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WHAT FOLLOWS ONE OF THE WORST JANUARYS IN HISTORY?

Key points

- The S&P 500 is on track for one of its worst January performances looking as far back as 1929. With only ten other years of a January fall of > 5%, similarities and differences can help us to understand what might lie ahead for investors over the balance of the year.
- Nine of the ten years observed saw the Fed tightening monetary policy either going into a frail January or during the year observed, as is expected to occur in 2022.
- In seven of those nine years, the S&P 500 proceeded to rebound during the following February to December to close the year above the end-January level.
- With the US economy not expected to fall into recession, triggering a pause in Fed tightening like in four of these seven episodes, we believe that 1977, 1978 and 2016 appear to be the best comparables for what may lie ahead for 2022.
- 1977 and 1978 in particular make for apt comparisons as the Fed kicked off its tightening cycle in 1977 only to accelerate it in 1978, similar to the Fed policy trajectory at end-2021 and as expected for 2022.
- Just as in 1977-78, we expect the S&P 500 to deliver 13-15% earnings growth during 2022 allowing it to drive returns should PE multiples stabilise in the months ahead.
- Such moderate, earnings driven returns paired with an elevated volatility profile suggest investors should use any respite to refocus portfolios on high quality, high visibility earnings streams. In addition, seeking opportunities to adding protection and asymmetric portfolio positions should also help cushion against the elevated drawdown profile that is common in the mini-cycle phase of the US economic cycle.

Global Investment Committee

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A look back: What triggered the January sell-off?

The S&P 500 is on track for one of its worst January performances looking back to 1929 having fallen nearly 9% at its low point for the month. Looking back to 1929, there have only been ten previous episodes of a fall of more than 5% putting January, 2022 in rarefied air.

While the most recent episode of such a large January drop was in 2009 in the midst of the Global Financial Crisis, a look across the decade of events highlights a number of commonalities as well as differences that can help us understand what might lie ahead for investors over the balance of the year.

Six of the ten years in which the January stock market performance was unusually weak – 1960, 1970, 1990, 2000, 2008 and 2009 – coincided with a US recession as measured by the National Bureau of Economic Research (NBER).

More telling, however, is that in nine of the ten years – the exception being 2009 – the Fed tightened monetary policy either going into the frail January or during the year observed, as is occurring in 2022.

Indeed, it is perhaps uncoincidental that markets began their swoon in early January, just as the Fed minutes of its December meeting were released revealing a much more hawkish tone.

This sharp pivot was seen in futures markets which have gone from pricing no Fed tightening in 2022 as recently as September, 2021 to the slowest Fed tightening cycle in history in November, 2021 to now, a tightening cycle that is faster than the cycles seen in either 1986 and 2016 (chart). Admittedly, markets have not yet priced aggressive tightening cycles as seen in 1994, 1999, or 2004.

What historically has followed a large January sell-off?

Encouragingly for investors, in seven of the ten years, the S&P 500 proceeded to rebound in February to December to close the year above the end-January level. Admittedly, in only four of those seven years – 1970, 1978, 2009 and 2016 – was the rebound large enough to recoup the full January losses.

Also reassuring for investors, two of the three years that the S&P 500 failed to rebound in February to December – 2000 and 2008 – came amidst a US recession, which we do not anticipate for 2022.

Tempering this optimism however, among the seven years in which a rebound followed the January swoon, in two of those years – 1939 and 1990 – the rebound was 1% or less and in another three years – 1960, 1970, and, 2016 – saw the Fed pause or outright pivot its tightening policy later in the year.

With Fed Chairman, Jerome Powell showing strong resolve to press forward with the FOMC's tightening agenda following the 24-25 January Fed meeting, US equities look unlikely to benefit from a pause or outright reversal of the current tightening trajectory at least at this point in 2022.

The remaining years include one weak and one strong February-December return period – 1977 and 1978. In both years, corporate earnings softened in January (falling 3-4% from December) before rebounding sharply through the balance of the year.

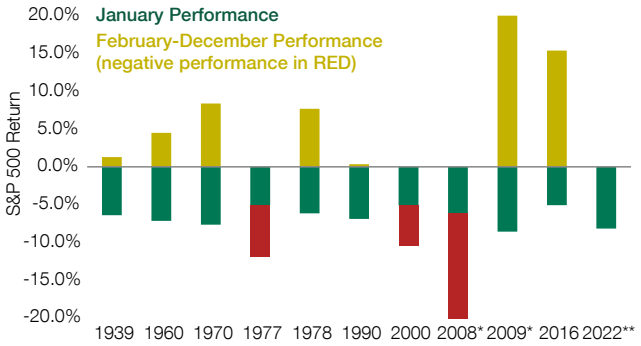
1977 saw S&P 500 earnings advance over 16% for the balance of the year while in 1978, the companies in the benchmark US index saw over 10% earnings growth in the comparable period. Indeed, this is similar to 2022 where S&P 500 earnings growth has shown little momentum in the early days of the reporting season, despite our expectation that overall earnings growth would rise from the current 8% consensus pace to closer to 13-15% by year-end.

The two years also share important economic parallels to 2021-22. Just like in 2021, the Fed kicked off its tightening cycle in 1977 before raising rates in earnest throughout 1978. Similarly, inflation, which was low and stable in early-1977, began to accelerate going into year-end before picking up further pace throughout 1978.

Importantly, what distinguished the two years for investors was that the S&P fell by a further 7% in 1977 while it rose almost 8% in the 1978 February to December period. With earnings growth robust, valuation developments held sway in both years over the balance of the year.

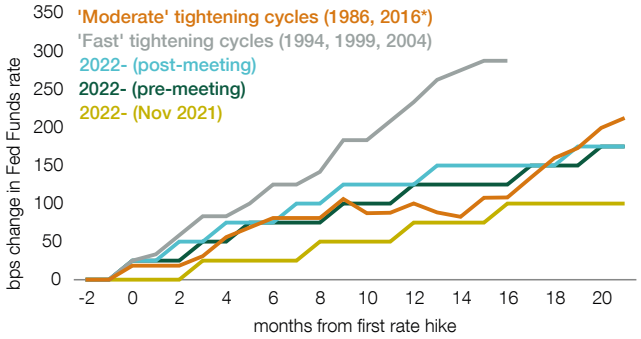
In 1977, PE ratios contracted 20% through the end of the year, more than overwhelming the strong earnings growth backdrop. In contrast, in 1978, valuations fell more modestly, by only 2% in February to December allowing earnings growth to take the lead in driving overall equity returns.

January, 2022 has been among the worst January S&P 500 performances looking as far back as 1929



Sources: Standard & Poor's, Bloomberg Financial L.P. and UBP * 2008 drawdown (-35%) and 2009 rally (+35%) cropped for scale ** 2022 S&P 500 return through 28 January

Futures markets have rapidly repriced a more aggressive tightening in Fed policy in December and January



Sources: Bloomberg Financial L.P. and UBP * 2022 data using Fed Funds futures

So, while history suggests that, more often than not, investors should expect a rebound following such a weak January equity market performance, a closer look into the intra-year economic and market dynamics suggests a more nuanced assessment.

The 1977 and 1978 periods offer the most analogous and admittedly, contrasting perspectives into how the balance of 2022 may play out for investors. Like in 1977 and 1978, we expect that investors can look to the 13-15% earnings growth that we forecast in the year ahead to be the anchor for their 2022 total returns. However, the trajectory for PEs likely will be the key driver for equities for the balance of the year.

How much risk remains to S&P 500 valuations?

The 2022 PE compression of nearly 11% that investors experienced at the January trough is already in excess of the modest 2% PE compression of 1978 though admittedly short of the 20% in 1977.

In 1977, as inflation started to accelerate and Fed policy began to respond, US 10-year yields kicked off their rise in 2H77, much as was the case in 2H21. S&P 500 PE valuations however, moved earlier and more aggressively in pricing the prospect of higher yields throughout 1977, driving the PE compression beyond the actual decline in yields.

Indeed, by 1978, S&P 500 PE ratios were pricing benchmark US Treasury yields that were almost 100 bps higher than the 8% market yields at the time. This allowed S&P 500 PE ratios to stabilise in 1978 despite Treasury yields rising to those 9% yields implied by the markets in January of that year.

While 2021 did not see an overly aggressive re-pricing of Treasury yields (chart), the 11% PE compression in January 2022 leaves S&P 500 valuations beginning to price in our expectation of a 2-2.5% 10-year Treasury yield in 2022, about 20 bps above current market yields.

Should our expectations prove correct, 2022 may replicate 1978 in which Fed policy rates and 10-year yields can both rise while S&P 500 valuations, which are beginning to fairly price the interest rate prospects ahead may instead stabilise and allow earnings growth to emerge as the driver to total returns looking ahead.

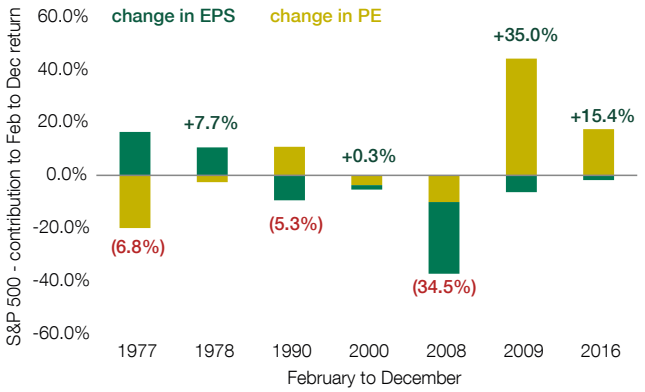
What is the risk of more aggressive Fed action?

Admittedly, with elevated and sticky inflation, the key risks to this outlook centre around the reaction function to the Federal Reserve policy trajectory.

In particular, while markets have repriced the Fed tightening prospects to be even tighter than seen in either 1986 or 2016 (see page 2), the adjustment still falls short of the 1994, 1999 or 2004 tightening cycles.

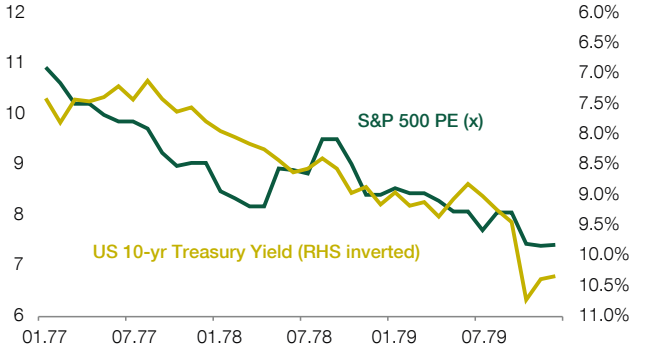
However, to look at policy only through the lens of Fed Funds rate changes underestimates the Fed's expected impact on the economy in the post-Global Crisis Era. With quantitative easing (growing the Fed balance sheet via Fed bond purchases) providing additional easing impetus when Fed Funds rates fall to zero, quantitative tightening (shrinking the Fed balance sheet) provides another avenue to tighten policy not available in pre-GFC cycles.

1977 and 1978 provide the best comparables to what may lie ahead for investors in 2022



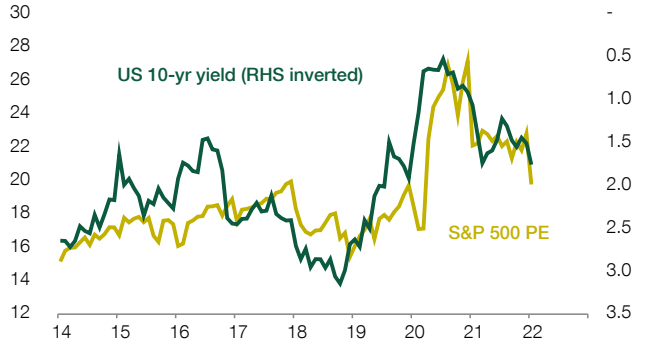
Sources: Standard & Poor's, Prof. Robert Shiller, Yale University, Bloomberg Financial L.P. and UBP

S&P 500 valuations repriced the higher yield environment in 1977 faster than the bond market…



Sources: Standard & Poor's, Prof. Robert Shiller, Yale University, Bloomberg Financial L.P. and UBP

…similar to what appears to be happening in the S&P 500 in early 2022



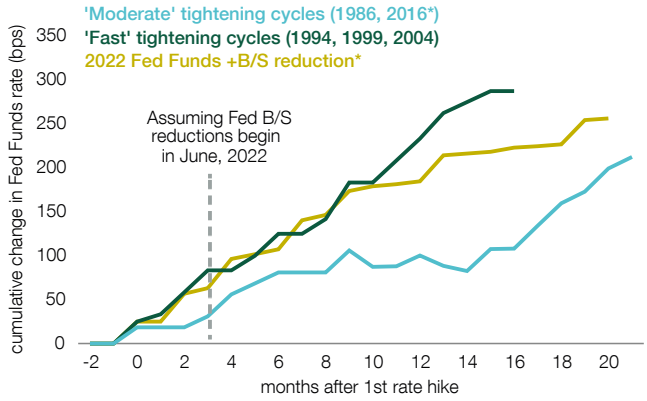
Sources: Standard & Poor's, Bloomberg Financial L.P. and UBP

With the Fed having outlined its preferred quantitative tightening framework – by allowing maturing bonds to drive the shrinking of the Fed balance sheet – using the 2017-18 reaction, it suggests that the balance sheet reduction programme outlined in January could add the equivalent of an additional 50 bps increases in the

Fed Funds rate by year-end and a total of an added 80 bps in Fed Funds by end 2023.

Putting this into the context of previous rate hiking cycles, it would leave the 2022 tightening cycle priced by the Fed Funds futures markets combined with the balance sheet reduction plan outlined by the Fed at its January meeting as the most aggressive post-1970s, tightening programme outside of 1994.

Futures markets combined with the Fed's B/S reduction plan = a historically aggressive tightening cycle



Sources: Federal Reserve Board of Governors, Bloomberg Financial L.P. and UBP *based on the Principles for Reducing the Size of the Federal Reserve's Balance Sheet, Federal Reserve Board of Governors (26 January 2022)

With the markets and the Fed's balance sheet and Fed Funds rate trajectories having shifted from the slowest to among the fastest tightening cycles since the 1970s, it suggests that an upside surprise to a 1970s-style acceleration in inflation may be needed to create substantial further tightening risk ahead of what is currently priced in by markets.

What should investors do from here?

Admittedly, while our base case has inflation peaking in 1H22 and easing going into year end, as seen in 2021 (when consensus expectations were similar), risk does exist that supply chain issues prove more persistent or already elevated energy prices are subjected to further supply shocks.

Indeed, mid-2021 expectations for 'transitory' inflation followed by a peak and slowing in inflation in late-2021 have already fallen by the wayside. In a similar fashion, current expectations for a 2nd half, 2022 easing in inflation may likewise turn out to be misplaced.

With these uncertainties, investors should still look to pro-actively manage the risk that a 1978-style, earnings driven outcome may still be overwhelmed by potential further PE compression ahead.

Indeed, with economic data signalling easing but not a significant slowdown in growth momentum, we continue to believe that the US economy sits in the midst of its mini-cycle phase following the pandemic-era economic recovery (please see Preparing for the Start of a Mini-Cycles, June 2021 for more details).

Indeed, drawing from these mini-cycle episodes and given the uncertainty that has emerged in markets in recent weeks, a focus on improving the underlying quality of corporate earnings making up equity and bond portfolios will be important to weather the elevated volatility that is common during these mini-cycle phases.

Moreover, given the admittedly rising risk of a policy error on the part of the Fed or other central banks and fiscal authorities around the world, as highlighted in our 2022 Investment Outlook, Embracing Change, pairing a quality focused bottom-up stock and bond selection strategy with an overlay of proactive risk protection against another round of January-like volatility looking ahead appears a prudent course of action in light of the modest return, elevated risk profile of markets even in a 1978-style outcome.

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