Public

This Month in the Markets

August 2022

Equity Commentary

Yo-yo Market

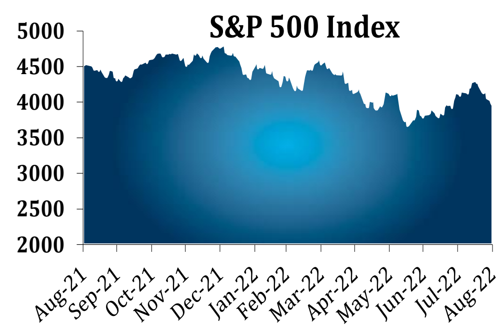
Inflation fears caused a broad-based sell-off in the equity market in August, as higher interest rates hurt growth stocks. The MSCI ACWI Net Total Return Index posted a loss of 3.7%. The MSCI World Value Index fell 3.1% compared to a fall of 5.3% in the MSCI World Growth Index. The S&P 500 slid 4.1%, while the MSCI EAFE Net Total Return Index decreased 4.7%. The MSCI ACWI Energy Sector index was once again the top performer, posting the only sector gain of 2.4%. The MSCI Information Technology Sector was the under-performer, with a fall of 5.6%. The former is benefiting from positive earnings revisions, solid margins, and exploding free cash flow. While the tech sector continues to suffer from a growth reset, margin contraction, and rising discount rates.

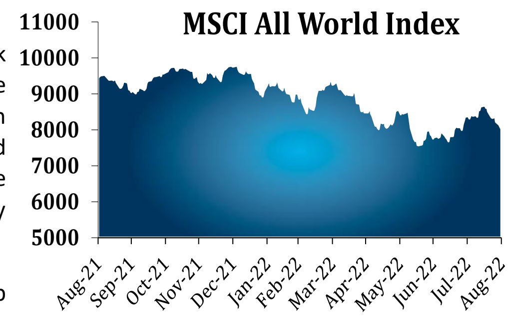
While the first half of August saw equity markets continue their rally from July, the back half of the month saw a course reversal. Initially, markets were emboldened by the easing of inflationary pressures and the expectation that rate hikes may be tempered in the medium term. However, it became increasingly clear that the Federal Reserve had no intention to step off the gas in terms of rate hikes, and the market began to reverse course. The resetting of rate expectations and the weakening economic data globally led to a retreat for global equity bourses in the last two weeks of the month.

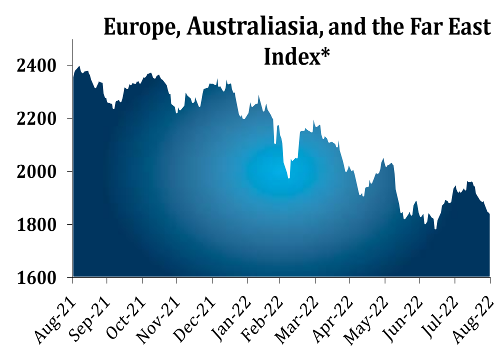
Several macro factors hang over the market these days. On the positive side, the job market in the U.S. remains robust, commodity inflation is moderating, and valuations have compressed somewhat. On the other hand, global central banks are raising interest rates and reducing liquidity, the Chinese property market is going through a major reset, an energy crisis still lingers in Europe, and earnings revisions have now turned negative. Accordingly, we continue to hold some excess cash at month's end with the intent to add to positions or enter new ones from our watchlist as opportunities present themselves. We would expect to see increased volatility in the medium term as markets struggle to price these factors, and the yo-yo action is likely to persist.

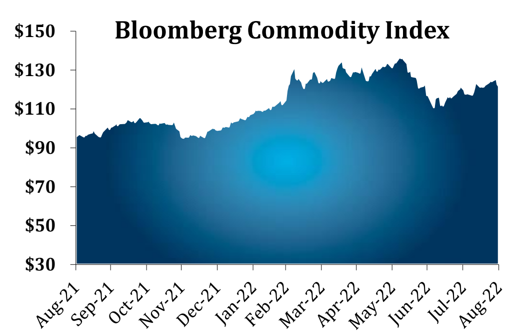
Avantor Inc. was the largest underperformer in the portfolio for the month, with a decrease of ~14% after analysts marked down earnings due to concerns about European exposure and the COVID revenue roll-off. The top performer in the month was Devon Energy Corp., up ~12%, which rallied after posting 332% earnings growth and the bolt-on acquisition of Validus Energy.

In August, we sold one position of the Vanguard Total World Stock ETF and replaced this with GXO Logistics Inc. ("GXO"). GXO is the world's largest pure-play global contract logistics company that manages global corporations' supply chains. Logistics businesses are very attractive assets due to the long-term nature of contracts, high switching costs, asset-light models, and strong free cash-flow conversion. GXO benefits from the huge opportunity surrounding the secular growth in eCommerce, automation, and supply chain outsourcing. GXO has revenue growth potential in the double-digit range due to its secular position, a return on invested capital much like other asset-light companies, and the resilience of a utility company due to its sticky long-term contracts. We find this combination leads to a very attractive business model overall.









*MSCI EAFE Index

Fixed Income Commentary

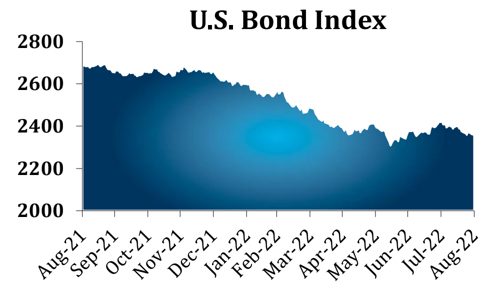
Powell Rubbishes Pivot

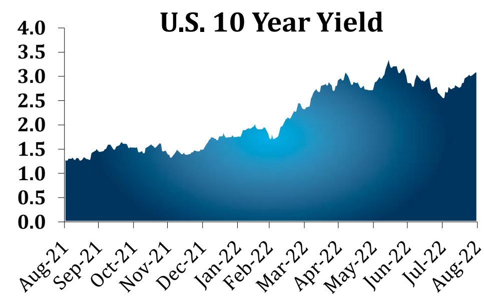
In the final paragraph of the July bond market monthly review, we wrote of the market's interpretation that the Fed had pivoted from fully hawkish to a less hawkish stance. One in which they would consider a greater consideration of slowing economic growth as opposed to a sole focus on inflation. In line with this Fed pivot belief, we ended August with fed fund futures pricing in approximately two 0.25% fed fund rate cuts in 2023. This stood in stark contrast to the Federal Open Market Committee's (FOMC) DOT plot, comprising FOMC members' individual projections for the path of the fed funds rate. The DOT plot showed almost two 0.25% rate hikes in 2023. Thus, there was a notable discrepancy between the Fed and the market with regard to the path of the policy rate. Fed governors and presidents were conveying a more hawkish tone as we moved through August. There was a resolute focus on inflation in speeches/interviews, pushing back against the notion of a Fed pivot. This came to a crescendo on August 25th when Chairman Powell spoke at the Jackson Hole Symposium.

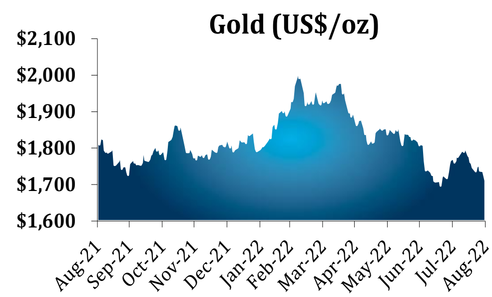
In Powell's eight-minute speech, he spoke exclusively on the need to quash inflation. He quoted former Fed Chairman Paul Volker (RIP), who was famous for stemming the incessant inflation of the 1970/'80s, as well as former Fed Chair Alan Greenspan. He used very strong language and left no room for interpretation about the Fed's stance on monetary policy. The following excerpt from his speech summarizes his message nicely: "History shows that the employment costs of bringing down inflation are likely to increase with delay, as high inflation becomes more entrenched in wage and price setting. The successful Volcker disinflation in the early 1980s followed multiple failed attempts to lower inflation over the previous 15 years. A lengthy period of very restrictive monetary policy was ultimately needed to stem the high inflation and start the process of getting inflation down to the low and stable levels that were the norm until the spring of last year. Our aim is to avoid that outcome by acting with resolve now."

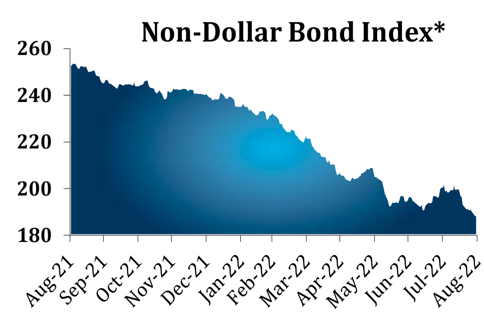
In response to Powell's speech, interest rates rose across the curve, continuing the trend that prevailed for most of the month. The 2-year treasury yield rose 0.61% to 3.49% in August, while the 10-year treasury rose 0.54% to 3.19%. As such, the 2-year-10-year slope remains inverted. The two rate cuts in 2023 that were priced in fed fund futures were largely priced out by the end of August. Clearly, the market took heed of the plethora of central bank hawkish messaging. Indeed, markets are pricing a strong likelihood of another 0.75% rate hike in the September 21st FOMC meeting. This would be the third 0.75% fed fund hike in a row. All eyes will be on the economic data between now and then, most notably the consumer price index release on September 13th.

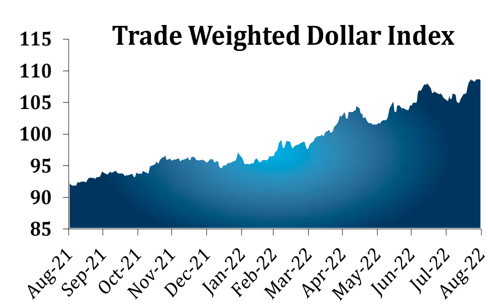
Elsewhere, the USD continued to appreciate while credit spreads widened (negative for corporate bond prices). This spread widening was most notable among the lowest quality/rated companies, while the investment grade market saw only mild spread widening. We remain hesitant to add credit risk at this stage of the economic cycle but will look for opportunities during the increased market volatility.











*Merrill Lynch Global Broad Market, Ex US Dollar Index

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