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WHITE PAPER

Will the 2nd Half & Beyond for Equities be different to the first?

A data-based case for a positive outcome

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Is the majority, right? Are equities set to perform poorly in the next 6 months?

In this white paper we set out sound reasons and observations that point to the probability of a different outcome. Despite the present barrage of bad news and sustained focus on the negatives in the world today, there are more compelling facts, trends and activities that mean things may not pan out as negatively as one might assume.

For those making key decisions with investments such as asset allocation, manager style allocation, sector exposures, risk management and so on, today's environment presents a perfect storm of factors set to mislead decision makers in these aspects of wealth management. We feel that providing a compelling non-consensus and open-minded view of the next year or so, especially now, is warranted.

The economy continues to evolve and there is little doubt that the last 2 years will cause a further change to its operating rhythms. Even though the economy is complex, industry participants tend to rely upon a few favourite data points to figure out the future. Additionally, the focus of commentors tends to coalesce around the consensus view of an issue.

We will look at the **5 common assertions** that tend to stir up worry and pessimism that are often used as a basis to alter present portfolios. We respond to each one with a counter view backed up by facts and observations critical to the likely future outcomes of each assertion. Before this let's begin with an essential reminder for decision makers about the human condition in processing information.

The 5 assertions

1. **Carbon energy prices will keep rising.**
2. **Global transport costs have skyrocketed, forcing supply chain cost increases.**
3. **Reshoring back to the West means higher prices.**
4. **The US economy is faltering, and now from the Russian war, the EU too.**
5. **The big one- interest rates. The resumption of rising rates is firmly established.**

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Behavioural biases every investor should know.

Our genetic responses to how we process information impacts how we make decisions more than you might think. Whilst people in the investment industry often project a precise ‘all seeing & knowing’ ability about the future, that fact remains that we too are just as susceptible to these biases: no matter our role, skills, or experience. It is critical therefore that to make good decisions we know how they impact matters. 5 crucial ones are below:

Negativity Bias: We notice the *bad* far more than the good. It’s why commentators lead with bad news. It gets our attention.

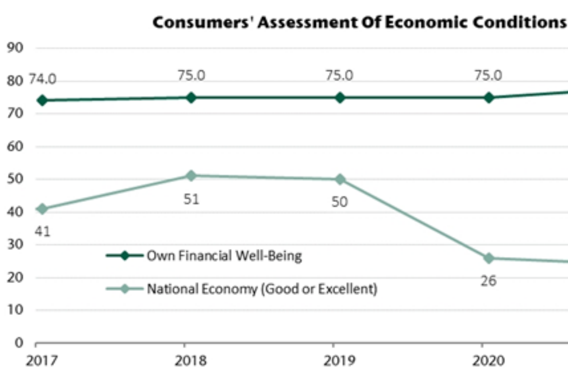
Cognitive Bias: We’re more aware of, and seek out, information *supporting* our view or assessment, even if we can’t point to why we have that view. As an extension, we often then block or discount information to the contrary.

Time Bias: The near term has a greater weighting in how we respond than longer time frames, even if it is counterproductive to achieving what we are seeking.

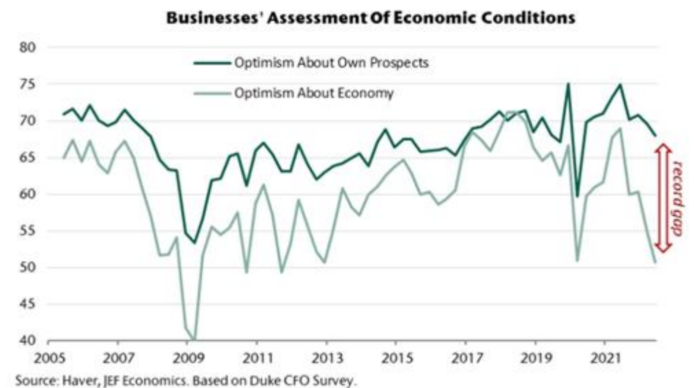
Straight Line Bias: We assume most lines and trends are *straight* and will continue unabated. By example, todays inflation rate combined with negative headlines is interpreted as inflation will keep increasing.

Fear Bias: We tend to prioritise and process negative information *ahead* of positive information. So much so that positive news is often received with cynicism or suspicion.

One way a combination of these can manifest is how we see the ‘world’ versus our own personal situation. Below are two surveys of sentiment by *consumers* and *businesses*. Each track where they think everyone else’s prospects lie (what they *believe*), versus their own circumstance (what they *know*). Note the large disparity for both groups.



Source: Haver, JEF Economics. Based on the Fed's Report on Well Being of US Households.



Source: Haver, JEF Economics. Based on Duke CFO Survey.

Therefore when making your next investment decision, ask yourself, how have these biases come to bear on the decision/opinion you’re arriving at? It may not always lead you to the right call, but it will certainly help reduce the risk of a poor one. What can be broadly observed from financial ‘sentiment indices’ is when the consensus is negative, that's when things tend to reverse, and well before commentators notice the move.

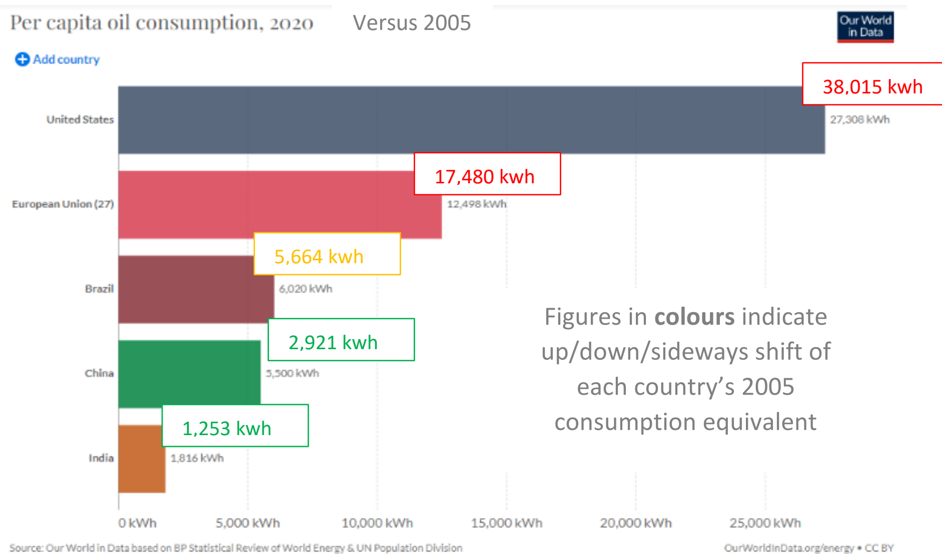
This is important to keep in mind as we present the **5 key assertions** for this year and next along with providing a counterpoint view to each.

The 5 Assertions and their Counterpoints

Assertion 1: **Carbon energy prices will keep rising** (as have most commodities).

A Counterpoint:

- Supplies globally can easily meet demand (the potential temporary exception of gas to Europe accepted). OPEC sees oil and gas price pressures as 'transient', and not worth the expense or risk of lifting output creating oversupply.
- **Net Carbon Demand** continues to drop as **Oil Intensity** in our economies also falls.
- Longer term, demand growth overall will be offset by green energy and shrinking populations in developed nations.
- There is scant evidence to support a sustained price rise above the present US $100-$120/ barrel trading range, especially as the US reopens shale extraction.
- Given this, for the next year or so, prices are not likely to either significantly increase or decrease.



Notable observations:

- US and EU oil consumption/capita has **dropped 29% in the last 15 years**
- Brazil, a developing nation has **increased by only 5% in 15 years**.
- China's per capita usage is now equal to that of Brazil's and **unlikely to grow** given their dependence on imports and a preference for alternate energy. **China's growth is negligible** given its economic growth over this time.
- India is the only major country where oil consumption is likely to rise due to a per capita usage of 30% that of Brazil and China. India's historical ties with Russia see it exploiting low Russian oil prices. Fortunately, **the population growth rate in India is -1% p.a.**, far less than the replacement rate.

Nuclear and Gas are now classified as GREEN in the EU. Don't be surprised to see old nuclear plants rebooted (at least for a while) and a begrudging social acceptance of nuclear in its future energy mix. Russia's antics will accelerate reduced demand for carbon energy (after an initial increase) along with the impact from vastly improved batteries for variable energy sources.

'Demand Destruction Effect'. When prices rise too high for societal 'tolerances', alternatives are found to them and/or less of the product or service impacted is consumed. By example, after all costs, solar (and increasingly wind) are near or even below the cost of new carbon fuelled power generation, and a mile ahead of nuclear. The last remaining challenge of renewables- power continuity- is quickly being overcome in both gravity and chemical battery storage solutions. As their risks decrease, carbon energy risks, for completely different reasons, are increasing. The Risk/Return/Price equation is changing fast.

Whilst the ongoing Russian war may hurt key EU nations for an initial *short period,* the irony is this has only accelerated the West's strategic withdrawal from relying on Russia's carbon and commodities longer term and rapid improvement in their defence abilities. It would take a dramatic regime change in Russia abiding by *rule of law* to see any sustained trust in Russia and a return to any form of reliance upon it. Russia may well win the battle (Ukraine) and set in place its own strategic defeat in losing the war (its economic future and internal security).

If we look more broadly across the basket of major commodities the story is the same as for carbon energy. Copper, aluminium, and iron ore as specific examples have fallen and headed towards more normalised trading ranges. Whilst 3rd world wheat supplies face serious interruption because of Russia, this has little impact on the overall commodity outlook.

What about commodities? This chart sets out the relationship as well as the current state of a composite of all major commodities with oil.

Their prices are already falling and are now well off their peak. We will tackle 'recession' impacts later.

No continuing upwards price pressure from oil or commodities = negligible impact on inflation in 23'. As both are cited as the key inflation drivers, imagine what this might mean.

Assertion 2: **Global transport costs have skyrocketed, forcing up supply chain costs.**

A Counterpoint: Shipping capacity and efficiency is rapidly improving with Covid logistical choke points evaporating

- In the next 2 years the equivalent of an additional 25% of all TEUs (20ft containers) shipping capacity in the world today (6+ million containers), will enter the water.
- Those ships are bigger and more efficient. They consume less fuel per TEU, with a very large proportion of new ships over a whopping 14,000 TEUs in size. Average ships size has expanded from >3000 TEUs to <4500.
- As a vaccine driven Covid BAU takes hold, bottlenecks are evaporating allowing containers to disperse normally.
- Container costs have averaged under $2k/TEU for over a decade - Covid increased this temporarily to $10k/TEU
- But after spiking above this level in October 21', it's now already falling DESPITE rising fuel costs.

Shipping cost price hikes were mainly covid related. Covid of course is an event not a permanent change. Already the technology deployed in how quickly vaccines were created (AI/supercomputer modelling and genetic engineering), manufactured then distributed, is something the world has not yet fully appreciated as a marvel of 21st century capability.

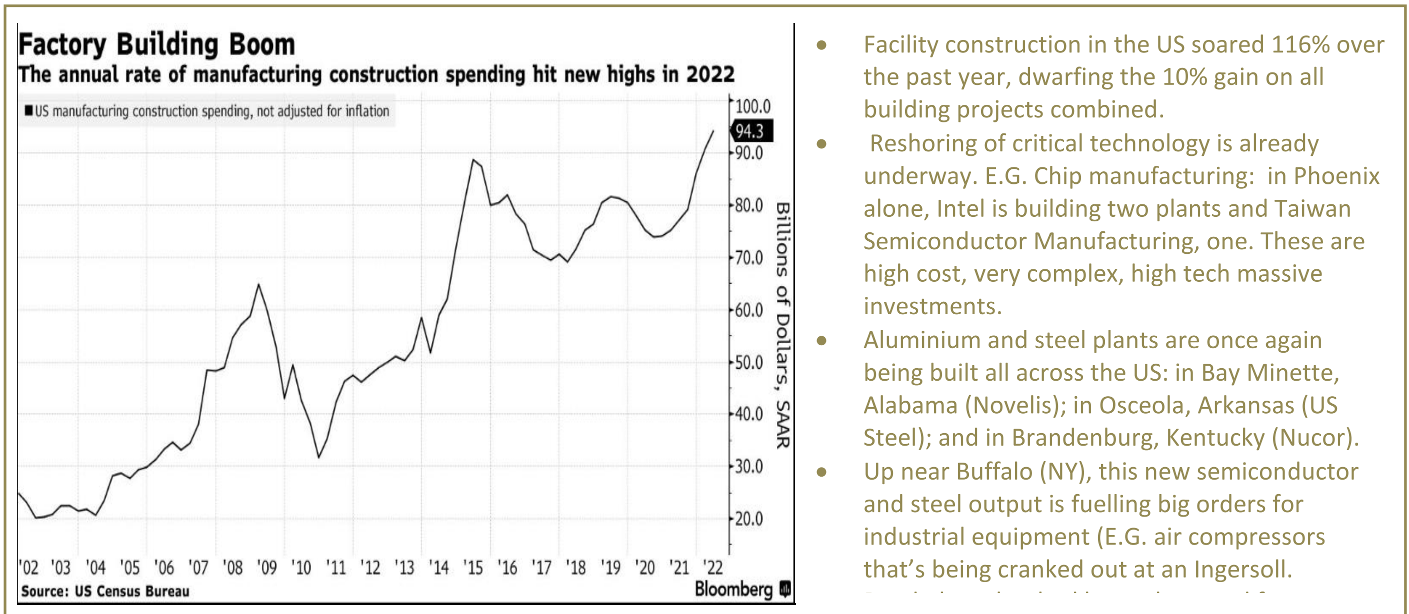
With Covid being normalised, oil prices steadying, container capacity expanding and becoming more efficient, along with congestion falling, what is the basis for high rates to continue?

Assertion 3: **Reshoring back to the West means higher prices.**

A Counterpoint. Mostly the evidence is surprisingly no, it does not. It comes down to what's being re-shored (incl. near-shored), and most goods are mainly higher-value/complex goods (e.g. technology). There is a strong argument that the positives already outweigh the negatives. This may also assist western economies increase resilience to geo-political events of the future, except for those few companies reliant on large revenues from nation states known for *abusing rule of law* and *international norms*.

- Multiple US tariff wars, Covid, Taiwan, Hong Kong, and now Russia – CEOs are adjusting their risk/reward calculations en-masse. (There's been exponential increases in both the number of corporations acting and those seriously planning moves)
- Re-shored goods by in large face lower transportation costs and delays, and less complexity.
- Higher technology inputs utilising higher skilled labour means wage price differentials are less than previously assumed in modelling.
- Automation of new plants is also reducing manufacturing-based wage pressures.
- No one is yet certain how much will return to major consumption centres (beyond strategic goods such as chip manufacturing and rare-earth mining) but indications are clear that it's a significant amount.

There are also emerging benefits, for example let's look at construction of new manufacturing facilities.



- Facility construction in the US soared 116% over the past year, dwarfing the 10% gain on all building projects combined.
- Reshoring of critical technology is already underway. E.G. Chip manufacturing: in Phoenix alone, Intel is building two plants and Taiwan Semiconductor Manufacturing, one. These are high cost, very complex, high tech massive investments.
- Aluminium and steel plants are once again being built all across the US: in Bay Minette, Alabama (Novelis); in Osceola, Arkansas (US Steel); and in Brandenburg, Kentucky (Nucor).
- Up near Buffalo (NY), this new semiconductor and steel output is fuelling big orders for industrial equipment (E.G. air compressors that's being cranked out at an Ingersoll.

Whilst part of this activity is in expanding capacity (something that's also not being well reported), a common theme is emerging -- the major re-assessment of supply chains in the wake of politics, bottlenecks, parts shortages, and higher oil costs. Let's look further at the response of big business.

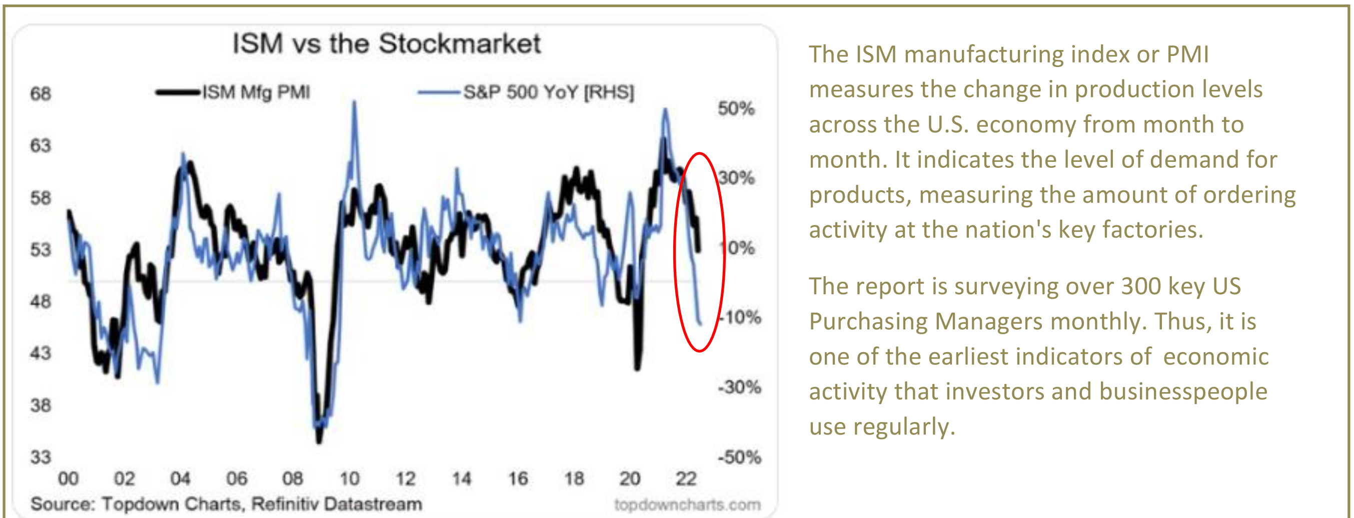
A UBS survey proves things are shifting fast. In 2022 it surveyed US, C-suite executives revealing the magnitude of the shift. 90+% said they were either already in the process of moving production out of China, or had firm plans in place. 80% were considering bringing some of this back to the US. (Mexico is also a popular choice.) It's worthwhile bearing in mind that the reestablishment of manufacturing in developed economies is supported by the meteoric rise in automation, eliminating many low-skilled, lower-paid jobs offsetting a shrinking workforce. Western factories today utilise a much smaller group of workers.

'Better and Cheaper' says Kevin Nolan, CEO at GE Appliances. "All this fretting about high costs in the US is overdone. It has been for years". Around 2008, he realized that on larger items – dishwashers upwards, the savings earned by eliminating overseas shipping could outweigh extra labour costs. Nolan discovered the key was in extracting high efficiency from the factory floor. Nolan began with a portion of GE's water-heater production relocating to Louisville. Other product lines soon followed. It's all been such a success for the company -- which is now, ironically, owned by China's Haier.

It's taken a pandemic for corporate momentum to emerge, especially as they properly factor in geo-political risk, having been absent for two decades.

Assertion 4. The US economy is faltering, and now from the Russian war, the EU is too

A Counterpoint: War is uncertain, but one of the two sides will eventually yield, perhaps even within the year. Markets as usual have already built-in the gloomier outcome. Headlines mostly focus on *single point in time* numbers or 'sentiment' to support their preferred negative view. The galvanising effect of Russian aggression for the UK, EU states, NATO and the acceleration of admission to both for new members; along with and new trade agreements with other nations, should not be discounted in post war recovery estimates**. Putin will surely go down in history as the EU & NATO salesman of the year**! Shifting to the US let's look at a prime economic indicator *over time* that tells another story than the consensus view.



The ISM manufacturing index or PMI measures the change in production levels across the U.S. economy from month to month. It indicates the level of demand for products, measuring the amount of ordering activity at the nation's key factories.

The report is surveying over 300 key US Purchasing Managers monthly. Thus, it is one of the earliest indicators of economic activity that investors and businesspeople use regularly.

As we can see, Investors are already expecting the US economy to contract, yet importantly *not to the extent* that it did during the pandemic, the GFC or the 2000 recession. Also note the **divergence of sentiment from reality** today versus history.

Despite all the rhetoric, US hourly wage growth is exceeding the inflation of goods and services (ex food and energy). Real wages are growing at (a moderate) 1.7% pace (see chart below), maintaining a healthy demand for labour and not too much of a concern for the Federal Reserve. Given the labour participation rate is low, there is little chance that we see wages driven inflation. This is what would concern the Federal Reserve, as unit labour cost growth is the real source of endemic inflation.

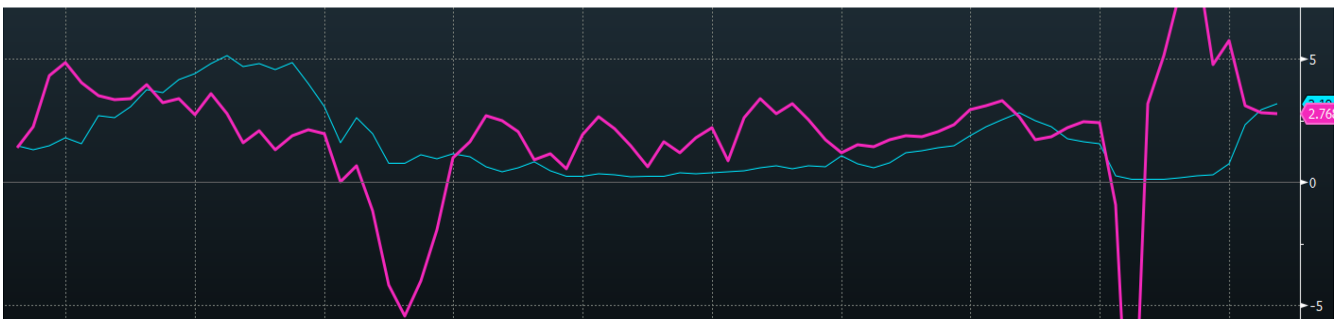
The underutilised employment market (low participation rate), positive real wage growth, robust consumer balance sheets (see chart below) and solid corporate balance sheets (as measured by interest cover/debt payback) **run contrary to a deep and protracted recession**. Poor outcomes across the above are prerequisites for a calamitous recession.

Markets typically look forward 6-9 months in setting prices. Therefore, it can be argued, that markets might well have another 5% fall to come, but it's more likely to be **a market of positive returns** six months and beyond.

Assertion 5. The big one- interest rates. The resumption of rising rates is firmly established.

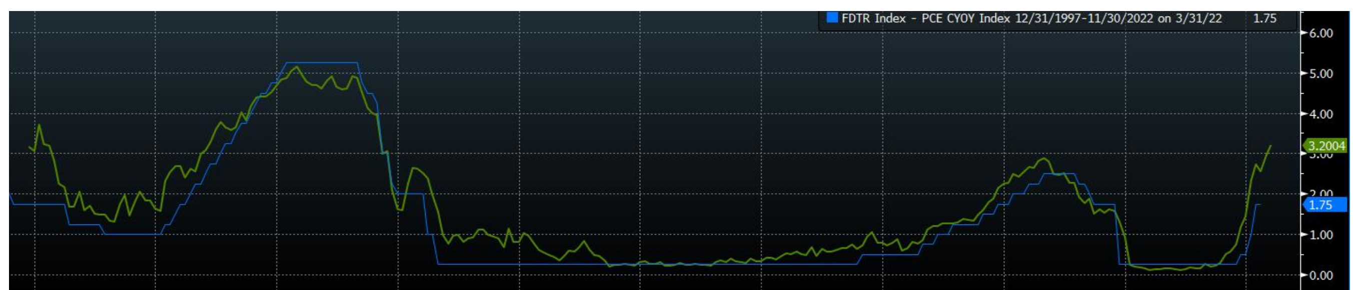
A Counterpoint: The chart below displays the US bond market's expectations for inflation after pricing energy, commodities, geopolitics etc. by bond markets into their rates. The top portion shows the next 5 years at 2.55% and the 5yr-10yr expectation at 2.14%. **Let's say that again… 2.55%** and **2.14%.** From this we can gauge the expectations for 10 years which currently stands at 2.35%.

Clearly interest rate rise expectations, where it counts, are rapidly declining which has implications for how much more the Federal Reserve is likely to tighten. Whilst there is sound basis to argue that the Fed Fund Rate is too low, it is unlikely to be lifted more than 3.5% due to the combined effect of slowing GDP growth and peaking shorter term inflationary expectations. Long term inflation averages a little over 3%, yet in the last 10 or so years, we got used to a once in a lifetime decade of ultra-low rates. Life, markets, consumers and companies adjust.



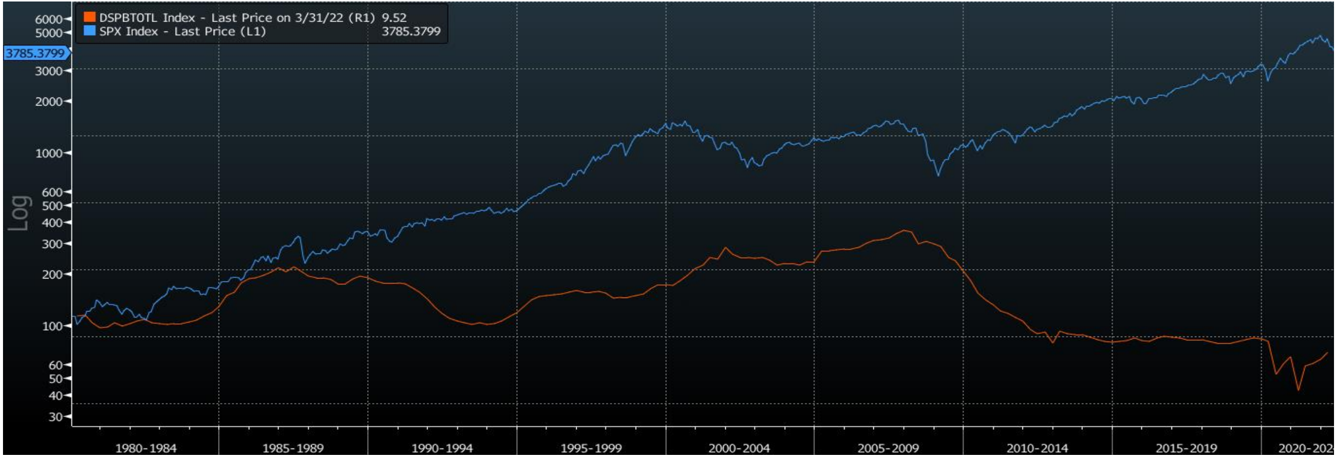
Longer rates: This is an Insync Funds internally constructed model above, the pink line (GDP growth & short term-longer term inflationary divergence) and the green line being the 2-year bond yield. This suggests that the Federal Fund rate (blue line in chart below) may not rise to the level anticipated by the 2-year bond yield.

Shorter rates: Below you will note that the 2 yr. Bond rate is expecting a further 150 bps of tightening, but as argued, even this short-term implied movement may prove to be too pessimistic. Green is 2 Yr US Bond rate, Blue is Fed Target Rate

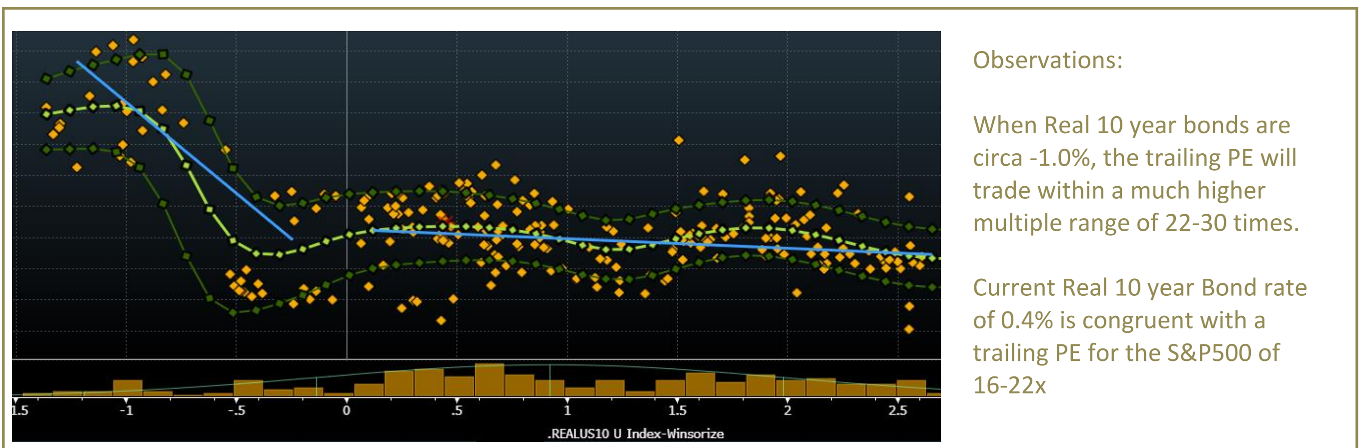


Even, James Bullard, a long-term Fed Governor, has expressed his desire to lift it to 3.5%. The cards are already on the table. As a result, it's more likely that they will not get to that level than lift it above 3.5%.

Isn't debt servicing going to be a real problem now for consumers? Given corporate balance sheets are in far better shape than in previous times such as the GFC, all eyes are on consumers. The orange line below tracks debt servicing cost as a percentage of household disposable income for the US consumer. Sitting currently at circa 10%, this is *significantly* below the 12% threshold that typically portends a consumer crisis. Historically, the economy and thus the S&P500 only undergo significant declines when this condition is met.



Price Earnings Ratio: Let's not forget that most beloved equity price indicator- PE ratios. Impacted heavily by interest rates, the downward quantum shift in Equity PE ratios, in response to a higher real 10-year bond yield, is now complete as can be observed below.



Has The Base Effect distorted inflations latest rise? When looking at bond rates below, it appears so. First a refresher on the Base Effect. This describes the danger of a percentage point headline result distorting how it's interpreted. In this case, the inflation number has experienced a significant increase from the past. When a number has previously been at a very low arithmetic value for some time, a small rise distorts the inferred interpretation of the result. Additionally, once a high rate has then resulted, after say 6 months (like where we are today), then to keep sustaining a high inflation rate, the increase now requires a larger input impact than the previous event. We can see no evidence for another, larger hit.

The chart on the previous page demonstrates that bond markets have concluded that the base effect makes it **unlikely that inflation can maintain above average rates for both the next five years** (bright purple) and the following 5 years (light purple).

A real-time observation when assessing the consensus view is that concerns are shifting slightly from inflation to the risk of recession and what that means for earnings. One should cast a thought to many of the recent beneficiaries of this year's volatility- 'consumer discretionary' (irrespective of their earnings) and ask themselves, what is likely to happen to their stock prices should recession eventuate?

So far, markets have suffered a **valuation de-rating** from fear of persistent high interest rates, and **not an earnings de-rating**. Investors are concerned with a policy error by the Fed that may tighten too hard at a time when inflation rates may be close to peaking and would likely come down quickly if the general economy slows.

All things considered, an asymmetrical outcome for equity markets result.
Equity markets have a lot more upside risk than downside risk when factoring in interest rates.

Overall Summary: Negativity moving forward, and the evidence do not match

1. Humans have an inbuilt bias to taking a single data point of today accompanied with implied negativity to then extrapolate this forward as a constantly increasing reason for more of the same.
2. Negative commentary is reflecting the present consensus but not the facts and data moving forwards.
3. This can lead to dangerous assumptions about equities over the next 6 months and beyond.
4. It would be easy to allocate away from equities and growth styles as a result, yet there remains strong information countering the inferred headline bias dominating discourse.
5. For inflation and interest rates to keep rising into the future as much as they to date, the counterpoints will have to significantly deteriorate. Yet we can clearly see concrete evidence that this is unlikely. Indeed energy and commodities as the major drivers in lifting inflation look set to steady, and not increase; this has a great impact on inflation across most of its subcomponents.
6. Economic activity may dip into a technical recession, but there is little supporting evidence for it being deep or prolonged.

Overall Conclusion: It could well be, once again, a game of two different halves.

Looking at the core drivers of inflation, it's hard to see price rises continuing as has been the case in the last year. Should the core drivers prices stabilize - inflation next year **would drop dramatically**!

There are compelling reasons to conclude that the very issues often quoted to support worse conditions ahead, will themselves find it very difficult to maintain their present trajectories. Remember the Base Effect.

Inflation in the last few decades has been abnormally low, and Insync is not alone in its view that as the current level will indeed retract, it's likely that it will settle around its longer-term norm. This is not bad for equity markets.

As the 5 commonly stated assertions for *maintaining a negative view on equities* are no longer supported with a more dispassionate look, then the next 12 months could well deliver **upside gains** 'surprising' equity markets, analysts, and portfolio asset allocators- along with most commentators.

So we leave you with this cynical final thought that's if it still 'feels' that more bad news is ahead, then ponder this table as we head towards Christmas 2022.

2nd half performance of the corresponding 5 worst 1st half returns in modern history (S&P 500).

Year	2nd Half % Change
1970	26.51
1962	15.25
1940	6.01
1939	15.01
1932	55.53
Average	**23.66**
Median	**15.25**
% Positive	**100.0%**

S&P 500 second-half performance after a first-half fall of 15% or more DOW JONES MARKET DATA

The S&P 500 did rise in each of those instances, with an average rise of 23.66% and a median rise of 15.25%.

Sources of information and facts used throughout this paper draw upon the graphs, data and research by:

Bloomberg Data, Bloomberg News, NBER, Dow Jones, Drewry, Freightos, IMF, S&P Global Platts, Top Down Charts (Callum Thomas), S&P 500 data, US Census Bureau, Our World In Data, Harver, JE Economics, Gap Minder Foundation, internal Insync FM I.P. Dodge Construction Network.

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