Equity Research; 2022 Round-up

COLLINS SARRI STATHAM INVESTMENTS

Research Report

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Analyst

Ravi Lockyer MSc Llb ASCI
Collins Sarri Statham Investments Ltd

Key Risks to Price Target

Not applicable

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A Tough One

According to Bloomberg, approx. US$18trn has been wiped off global equity indices during 2022. The MSCI World Index lost 19.3% in 2022 driven by a sharp uptick in global inflation which necessitated long overdue monetary policy normalization.

Source; www.msci.com

The Nasdaq Composite opened 2022 at 15,644.97 and has lost 33% as investors have shifted out of non-income earning assets.

Source;www.nasdaq.com

In the "*Everything Bubble*" writer Graham Summers documents that we are living in an era of 'serial bubbles' where assets experience bubble conditions created by the US Federal Reserve.

The thought process was carried on by Elliot Partners who claimed that an overly lax monetary policy had boosted all asset prices from commodities to crypto, from bonds to equity, from property to media rights.

Near zero interest rates were always a pleasant happenstance, a 'treat' that had to end one day – and it ended in 2022.

As the world moves on from ZIRP ("zero interest rate policy) investors, consumers and companies have to consider the impact of normalization on themselves. What are the new cash outflows? what debt load is appropriate in this environment? what assets can be used to reduce debt?

Reality checks have already occurred for highly geared companies. Investor exodus has occurred when boards have gone on acquisition sprees or debt binges or where debt loads need to fall, but there is no plan in place.

The US central bank's money printing binge over the C-19 pandemic period (2020 US broad money supply M0 + $3.38trn, 2021 M0 + $13trn) now looks excessive and has created significant inflation in 2022.

The ongoing tragedy of the Russia/ Ukraine war was the other major defining event of 2022. Leaked NATO, US and German intelligence suggests Russian President Vladimir Putin had been planning to invade a year before 24th February 2022. Media theories of Putin's various illnesses, none of which have been proved is a timely reminder that the information age is pregnant with disinformation.

What is clear is as long as Putin remains in situ – the rest of the world will maintain significant restrictions on the Russian economy. Historically sanctions have only achieved regime change in South Africa and have otherwise taken their time.

Bank of England Governor Andrew Bailey made the point 'that no-one knows what Putin will do next'. Hence geopolitical stress could remain a feature of 2023. As the war winds down over 2023 there are grounds for optimism that inflationary pressures will ease.

FTX – the crypto illusion ends

Crypto investors had thought themselves well versed in crypto risk factors. Money laundering, a lack of regulation, price volatility, key custody were major issues but somehow crypto buyers were fore-armed with counter arguments about the failure of 'fiat' paper currencies.

The collapse of FTX (the world's second largest crypto exchange) was the moment the veil was pulled back and crypto's ugly realities revealed.

The digital coin industry has had arguably a fatal knock. Around US$8bn of investor funds were wiped out by the 11th November collapse of FTX – a centralized crypto exchange, answerable to no-one, that created billions of imaginary money (FTT tokens) to prop up losses in FTX crypto proprietary trading at another group company Almeda Research – whose losses had been triggered by market sell offs in crypto currencies in response to the US Federal Reserve rate hikes.

Run by a team that could have come from central casting – living and sleeping together – FTX (once valued at US$32bn) bought Bahamian homes for employees and put the properties in their names.

FTX was a fraudulent operation that stole depositors' cash for as long as it was able to do so. Crypto backers start 2023 with the industry still unable to provide answers as to the myriad of credibility challenges now faced.

UK performance could have been worse

The 2022 performance of UK indices widely diverged. UK blue chips ended 2022 +1.7% whilst UK mid caps were -19.5%.

The UK blue chip outcome was respectable vs international peers and feels like a lucky escape. It is with a mix of relief and pride that despite its faults, UK blue chips ended 2022 up. This was thanks to strong performance from miners, and a number of top 20 companies, AstraZeneca, BAE, Diageo, GSK.

Mid caps have stabilised since the October fiasco. Its constituent population of retailers, insurers, challenger banks, housebuilders, investment trusts, travel, transport and services companies are all rate and FX sensitive industries. -19.5% masks wide sector divergence with banks and ITs holding up, but retailers, and housebuilders down >50%.

2022 domestic events came thick and fast, the 70th Jubilee, the sudden departure of PM Boris Johnson, the Truss arrival, the passing of Her Majesty, the Truss departure, ending the year with PM Rishi Sunak who has arrived at no 10 having only been an MP since 2015.

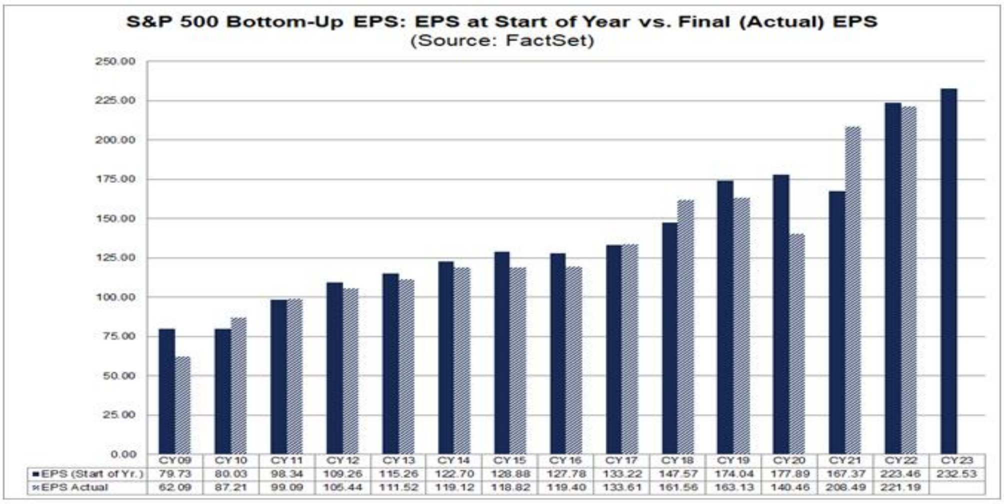
2022's 'must see' event was the Truss government's attempted re-run of the 1971 Heath/ Barber experiment of tax cuts in the midst of an inflationary spiral. Aware of the likely reaction to such policies, Truss bypassed the OBR, sacked senior civil servants, and refused to detail funding plans, so uprooting the UK's normal checks and balances.

The Truss approach of maverick populism happens the world over. The episode's silver lining is that here, when mistakes are made (the blue rinse brigade's choice of Liz Truss) and then realised they can be quickly reversed. So much for the 1922 Committee's rules on new PM's having 12 months grace. The Truss episode clarified how weary investors are of the UK's frequent political disruptions since 2016.

PM Sunak/ Hunt have restored confidence and credibility for now, imposing a raft of stealth taxes straight out of Gordon Brown's playbook.

As 2022 closes the Chinese government has lifted border/ travel controls at a time of a C-19 re-emergence in large urban areas. This looks again like a government stepping on the gas and the brakes at the same time. Or maybe China simply wants to export the pandemic all over again.

The US blue chip equity market fell 19.95%. Investors now expect 2023 EPS of $232.53, at year close of 3,839.50 this is a forward P/E of 16.51x. The index close is about 1,000 points below expectations at the start of 2022.



Source; www.factset.com

The Musk/ Twitter deal is similar to LBO deals that ended previous booms, KKR/ RJR Nabisco in 1989 and AOL/ Time Warner in 2000. If hubris had a name in 2022, it was Elon Musk. With just $2bn cash he purchased loss-making Twitter for $44bn using $13bn of bank debt and mortgaging his Telsa shares. Bloomberg now reports his $200bn losses are unprecedented.

We end 2022 with US long yields rising, and back above 4% in the UK. Market forecasts of a peak Bank rate of 4.5% might be right, but this is semantics. For US and UK mortgage rates, the damage is already done and consumer behaviour will adapt as rate fix hedges expire and cash outflows increase.

Conclusion

A tough year and rightfully so. Investors are now in a world where they can no longer rely on central banks riding to the rescue, the 'Greenspan put'.

A few pointers:-

a) 2023 starts with low investor expectations. Some hard lifting has been done in 2022, so a discounted market is a good place to begin.
b) Valuations have ended at 16.5x for US blue chips – a mid range rating
c) Geopolitical/ inflationary tensions are elevated and the path to peace unresolved
d) Alternative assets in particular crypto have failed to live up to their earlier hype of providing credible investment options
e) High levels of portfolio diversification remain important

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