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Economic forecasts are not likely to dictate market returns

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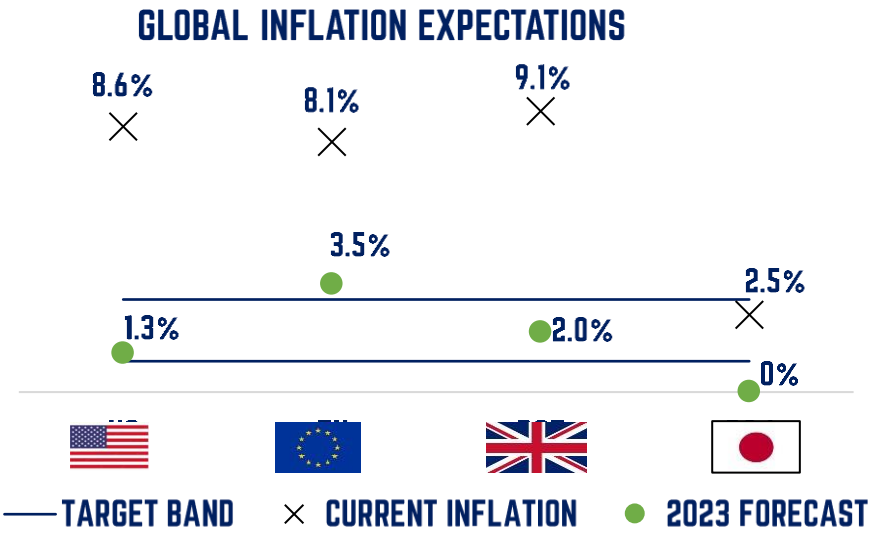
Market chatter about a possible recession intensified during the month after the latest economic indicators suggested that inflation has yet to peak. US inflation hit 8.6% in May, exceeding analyst expectations of 8.3% and making it the hottest inflation print in over 40 years. COVID-19 related supply chain disruption in combination with the invasion of Ukraine have driven energy prices up, with food prices trailing not too far behind. Consumers everywhere are feeling the squeeze as there are limited signs of the macro environment improving in the near-term and many analysts are starting to forecast a recession, with a consensus probability of 33% in the US according to Bloomberg.

As illustrated by the graph below, the most recent inflation prints have been some of the highest we've seen in decades across the globe, and well above central bank target ranges of between 1% and 3%. In response, the Fed took historic action, hiking interest rates 0.75% (their largest since 1994) and reaffirming their intent to continue to use aggressive monetary policy to get price increases under control. Although they have little impact on energy or commodity prices, interest rates play an important role in influencing aggregate demand. Increasing rates typically result in a lower willingness to spend, which in turn reduces the demand for (and hopefully the cost of) goods and services.



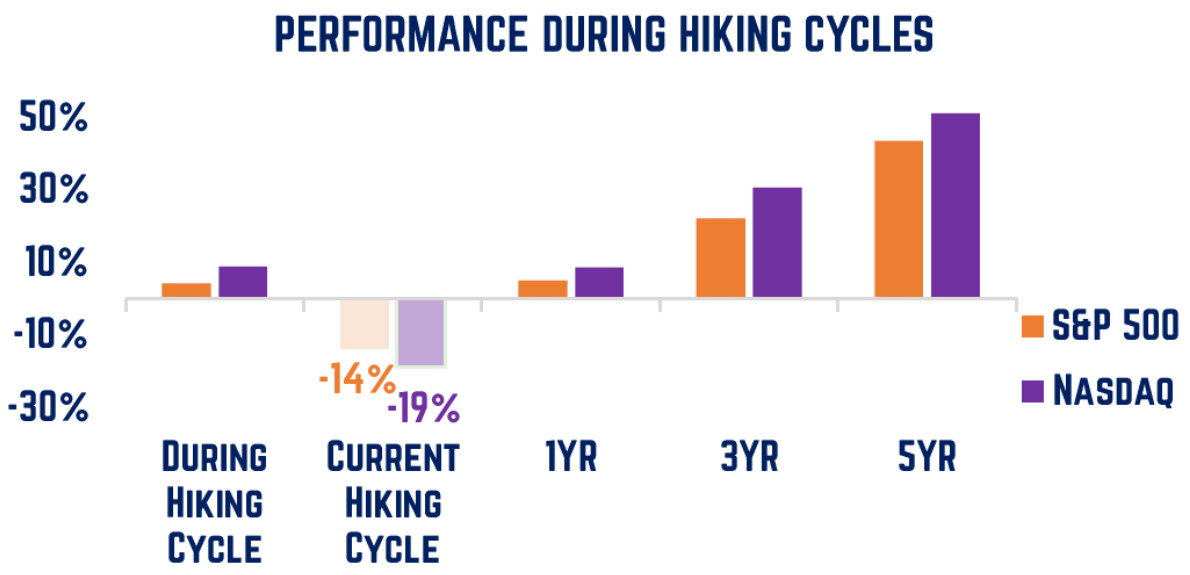
Source High Street, Bloomberg

This strained macro backdrop has weighed heavily on investor sentiment and spurred a risk-off environment, resulting in global capital markets, and particularly growth style investments having a torrid first half of the year. In May, US stocks and bonds entered into a simultaneous correction (more than 10% down) for the first time in 50-plus years. At the time of writing, the S&P500 is down around 18% year-to-date and the tech-heavy NASDAQ Composite down around 26%.

This has prompted understandable worry amongst investors given the uncertain outlook. However, using history as a guide can provide a degree of reassurance that economic forecasts alone are not likely to dictate market returns in the longer run. The graph below shows the average S&P 500 and NASDAQ Composite performance during the last 12 rate hiking cycles, dating back to 1971. We define a rate hiking cycle as an increase of 100bps or more in the Fed funds rate over a 12-month period and mark the end of the cycle after a 12-month period of a stable or declining Fed funds rate. Interestingly, both indexes have produced a positive return, on average, during previous tightening cycles. While the current performance contradicts this trend, the rate hikes have only just begun and will likely persist for the foreseeable future as the evolving inflation outlook becomes a growing concern for the Fed.

Nevertheless, the market continues to speculate as it attempts to price in the intensity and frequency of rate increases within the current cycle. This could paint a positive picture for the market in the medium term since, if history is anything to go by, returns tend to be stronger towards the back end of the Federal Open Market Committee's (FOMC) moves.

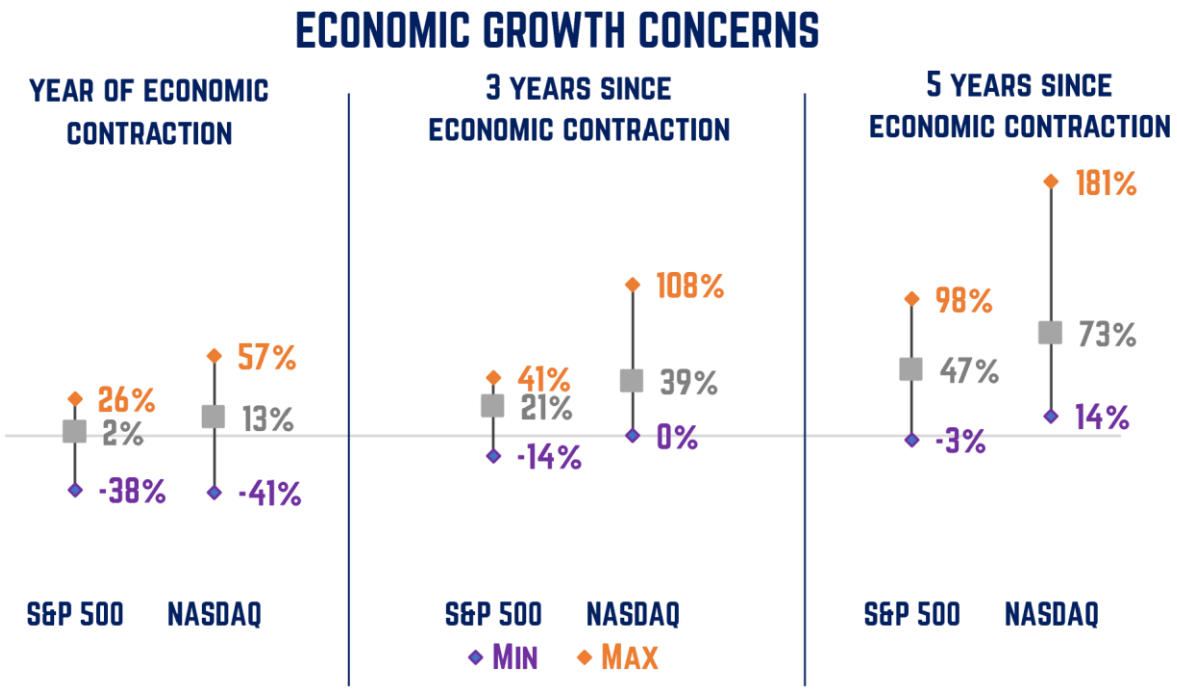
Further indications that the current weaknesses might pass can be garnered from the average one, three and five-year performances from the onset of the rate hikes. If anything, this implies that short-term volatility in tough macro conditions is only temporary, and that it pays to remain invested throughout these challenging periods.



Source: High Street, Bloomberg

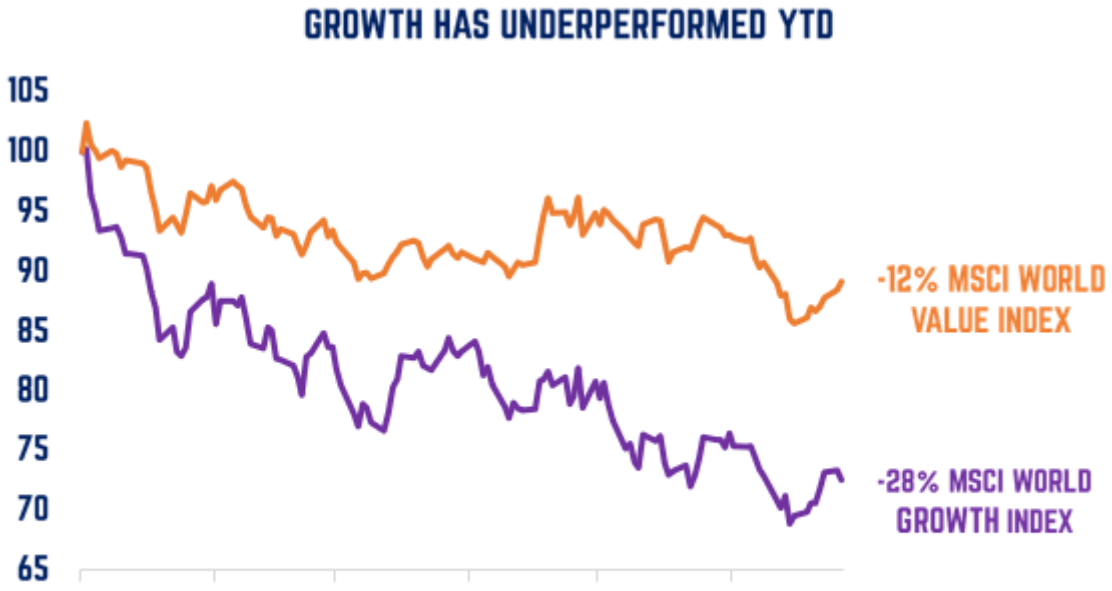
Economic growth concerns are also at the forefront of the narrative and there is a significant amount of uncertainty regarding how many rate increases the US economy can withstand without sliding into a recession. A consequence of rate hikes comes in the form of slowing economic growth; if demand is destroyed by too great a degree, the economy will move into a recession. This puts central banks in a difficult balancing act between making a meaningful dent in the spiralling cost of living and protecting unemployment and the economy. A sustained downturn can be extremely harmful for unemployment, asset prices, and investment. However, they don't have to be ruinous – a short-lived dip in economic growth can lead to a fast-paced, V-shaped recovery.

The chart below shows the performance of the S&P 500 and NASDAQ in the year of an economic contraction (negative real GDP growth) as well as the performance in the proceeding three- and five-year periods. There have been six such corrections since 1971. Taking an average of these, the S&P returned 2% and the NASDAQ, 13% in the year of the contraction and we see the subsequent returns gather pace in the proceeding three- and five-year periods, with the NASDAQ (or a growth bias) significantly outperforming the S&P 500.

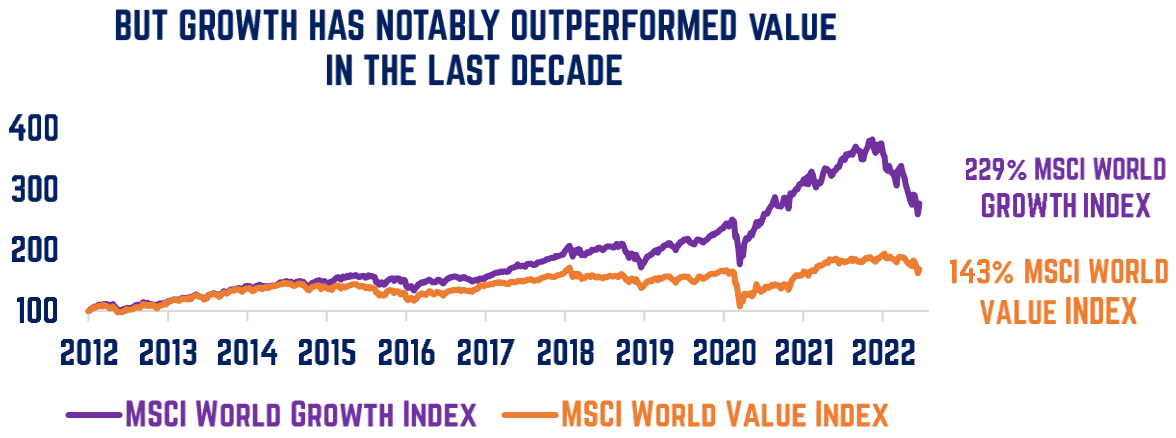


Source: High Street, Bloomberg

This reinforces the story behind growth style investments, which have significantly outperformed value over the past decade. The MSCI World Growth Index and the MSCI World Value Index achieved total returns of 229% and 143% respectively over this period. Although growth has been out of vogue since the start of 2022, assessing historical trends can hopefully help to ease some investor concerns and circles back to the old investing adage that “it is not about timing the market, but about time in the market”.



Source: High Street, Bloomberg



Source High Street, Bloomberg

At High Street, we simply see growth as too cheap at these levels and have positioned our Wealth Warriors Fund well for recovery in a trend which we expect to resume over time. The focus of the Fund is on cutting-edge themes which we anticipate will shape the future of the world. Our conviction in these companies remains high given their strong long-term prospects driven by solid competitive moats, ability to scale, strong margins and therefore cash-generative abilities. This provides a considerable runway as they operate in early-stage sectors such as cyber security and data processing.

Glacier Research would like to thank Vicky Kan & Christopher Brownlee for their contribution to this week's *Funds on Friday*

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