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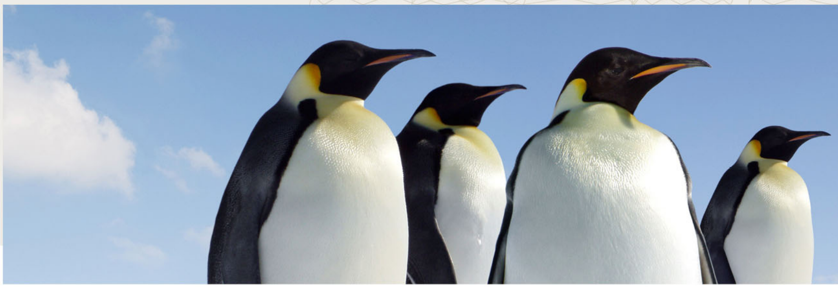

For Your Perusal

Highlighting Interesting Investment Research

Reflecting on 2022

The year of 2022 can be described by several diverging factors. When reflecting on 2022 it is important to note the preceding factors that changed quickly that resulted in the dramatic changes that occurred during the year. Coming into 2022 the global financial markets were riding a wave of low interest rates, fiscal stimulus through government grants and the largest monetary stimulus (QE) packages released by central banks in history.

The equity markets were riding the wave of TINA, there is no alternative, in reference to the idea that equities were the only option for investor returns given the alternatives such as bonds which provided zero and in some cases negative yields. By the end of 2021 equities and particularly growth shares were trading far beyond what could reasonably be expected under normal market conditions. Similarly global bonds were also at their most overvalued in history often referred to as return free risk investments.

Ready for a Correction

The conditions were ripe in early 2022 for a significant market correction. This correction quickly turned into a bear market with the catalyst being the rise of rampant inflation. The coronavirus pandemic-era combination of supply shortages and high demand pushed up inflation and saw the Federal Reserve Bank (Fed) pivot from viewing inflation as transitory to aggressively pushing up interest rates to curb runaway inflation. The Russian-Ukraine war also had a major impact on the energy costs for the whole of Europe, contributing substantially to inflationary pressures.

These interest rate and inflation dynamics have put downward pressure on consumer spending, company valuations, the real estate market and corporations that are refinancing their debt levels at higher interest rates.

The change in the macroeconomic environment from stimulatory to restrictive led to a rapid change in sentiment towards both equities and bonds simultaneously. The S&P 500, which measures the stock market performance of the top 500 companies in the U.S, has come down approximately 17%. The Bloomberg Barclays US Aggregate Bonds Index has had an equally poor year, with a drawdown of about 16%. Both of which have however more recently bounced off their bear market lows in the latest response to what seems to be a softening in the inflation outlook. One of the few assets that have provided protection has been cash, within the safety net of a strong US Dollar.

The standout sectors that performed poorly during the year were mostly the companies in the growth sector that were deemed Covid beneficiaries who saw their share prices rise by many multiples since the beginning of the Covid pandemic only for many to fall by 70-90%. Some examples include Coinbase, Robinhood, Carvana and Zoom with the companies hardest hit being those that are unprofitable with a low chance of becoming profitable anytime soon. Emerging markets also came under pressure with Chinese technology companies in particular selling off dramatically shedding more than half their market caps despite showing signs of value.

From Growth to Value

The retreat of growth shares saw a rotation into value shares, many of which are deemed "old" economy shares like banks and oil producers that had underperformed in the prior years as growth and innovation shares in the software and technology industries gained favour. These value sectors performed relatively well despite the broad weakness across asset classes. The energy sector stands out as one of the best performers this year by a long way, led by oil and gas companies. Certain commodities in the mining sector have also seen significant gains. Coal has been a major gainer this year in terms of both the rise in the coal price and the substantial upward move in coal miner's share prices. Defensive sectors were also relatively strong performers with pharmaceutical companies being a good place to be invested in for 2022. Similarly, tobacco companies also produced decent returns as investors searched for cheap defensive sectors that had predictable demand and cashflow. Banks also faired better than the broad market as they benefited from the rise in interest rates after many years of artificially suppressed yields. The rise in interest rates benefited banks both from a global and South African perspective as net interest margins expanded adding to banks earnings despite an environment of pressure on the broader markets earnings growth.

A Loss for ESG

An interesting aspect that emerged from an analysis of the sectors that performed well is that many of the underlying stocks in these sectors can be viewed as undesirable based on low environmental, social and governance (ESG) factors. Energy companies are likely the most controversial in this case given these companies' business agendas are contrary to what global governments are trying to achieve in fighting climate change and adhering to the UN's sustainable development goals.

Their performance however is not surprising given the global backdrop in which the Russia-Ukraine war has disrupted the entire energy supply system and created a profound supply and demand mismatch. As a result, the shift to a fossil-free future has primarily been shifted out as countries are forced to rely on "dirty" fossil fuels.

Yield Alternatives

The dramatic shift in the levels of interest rates in 2022 has created a situation where investors had more choice particularly for those investors looking for yield. This is evident particularly for pension funds or older investors who have a focus on income. They could shift capital from expensive equities to cash that now after many years provided some low-risk yield in the face of falling bond and equity markets. This tactical asset allocation adjustment also influenced the capital flows within markets in the short-term.

Portfolio Reflections

Investors should continually evaluate and reflect on their investment processes as well as their investment holdings. The dramatic changes and market moves globally during 2022 provide a great opportunity for reflection given the extreme tests that have been exerted on portfolios during the year. Markets work in cycles, but forecasting these cycles is exceptionally difficult so it is important to ensure that your portfolio is maximised not only for returns but also for risk!

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