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B Capital Commentary and Outlook Update 2Q 2022

There were already risks on the horizon at the end of 2021. Each of those risks took on some weight as the first quarter of 2022 got underway, as inflation rose everywhere more than expected, and Russia invaded a neighbouring eastern European country in a more widespread attack than was anticipated.

The S&P500 benchmark index of American shares fell by -5.3% in January which was its biggest monthly decline since the start of the coronavirus pandemic in the first quarter of 2020. That was the weakest January since the nadir of the global financial crisis back in 2009. In fact, if it weren't for the last two positive trading days of the month, it would have been the worst January ever recorded for the index.

The FTSE All World stocks index, including dividends, dropped -5.1% in the first three months of the year, and at the same time, soaring inflation and tighter monetary policy wiped -6% off the Bloomberg Global Aggregate Bond index, leaving the tried and tested mix of equities and bonds in portfolios in a tricky position.

In the first quarter we have considered the rising risks to the global economy and progressively made changes to preempt a potential acceleration of the bearishness that has swept financial markets. Growth will still be above trend we believe but the rosier forecasts a few months ago need to be tempered with some caution.

Short-dated fixed income has been less affected which is as we expected. Equities remain the likely source of returns for the year but some tactical sector allocations may make sense to react to inflation pushing higher than first thought. At the regional level, we kept our overweight bias to the US which still looks a better bet than Europe, which many analysts had suggested would outperform having lagged over the last decade. In fact, with energy prices much higher and a spike in geopolitical risk, it looks like Europe could dip into recession before anywhere else.

A higher but still small probability of recession combined with hawkish policy maker comments are testing the nerves of investors after a bull market that has endured for some time longer than many thought possible. Volatility has picked up and EPS guidance has been marked down in the first earnings season of the year. One should remember however that CFO's like to lower guidance so that the earnings results come out with a beat versus analysts' estimates.

According to data provider Factset, while analysts were decreasing EPS estimates in aggregate for the first quarter, they were also increasing EPS estimates in aggregate for the next three quarters. The bottom-up EPS estimate for the second quarter increased by 1.6% (to $56.07 from $55.16) from December 31 to March 31. The bottom-up EPS estimate for the third quarter increased by 2.4% (to $59.23 from $57.82) during this same period. The bottom-up EPS estimate for the fourth quarter increased by 3.9% (to $60.59 from $58.31) during this same period. The full calendar year 2022 bottom-up EPS estimate increased by 2.0% (to $227.80 from $223.43) from December 31 to March 31.

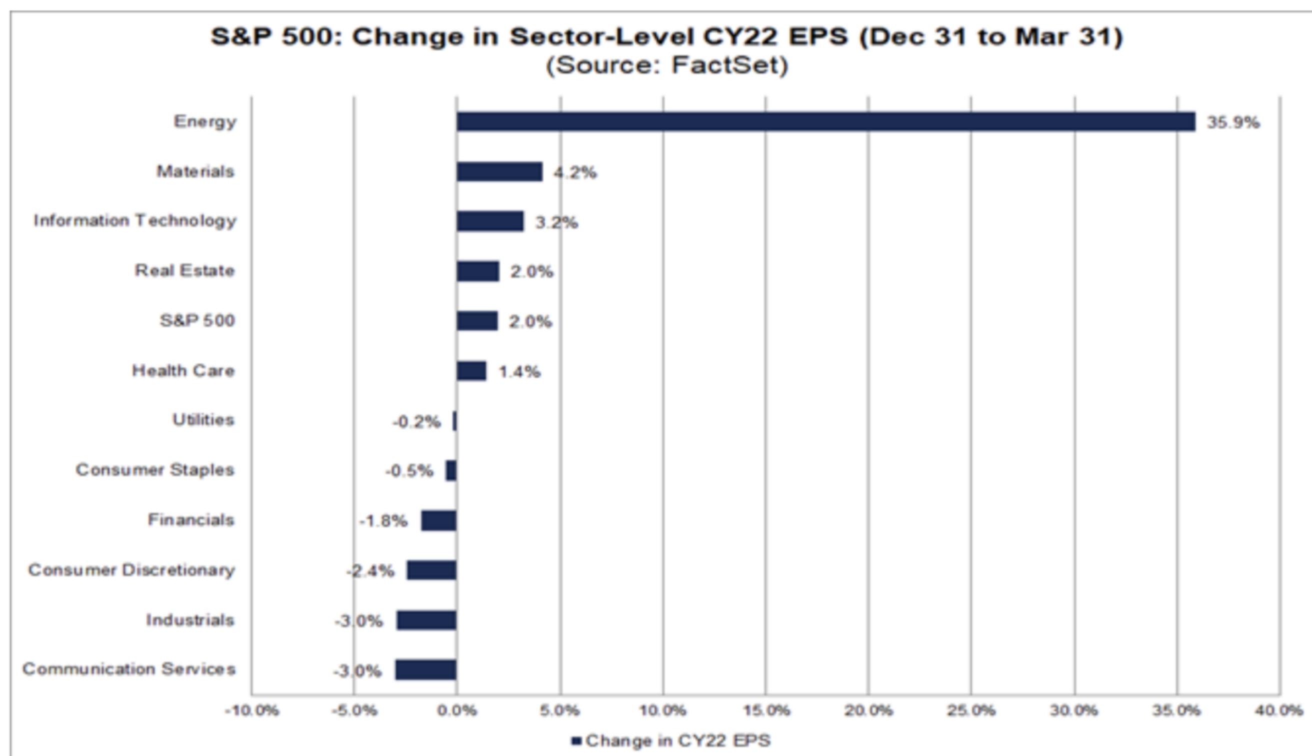

Fig 1 - S&P500 Sector Earnings Estimates, Changes For 2022

Source - Factset

To further analyse the data, if we attach an 18X PE ratio to the EPS estimate for the year we get an S&P500 Index level of 4'100.40. This is not a guide but it shows that the benchmark index is not in serious overvalued territory but may be trading a little rich by around 6%. The usual reminder that the power of compounding dividends still applies, so sitting out of the market can erode the value of a portfolio as time goes by. As ever, some diversification is wise and a combination of mainly large cap equities and short-dated fixed income will smooth the volatility and eventually lift portfolios back above their recent peak at the end of last year.

In the event of the two main risks highlighted earlier becoming even more serious, which could happen of course, we have also added where appropriate within our mandates to more precious metals and to cash. This is not to say we have become bearish but simply feeling that prudence is warranted and that we aim through our multi-asset class approach to be unconstrained and focused on delivering positive returns with no permanent loss of capital. Indeed we feel that markets will eventually ride out the worries of Q1 and we will see the evolution and survival of companies and consumers just as we did when the COVID-19 crisis hit in 2020.

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