Global Thematic Investors' Diary

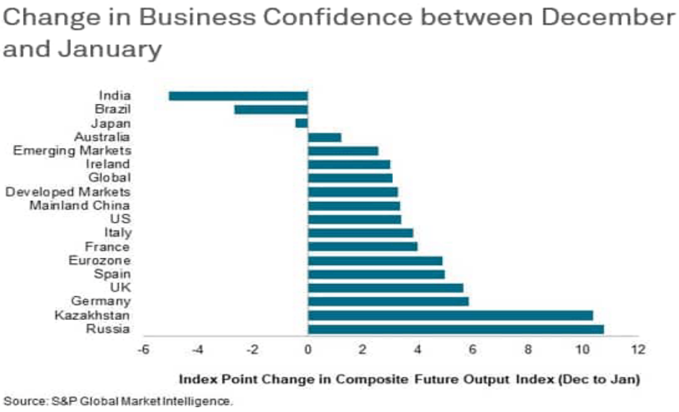
Iain Little 14th February 2023

Sentimental Journey

We got lucky in January. Maybe our lucky Chinese New Year rabbit smiled on us.

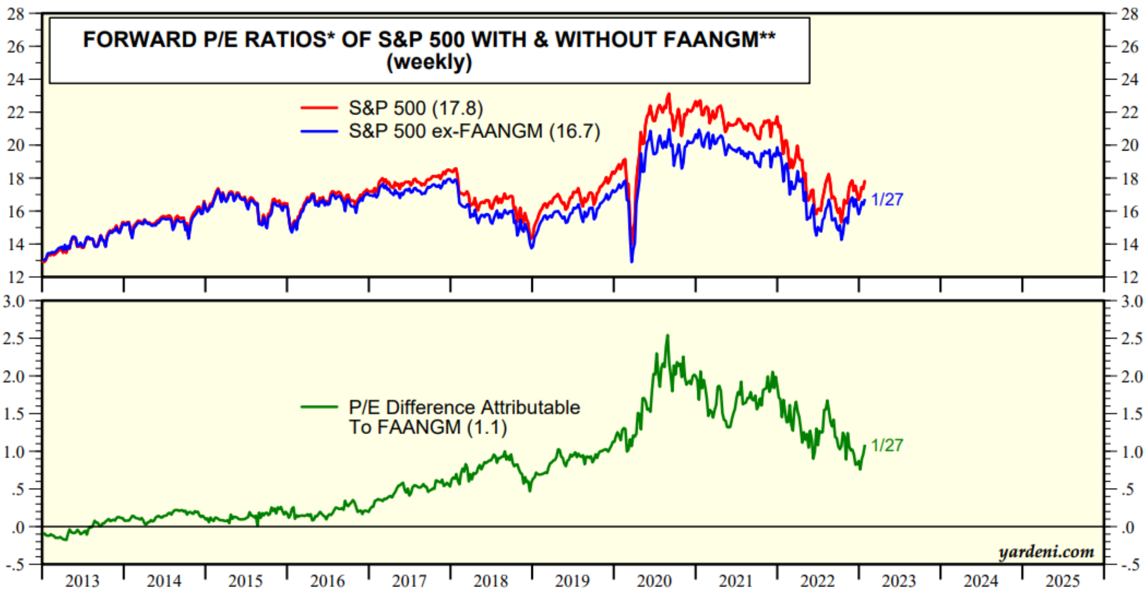
We wrote *"The Times They Are A-Changin'"* diary when sentiment was depressed. Fortunately for us, investor positioning was worse, even suicidal. Cautious investor positioning always leaves a market open to a dramatic rally, and that's what we got. Behaviouralists won't be surprised. Bank commentators -and we see most of them- were going for recession by Q2, with a late Q3 or Q4 recovery, rescued by a Federal Reserve easing monetary policy into year end. Bonds were lifted in asset matrices, and for most banks, equity allocation still lies below or at the neutral median. Since 2023 dawned, most markets have rallied by between +5% and +10%. Small and mid-cap UK stocks, a leper colony for investors in 2022, down nearly -40%, are up by nearly +15%. China, opening after its weird Covid lockdown, got a shot in the arm from upgraded economic forecasts. In short, a near universal change of sentiment in both bonds and equities, whose normal behaviour -to diversify risk away from each other- failed to materialize in 2022, as both fell by roughly similar amounts.

Apart from the welcome fall in inflationary expectations, and the benevolent effect of lower bond yields on equities, real world forward looking indicators have improved. Here's business confidence over year end:



Where next? The best comment, as it also applies to us, comes from one of our managers, Terry Smith: *"Our companies should demonstrate a relatively resilient fundamental performance in such circumstances, and* ***the only type of market which ends in a recession is a bear market."***

We are reminded by another market veteran we've followed for 40 years, Ed Yardeni, that the FAANGS, the mega tech US stocks which led the 2014 to 2021 bull market, still inflate the PER market rating. Without the FAANGS, the forward market multiple is only 16.7x, making it barely 2 points higher than the long-term average. Bearish commentators claim that earnings are about to take a hit, raising the PER, and rate rises are still in store. (Remember that 2 main factors influence share prices: the valuation of earnings, influenced largely by interest rates, and the earnings themselves). There may indeed be something to the bears' claim.



Our investment policy discounts this possibility. While 10-year bonds yield 3-4%, and inflation looks like basing near 3-4%, **fixed income should remain slightly underweight. Equities remain the only liquid assets with a chance of surviving or benefitting from high inflation.**

We emphasise quality (consumer staples, healthcare), value (golds) and yield (energy, resources), and look to reduce vulnerable, fragile assets in favour of anti-fragile ones.