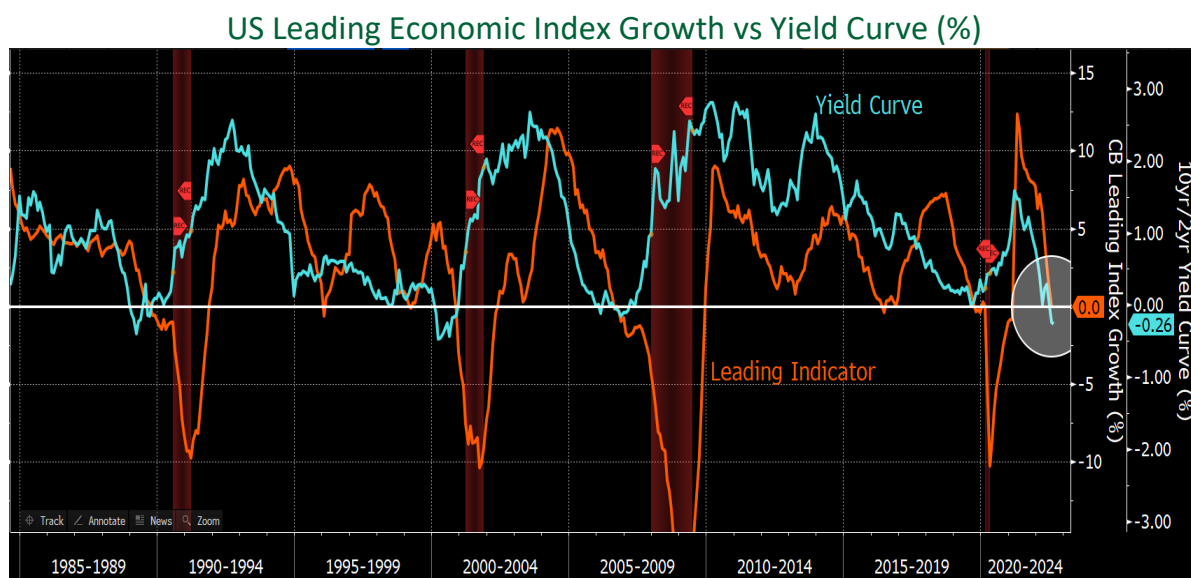
We have subjectively allocated weights (the blue column) and perceived risk levels (on investor perceptions, the orange columns, on a scale of one to ten) to the respective factors over each of the past four quarters. We then calculated the overall negative impacts on investor perceptions (the green columns). Finally, we calculated the percentage changes in these numbers over the successive quarters (the bottom line).



Considering this model, there clearly was good reason for the bad stock market performance in the first half of the year. Whilst the current reading (4.8 points) is still much worse than the reading in the last quarter of last year (2.8), it is materially (-43%) better than the second quarter of this year, and it seems that the combination of the macro risk levels is stabilizing. In this context, the improving stock market performance in July makes sense. As usual with investing, the trend in readings is more important than the absolute level of the reading.

### 3. US RECESSION

While the Fed seems relatively confident around the US economy, a potential US recession is one of the major risk factors in our preceding assessment. The following chart shows two important indicators in this context:



Both the Leading Economic Index and the Yield Curve currently give warning signals of an upcoming US recession. In our view, it would be ignorant not to take thorough cognizance of these signals.

That said, we believe there are not material imbalances in the US economy and that a ‘soft landing’ is a high probability. We believe share prices already reflect a bleak economic outlook and therefore do not fear a recession too much.

### S&P 500 Growth / Value Ratio



The above chart reflects the S&P Growth / Value ratio. Growth has outperformed Value at a ratio of 2.1:1 over the past 26-year period. Along with that, and relevant to our discussion above, it has outperformed materially in each of the past three recessions. We have little reason to argue otherwise for the next recession.



## 4. FINANCIAL RISKS

Many investors are concerned about the potential liquidity constraints that may follow from the Fed reducing its balance sheet and restricting money growth to contain inflation:

Fed Total Assets (\$m) and M2 Money Growth (%)



We have explained in a previous note that, because of the relatively short duration of the Fed's book, over a quarter of its intended asset reduction can be achieved by the end of next year simply from bonds maturing. We do not foresee the need for aggressive placings in the market for quite a while. In terms of money growth, M2 is already at its historic average level. We can expect some further restrictions, but with core inflation seemingly in a negative trend, it seems it can be done in a disciplined manner and not unsettle capital markets too much.

Merrill Lynch Global Financial Stress Index vs MSCI World Index



The above Global Financial Stress Index reflects cross market risk measures, hedging demand and investor flows. Its chart is presented on an inverse scale to illustrate its (negative) correlation with share prices. Its reading was in excess of one standard deviation recently, but is currently in process of receding. As reflected in the chart, such a trend has historically supported share prices.

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



## 5. QUARTERLY DROPS

Excluding this year, two successive negative quarters for the S&P 500 with an overall loss of over 20% has only happened seven times since WWII.

### >20% S&P 500 Drops Over Two Successive Quarters – Subsequent Performance (%)

|          | 2-Quarter Drop | Next Quarter | Next Half | Next Year |
|----------|----------------|--------------|-----------|-----------|
| Jun 1962 | -23.5%         | 2.8%         | 15.3%     | 26.7%     |
| Jun 1970 | -21.0%         | 15.8%        | 26.7%     | 37.1%     |
| Sep 1974 | -32.4%         | 7.9%         | 31.2%     | 32.0%     |
| Dec 1974 | -20.3%         | 21.6%        | 38.8%     | 31.6%     |
| Sep 2002 | -28.9%         | 7.9%         | 4.0%      | 22.2%     |
| Dec 2008 | -29.4%         | -11.7%       | 1.8%      | 23.5%     |
| Mar 2009 | -31.6%         | 15.2%        | 32.5%     | 46.6%     |
| Jun 2022 | -20.6%         |              |           |           |
| Average  |                | 8.5%         | 21.5%     | 31.4%     |
| Median   |                | 7.9%         | 26.7%     | 31.6%     |

Source: Bespoke, July 2022.

The above table considers the subsequent returns following such negative events. Both the median and average subsequent returns have been attractive off the low respective bases. This year's drop (to the end of June) has been followed by a return of over 10%.

## 6. FREE CASH FLOW

### S&P 500 – Free Cash Flow vs Treasury Yield (%)



The S&P 500 Free Cash Flow Yield is currently close to its long-term average (the orange line in the above chart). Its spread with the Treasury Yield, similarly, is close to average (the green line). This does not leave much room for negative surprises.

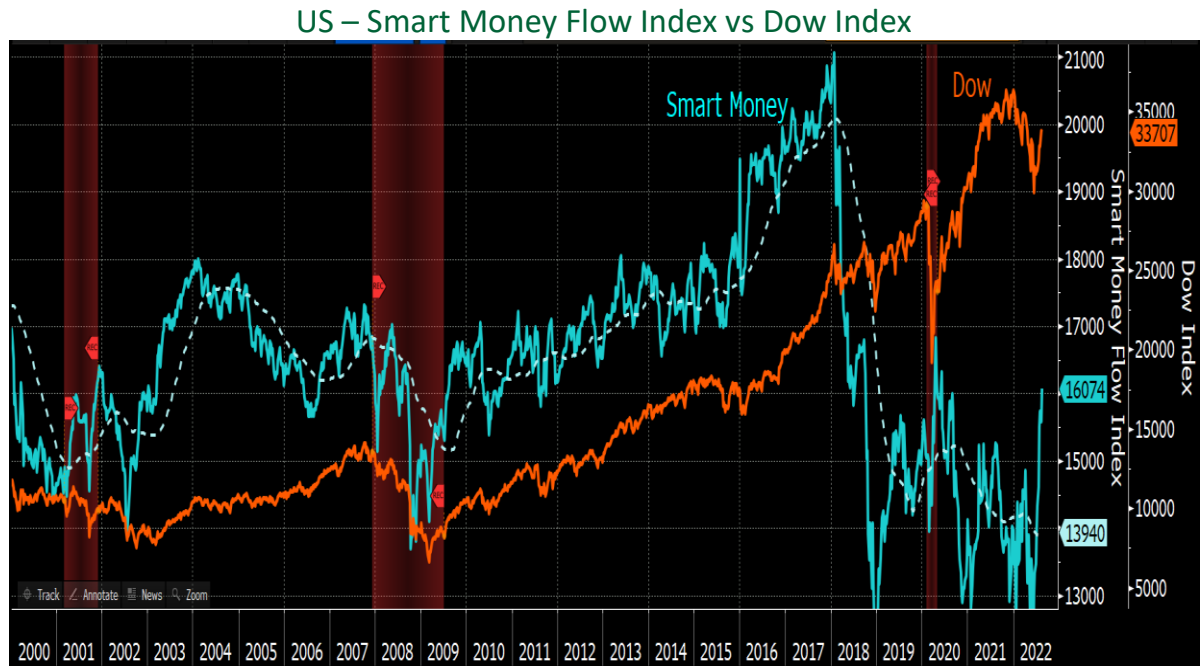
With overall liquidity in the economy getting tighter, we believe companies with strong cash flows may become more attractive against those that do not. The latter may become more volatile with less reason for a rerating against the former.

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

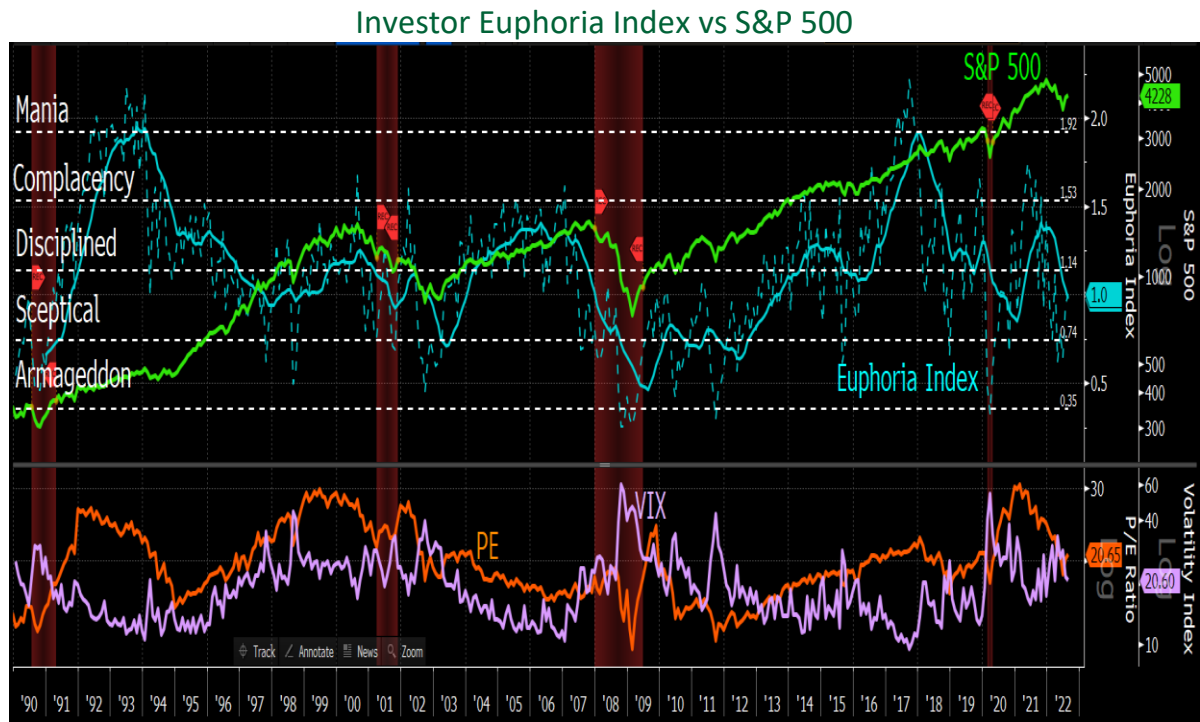


## 7. TECHNICAL PICTURE

The following more technical charts reflect current market perceptions:



The Smart Money Flow Index reflects the actions of the more aggressive traders in the first and last thirty minutes of each trading day. Having recently been at historic low levels, the index recently reacted sharply to record levels since the last recession. Traders clearly have become much more optimistic.



We have created an Investor Euphoria Index by adjusting the S&P P/E ratio with the VIX volatility index. Its readings in different standard deviation categories provide indications between extreme negativity (Armageddon) to extreme optimism (Mania). It has a fair recommendation record, and currently lies in the Sceptical category – which implies a Buy orientation.



## Secular S&P 500 Index (S&P 500 Index / Gold Price)



The Secular S&P 500 Index in the above chart has clear bull and bear markets. Its current bull market started after the Financial Crisis. Although its growth angle is less steep than earlier, it is striking that neither the Pandemic nor this year's weak first half changed its trend of direction. This argues for structurally staying in the Equity asset class.

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