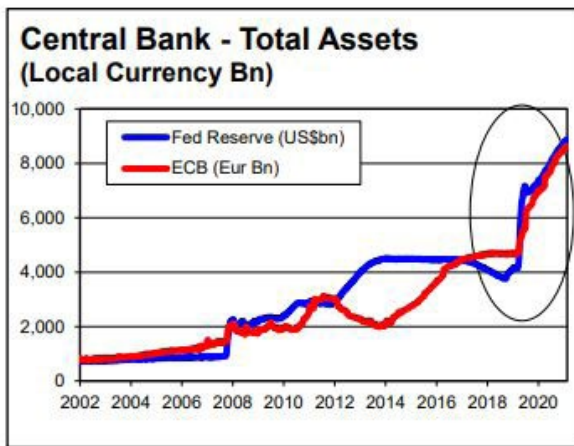


Airlie Insight: The dominant narrative of 2022 for stocks

The return of volatility could be it.

Last quarter we talked about the danger of following blindly (and reacting to) the 'dominant narrative' that is prevalent at any time in the market. However, there is no denying we are at the crossroads where inflation plus central bank tapering equals higher interest rates. Nothing encapsulates the excesses of the past decade better than the chart below showing central bank asset growth (i.e., buying assets/money printing). It seems unlikely that the similarity in the growth of global equity markets over this period is a coincidence.



Is this inflation spike transitory or structural? Some of it is clearly transitory driven by covid-19-affected supply chain issues; however, add in the energy and commodity price shock from the Russian invasion of Ukraine and suddenly 2022 looks different from most of the past decade. The 'dominant narrative' is all-encompassing, and the first impact is an increase in volatility in equity markets. In 2021, the S&P 500 Index had the fewest market drops (or 'drawdowns' in the professional lexicon) in recent history. It seems reasonable that the uncertainty of just how high rates will go will lead to a lot more volatility, and this has certainly been the case thus far in fiscal 2022. From recent peaks, the NASDAQ and S&P 500 fell 22% and 13% respectively but have now rallied 13% and 9%. The S&P/ASX 200 has done even better – falling 10% from

the January high only to rally 10%, leaving it only 1% from the all-time high set in August 2021. The Australian market has been bolstered by its high weighting to banks and energy and resource companies.

Many pundits are calling this sudden snap-back rally a 'dead cat bounce' due to perhaps a view that the Russian-Ukrainian situation evolves into some sort of truce hopefully soon. At that time the 'dominant narrative' will then return and take charge leading to slowing economic growth and possibly recessions. The chart below shows that it's certainly been the case that markets do not do as well when inflation is both rising and is above 3%. This is the exact opposite situation of the past decade where we've had falling inflation and below 3%. Not shown on the chart is that markets produce negative returns when inflation persistently exceeds 6%.

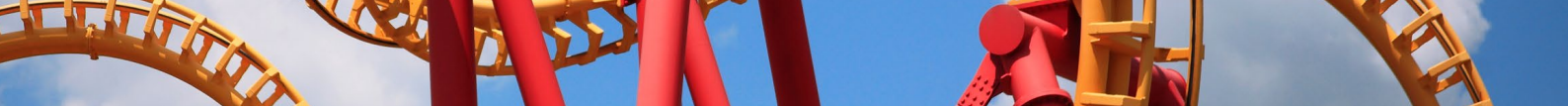
Inflation Is Not Great For the Stock Market
Annual returns for the S&P 500: 1928-2020

Rising Inflation	Falling Inflation	Inflation >3%	Inflation <3%
6.7%	16.5%	6.3%	15.7%

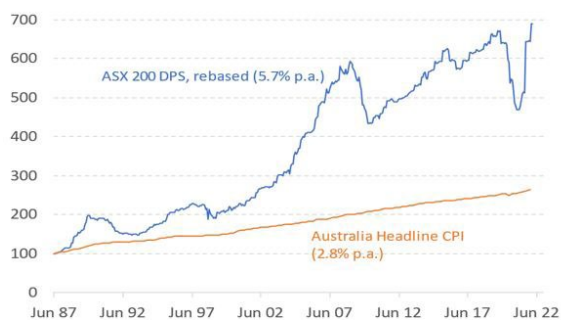
Source: Ben Carlson, A Wealth of Common Sense

So, what does it all mean and what to do? Unfortunately, it's impossible to answer. We've met investors this year who have proudly told us they've gone to cash as the market hit the 10% drawdown because the 'dominant narrative' is obvious – equity markets will fall, economies will falter. They may ultimately be right, but I've wondered what they make of the rally back to within 1% of all-time highs?

The performance of non-profitable tech, the return of so-called value stocks, and the valuation implication of higher rates lead us to think that the one-way trip of the market over the past decade and the return of volatility may mean stock-picking comes to the fore and there are increasing opportunities for active managers to differentiate themselves. Also not forgetting the fact that the equity market is the best place to counter inflation. The chart below shows that just the dividends alone from listed Australian equities have preserved investors' buying power over the long term.



Dividends vs CPI



Source: MST Marquee

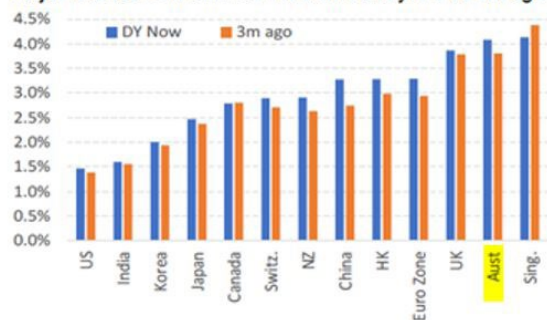
With all the doom and gloom and headline fodder provided by the above debates it's easy to forget that the Australian economy remains in good shape. The strength is widely spread across the economy: from households enjoying strong employment prospects with wage rises, increasing house prices, falling mortgage repayments (for now), to miners reaping solid commodity prices, farmers rebounding from the drought, and banks experiencing renewed credit growth.

So where to from here? The case for further strength in equity markets is a relative one. Absolute valuations are high relative to history and are vulnerable overall to higher interest (discount) rates. The energy shock brought about by Russia's invasion of Ukraine and higher commodity prices generally are supportive in the short term to our resources-heavy market. Also, as the chart

below shows; equally supportive is the forecast dividend yield available from the ASX 200 – a healthy dividend return of 4.0% – making it the equal-highest-yielding equity market in the world. Calendar year 2021 was a year of significant capital return for investors, as many ASX companies were carrying surplus capital: banks, miners, retailers, and many industrials had seen dramatic balance sheet improvements over the past 18 months. We expect continuing healthy capital returns to shareholders, notwithstanding the global uncertainty.

Fig 6: Australia ranks equal 1st on div ylds

Major market 12-month forward dividend yield vs 3m ago



Source: MST Marquee

By Matt Williams, Portfolio Manager

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