ROCQ CAPITAL

Fourth Quarter 2021

The quarter started strongly in equity markets with more than 80% of companies in the S&P 500 beating Q3 earnings expectations, pushing the index to a new all-time high. That strength continued through most of November until the discovery of the new Omicron variant of COVID-19 later in the month, causing a swift sell-off. December then saw a 'Santa Claus rally' when concerns over the severity of Omicron were diminished as data came out of South Africa showing a generally milder impact. The cumulative effect of this was a strong move upwards in equities over the quarter, with leading developed market indices such as S&P 500 +11%, FTSE 100 +4.8%, Eurostoxx 50 +6.5%, and the broad MSCI World +7.9% (total return in local currency).

The strong performance of market indices hides the variation below the surface. Smaller companies in the US and UK underperformed over the quarter, with the move particularly pronounced in the US. The Russell 2000 returned 2.1% against the S&P 500's +11% as small caps sold off more aggressively before failing to rally following the Omicron news.

Whilst the UN Climate Change Conference (COP26) in November was generally regarded as falling short of the commitments required to avoid disruptive climate change it did see several announcements and commitments that were seen as encouraging. India's net zero by 2070 pledge and Sino-American emission cuts were highlights in that regard. Emerging economies remain resistant to prioritising the transition to clean energy over economic progress without support from the wealthier countries who have previously been most guilty of high emissions. The funding required to meet the 1.5C warming limit is enormous, with developed countries moving towards a spend of $100bn per annum on climate finance.

At their December meeting, the US Federal Reserve ('Fed') doubled their monthly tapering from $15bn to $30bn which, combined with the narrative from recent governor speeches, leads to the possibility of rate increases coming sooner and more frequently than previously thought. The existing expectation of hikes in 2022 saw shorter-dated two-year Treasury yields almost triple over the quarter, from 27bps to 73bps. With the 10yr barely changing (1.49% to 1.51%), markets created a bear flattening in yields, typically seen in the middle of economic cycles, and moderately bullish for stocks over the short to medium term. Credit yields moved up in tandem with government yields and unsurprisingly spreads widened at the same time as equities sold off on the discovery of Omicron.

In December, the Bank of England ('BoE') became the first G7 central bank to raise rates since the onset of the pandemic, adding 0.15% to the historic low of 0.10% as inflation pressures continue to mount. This was nevertheless a month later than expected by markets after a November hike was priced in. The coincidental timing with the discovery of, and uncertainty created by Omicron was unfortunate but with inflation high and rising, a tight labour market, and the potential for increased supply-side issues, the Bank was confident in its actions.

The primary driver of central banks hiking or intimating near-term increases is undoubtedly inflation. November's Consumer Price Index (CPI) reading in the US hit 6.8%, the highest rate since 1982, with the UK and Germany not far behind at 5.1% and 5.2% respectively, well ahead of the 2% level favoured by central

banks. Wage increases are stoking the inflation fire as employees switch jobs at an increased pace and employers are forced to pay up to hire and retain staff. Increased availability of remote working jobs as employers have become more flexible during the pandemic has created a hot labour market. Eventually, these costs will be passed on to consumers, driving more inflation. Consumer demand and supply chain issues also contribute significantly although some of these factors, particularly increased commodity and semiconductor availability in recent months, are cooling supply chain issues. Freight benchmark rates (as measured by WCI Composite Rate / 40ft box) have come off slightly since their peak in September, although remain over six times higher than their pre-pandemic levels.

Outlook

Omicron appears to be the catalyst for COVID to transition from pandemic to endemic. Cases have increased at a staggering rate but the positive result of that is a rapidly heightened level of 'natural immunity' which, along with ever-increasing vaccination rates, acts much like a rapid burn that spreads quickly before putting itself out. Governments must decide at what level they are comfortable for that to happen; we cannot completely eradicate the threat, so goals must be decided and compromises made. The influence this has on markets, and more importantly, the lives of the population, will continue to fade.

As we move through the first quarter, base levels for inflation will be notably higher than those seen before vaccine developments in Q4 2020, so we expect to see inflation numbers tapering somewhat, although remaining above central bank targets. Central banks will nevertheless try to make small increases to base rates – a strong economy historically provides a good opportunity and they will want to have ammunition in the case of another crisis, although we do not see moves being dramatic or reaching anything like pre-2008 levels anytime soon.

We remain confident in equity positions, particularly favouring those with strong earnings growth potential. Higher interest rates and inflation are typically positively correlated to earnings growth, with the underpinning cause a strong economy. Smaller, as yet unprofitable growth stocks have been sold-off in recent weeks as some struggle to meet optimistic earnings targets but the outlook remains positive for many, particularly in the technology and disruptive spaces. Larger, enormously profitable, consistent earnings growers will continue to form the backbone of exposures in portfolios. The current dispersion between the most expensively valued stocks in the S&P 500, and the least expensively valued, is near 25-year highs, so investing in high conviction managers who concentrate their positions in their highest conviction companies, remains an attractive approach.

Finally, and at risk of repeating ourselves, we see fixed income volatility to remain elevated. The industry standard measure, the ICE BofA MOVE Index, rose 30% in Q4. The Fed and BoE will continue to taper and increase rates absent a further crisis developing, moving rates and yields higher. We remain positioned in shorter duration holdings, combined with those strategies able to quickly and nimbly move their duration position around.