H1 2022 IN PERSPECTIVE

HOW MUCH FURTHER CAN STOCKS AND BONDS FALL, HOW LONG WILL THE DOWNTURN LAST, WHEN CAN WE EXPECT TO RECOVER THE LOSSES INCURRED THIS YEAR?

While we do not have a crystal ball and cannot give any guarantees about future performance, we endeavour to provide our portfolio commentary on a best-efforts basis. The best way to navigate these queries is look at similar episodes in the past, with the humility to admit that this is merely an indication of what the future holds, and we are talking about probabilities rather than certainties. History does not repeat itself, but it often rhymes.

WHICH HISTORY?

History is not homogeneous, and any historical analysis can give widely varying results depending on which time period we are looking at. The first step is to define which period of historical market performance most closely resembles the current macro-economic environment. The defining characteristics of the current environment is monetary tightening and an inflation spike. This is crucial since the recent history of markets has seen the exact opposite, i.e. a loose monetary policy and below target inflation.

The careers of most market participants and the calibration of most risk systems is limited to the past 10 or 20 years, which shapes the expectations of how asset classes and markets behave. However, since 2009 we have seen asset markets being distorted by quantitative easing, while the low inflation environment arguably started much earlier when China joined the World Trade Organization in 2001. This means that the last 10 years, or even 20 years, is the wrong period of history to draw any meaningful inferences from.

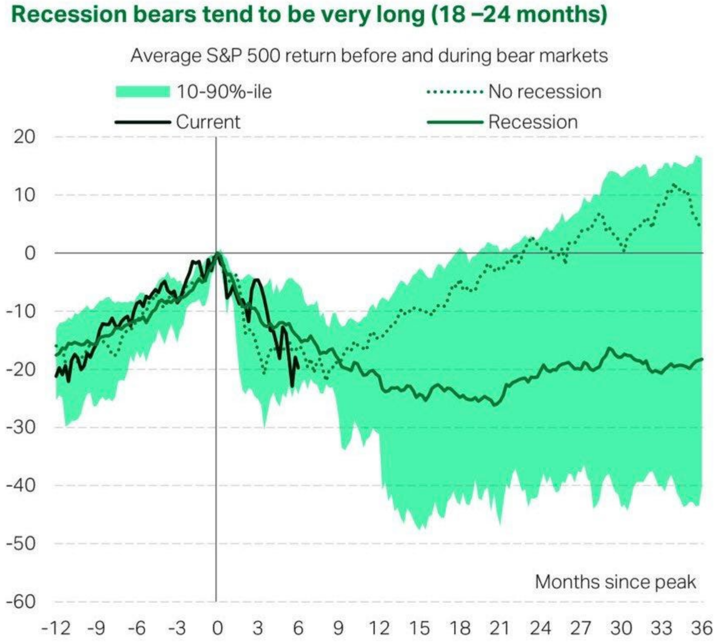
Several commentators have pointed to the period of the 1970s as another instance of meaningful monetary tightening and inflationary shock caused by the supply side. However, this might be too extreme an example. Central banks now have a lot more credibility in tackling inflation than they did in the 1970s, and the inflation targeting regime was formally incorporated into central bank objectives only in the 1990s. Hence the level of tightening and corresponding economic contraction we saw in the 1970s is probably not warranted this time.

Looking further back in time before the 1970s has limited utility, since the monetary regime in place was vastly different, viz. Bretton Woods and the Gold Standard before that. And the world is much more inter-connected now than it was 50 years ago, whether it be trade flows or the movement of capital and labour.

The upshot is that there is no other period of history which exactly replicates today's circumstances. However, we can say with a fair degree of confidence that the coming months will be quite different from the last 10-20 years, as we shall explore in the subsequent sections.

THE 2022 EQUITY MARKET DRAWDOWN IN HISTORICAL PERSPECTIVE

This is quite significant since recent equity market drawdowns have been either shallow or short-lived or both. Investor behaviour suffers from a recency bias where expectations are set by the 2020 Coronavirus selloff, which lasted for just a month. However, historically equity market drawdowns tend to be much longer, especially if accompanied by an economic recession (see chart below). It is useful to remind us that it took 7 years and 3 months for the US equity markets to recover their previous highs after the 2000 downturn. The 1973 downturn lasted even longer, and it took 7 years and 6 months to reach their previous highs.



Source: Marlin Capital

Perhaps the most sobering statistics come not from the US but from Japan where the Japanese stock markets have still not recovered from their downturn in 1989 and are c. 1/3rd below their 1989 peak. Now it is not our thesis that the global economy is going to resemble Japan, but it is useful to frame the timeframe of this drawdown in perspective.

Additionally, we also need to take the effects of inflation into account since the analysis above is for nominal values, i.e., without inflation. For real value drawdown, i.e., stock market performance adjusted for inflation, there have been occasions where the US market has taken 10 years or more, to recover their previous real value highs (see chart below).

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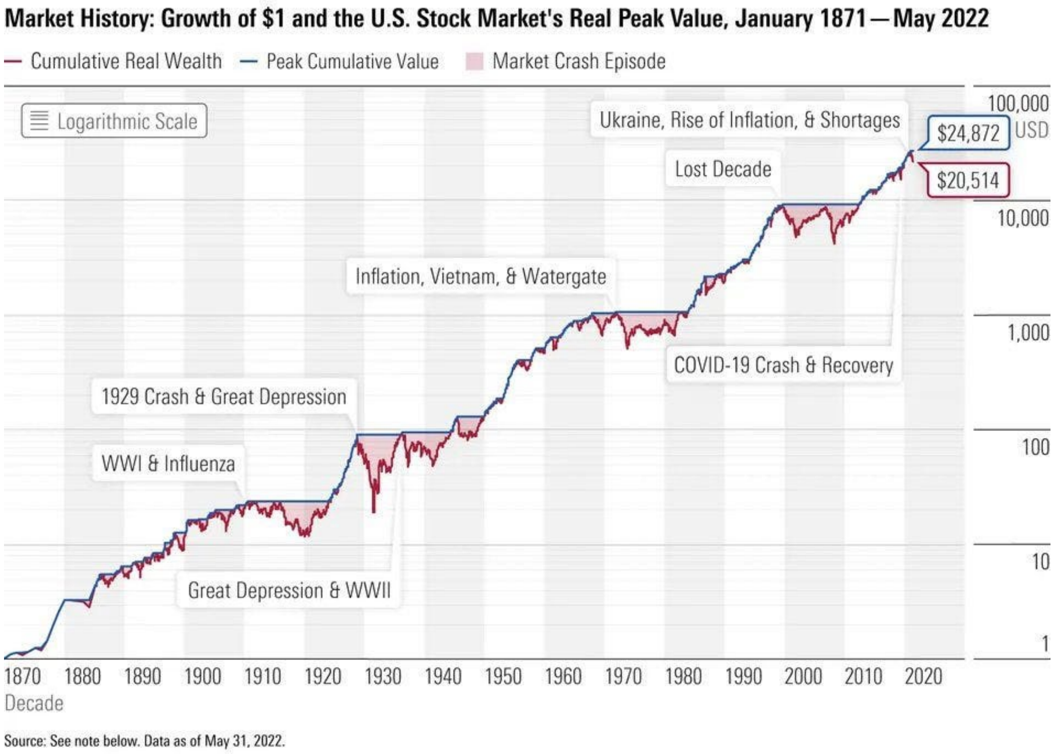
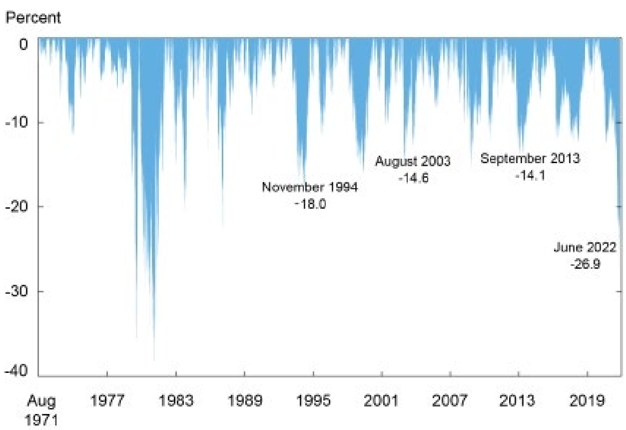


Source: Topdown Charts Research

The takeaway is that while equities are a good long-term source of return and growth of capital, there are significant periods of time where markets can remain volatile and trade sideways. The easy returns of the Quantitative Easing era have been exhausted. From now on, markets will reward those investors who have patience and a long-term perspective.

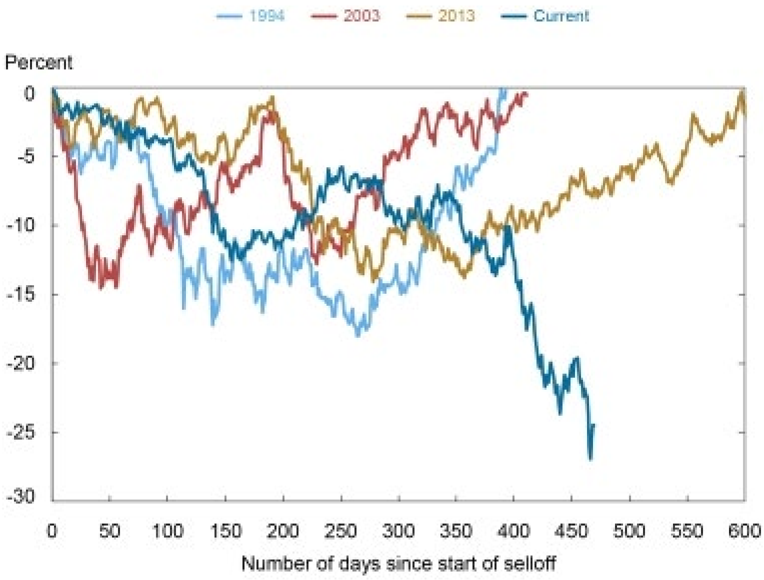
THE 2022 BOND MARKET DRAWDOWN IN HISTORICAL PERSPECTIVE

While prolonged equity market drawdowns have been rare over the past 20 years, the current bond market drawdown is even rarer since bond yields have been going down (and hence bond prices going up) over the last 40 years. It is fair to say that most fixed income investors remain unprepared for large losses in so-called "safe assets" like US Treasuries. The current bond selloff comfortably exceeds the selloffs seen in 1994, 2003 and 2013. We need to go back to the 1970s-1980s period to see the kind of losses we have seen in this selloff (see chart below).



Source: Federal Reserve Bank of New York

In terms of the length of the drawdowns as well, the US Treasuries selloff seems to be longer than those we have seen since the 1990s. While previous selloffs were shallower and bonds regained their previous highs within a year or two, the depth of the current selloff indicates that the broader market will probably take considerably longer to recover (see chart below).



Source: Federal Reserve Bank of New York

THE 2022 MULTI-ASSET DRAWDOWN IN HISTORICAL PERSPECTIVE

However, the real outlier in terms of market behaviour has been the combined performance of stocks and bonds in a standard multi-asset portfolio. All the way back to the 1970s, bonds have delivered positive returns in all years when stocks had a negative return (as shown in the table below), cushioning the blow to diversified multi-asset investors. 2022 has been one of those rare occurrences where equities and bonds have delivered negative returns together.

Year	S&P 500 Total Returns	Bloomberg US Agg Index Total Returns
1977	-7.2%	+3.0%
1981	-4.9%	+6.2%
1990	-3.2%	+9.0%
2000	-9.1%	+11.6%
2001	-11.9%	+8.4%
2002	-22.1%	+10.3%
2008	-37%	+5.2%
2018	-4.4%	0.0%
2022 YTD	-19.6%	-9.9%

Source: Bloomberg

So, what has led to this strange behaviour where stocks and bonds have suffered losses simultaneously? The answer lies in the differing ways in which stocks and bonds react to inflation and growth shocks. As long as the markets are not concerned about high inflation, stocks and bonds act as diversifiers to each other. This is because stocks and bonds react in opposing directions to growth surprises. Any negative growth surprise is negative for stocks but positive for bonds. And vice versa. However, when high inflation becomes a concern for markets then stocks and bonds suffer losses simultaneously as high inflation hurts both these asset classes (i.e., stock-bond correlation becomes positive).

For the past 30 years, stocks and bonds acted as diversifiers for each other since inflation remained under control. However, the past year has seen high inflation re-emerge as a concern for markets, causing stocks and bonds to suffer losses simultaneously. Looking forward, this is expected to be short-lived, and bonds should continue to diversify risk as market concerns shift away from inflation towards the question of growth and whether we will have a recession or not. However, both stocks and bonds will be significantly more volatile than we have seen in recent history.

OVERCOMING THE RECENCY BIAS

Investors have been lulled into a low volatility environment backed by the quantitative easing policies of major central banks over the past 12 years. This has led to most clients being mentally unprepared for a return to normal level of volatility. Unlike the 2020 drawdown where equity markets recovered within 1 month, most "normal" drawdowns are deeper, longer, and messier. Even if there is no economic recession, large drawdowns are much more frequent than what we have seen in the Quantitative Easing (QE) era of 2010 onwards. Taking the S&P and the Bloomberg Aggregate Indices as proxies for equities and bonds, the table below shows the frequency of 6 month moves in the "pre-QE era" (1970-2009) and the "QE era" (2009-2021).

S&P 500 Index	Pre QE Era (1970-2009)	QE Era (2010-2021)
6M Moves	Frequency	Frequency
-50% to -45%	0.0%	0.0%
-45% to -40%	0.1%	0.0%
-40% to -35%	0.3%	0.0%
-35% to -30%	0.7%	0.0%
-30% to -25%	0.6%	0.0%
-25% to -20%	1.4%	0.1%
-20% to -15%	2.3%	0.4%
-15% to -10%	5.6%	1.7%
-10% to -5%	9.9%	5.6%
-5% to 0%	12.8%	11.0%
0% to 5%	20.1%	19.8%
5% to 10%	18.6%	30.7%
10% to 15%	10.8%	18.0%
15% to 20%	8.8%	8.0%
20% to 25%	4.5%	3.3%
25% to 30%	2.0%	0.9%
30% to 35%	0.9%	0.2%
35% to 40%	0.3%	0.1%
40% to 45%	0.2%	0.1%

Source: Bloomberg

As you can see, large drawdowns were a lot more commonplace in the world before QE. For example, in the Pre-QE era, there was a 1-in-9 chance that on any given day, the 6 monthly drawdown in stocks would be -10% or worse. In the QE era, the chance of a 6 monthly equity drawdown of worse than 10% was 1-in-44.

Looking at larger moves, the difference is even starker. The chance of a 6 monthly equity drawdown of worse than -20% was 1-in-30 in the pre-QE era. The corresponding number in the QE era was 1-in-755.

In bond markets, the effects of QE are even more pronounced. The maximum 6 monthly drawdown in the Bloomberg aggregate index never exceeded -3.5% during the QE era. The magnitude of Year-To-Date drawdowns which we have seen in the bond markets were only seen in the pre-QE era (see table below).

Bloomberg Aggregate Bond Index	Pre QE Era (1976-2009)	QE Era (2010-2021)
6M Moves	Frequency	Frequency
-16% to -14%	0.0%	0.0%
-14% to -12%	0.2%	0.0%
-12% to -10%	0.3%	0.0%
-10% to -8%	0.0%	0.0%
-8% to -6%	0.5%	0.0%
-6% to -4%	1.2%	0.0%
-4% to -2%	3.0%	7.1%
-2% to 0%	8.7%	17.2%
0% to 2%	16.4%	25.6%
2% to 4%	19.0%	31.4%
4% to 6%	22.6%	13.9%
6% to 8%	13.3%	4.7%
8% to 10%	6.0%	0.2%
10% to 12%	4.2%	0.0%
12% to 14%	1.4%	0.0%
14% to 16%	1.0%	0.0%
16% to 18%	1.2%	0.0%
18% to 20%	0.5%	0.0%
20% to 22%	0.3%	0.0%
22% to 24%	0.0%	0.0%
24% to 26%	0.2%	0.0%

Source: Bloomberg

KEY CONCLUSIONS

- The current macro-economic environment is very different from what markets have got used to over the past 10-20 years.
- Equity market selloffs can last a lot longer than recent downturns.
- Bond markets have not seen a selloff like this for over 40 years.
- However, bonds should continue to diversify portfolio risk as market concerns shift away from inflation towards the question of growth.
- Investors will have to overcome their recency bias to prepare for “normal” markets. From now on, markets will reward those investors who have patience and a long-term perspective.