Commentary on recent market volatility

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2022 has seen one of the worst starts for markets in years. After a difficult first quarter in which both bonds and equities saw significant selloffs, markets continued to deteriorate right through April and May. By some accounts the selloff in the U.S. 10-year Treasury through till April was the worst start of a year for that market since 1788, while the seven straight weeks of declines for U.S. equity markets is one of the worst streaks since the 1930s. While neither of these factoids mean much in themselves, they do highlight just how unusual and uncomfortable markets have been this year. As I type this note markets are set to finish this week on a strong bounce, breaking the seven-week losing streak and erasing much of May's prior decline. Whether markets have bottomed or not remains to be seen but moral always improves when the beatings take a break. I want to take a moment to step back and assess some of the drivers of the selloff and the potential implications and messages for investors going forward.

Message number one is a resounding Don't Panic. For long term investors the secret to building wealth has always been about compounding returns in the markets over years and decades, a process that has always entailed riding through both ups and downs with ample evidence to show that those who try to time the bumps along the way tend to be worse off than those who stick with their long-term investment plans.

Message number two, a market correction was not unexpected, and it was all about the U.S. Federal Reserve (Fed). If we step back and ignore most of the day-to-day noise in the markets and on TV, much of what has unfolded makes sense and is healthy. Although the speed and magnitude of the correction in many asset markets has exceeded our expectations from the start of the year, the general trend and reasons for the correction were as we outlined at the start of the year, It underpinned why we shifted to a more cautious positioning in our funds (CI Global Income & Growth), reducing equity exposure and increasing cash levels. The rational was that the U.S. economy was growing rapidly, unemployment was plunging, inflation was soaring, and the Fed had interest rates set at Zero! Interest rates were way too low, still set at pandemic levels, as the economy was recovering robustly. The Fed clearly had to get rates back to a more normal level as soon as possible, and they had started to communicate that in November of last year. That hawkish pivot towards rate normalization continued right through April as the Fed kept guiding an increasingly aggressive path for monetary policy. By early May the U.S. 10-year Treasury bond yield hit 3%, a doubling versus the roughly 1.5% we started the year at. That was fast. To be honest we had expected to reach the 3% range closer to year end rather than by May, but markets will do that. The increased inflationary pressures from the unexpected Russian war and energy price spike also pulled the agenda forward. But at 3% on the 10-year, I would argue that the interest rate adjustment consistent with returning to a more normal or neutral interest rate range is now done! This is important as the Fed's thinking about the path of monetary policy and inflationary outcomes really has to start with getting back to neutral. Only then can a more informed debate on the future path for interest rates take place. For now, the pain in the bond market is done.

Message number three, the stock market had to discount the higher interest rates. This was the message in our move to reduce our equity exposure in December. Higher rates meant equities had to correct. Now the speed at which

interest rates rose has meant more pain in both equity and bond markets as a slower pace would have allowed more time for markets to adjust, but for now it is my view that equity prices (as well as bonds) have fully priced in the shift in interest rates back to neutral. Markets have repriced, it was painful but is now done. Markets may even have overshot a bit, that will depend on how the underlying economic fundamentals (growth, inflation, earnings etc.) unfold from here.

Message number four, our base case for the fundamental outlook remains subdued but constructive and we do not expect an imminent recession, nor runaway persistent inflation. Of late market fears have bounced from inflation fears to recession fears both of which appear overdone in my opinion. Yes, growth is slowing, as expected, and will continue to do so, but it is hard to see the economy tipping into recession in the coming 6-12 months given the underlying health of the consumer balance sheets and household incomes. Peak inflation is also now behind us as base effects, easing supply chains, ebbing demand for goods are all disinflationary while an acceleration of demand for services/experiences and elevated energy prices will continue to be inflationary. On balance we expect a continued downward trajectory for inflation in coming months, but the pace of decline is something we will be monitoring very closely.

Message number five, the rate reset is done and markets from here should move in line with the fundamental outlook. Already in recent weeks we have witnessed a shift in market correlations between bonds and equities back toward the norm of recent decades where an equity selloff sees bonds rally and vice versa. Consistent with the view that markets have now repriced the Fed. While different views of the fundamental outlook will dictate different views for asset prices, our base case remains constructive on the fundamental outlook. Peak growth and peak inflation are both behind us, but slower growth and slowing inflation are not the same as a recession nor stagflation. We are entering a more mature stage of the cycle but if we are correct on our fundamental outlook then while markets may continue to grind sideways the sense is we are in a bottoming process that should see a return to modestly higher markets into year end.

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