Market overview 2022

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Well, 2022 is finally over and, from an investing perspective, one can only say “good riddance”. Sure, some energy, materials and value investors made out like bandits during that period but, generally speaking, the places to hide were few and far between. Most asset classes besides commodities were down double digits, be they bonds, equities or listed real estate. Need we mention cryptocurrencies?

In some ways, one could argue that it was a good thing that the bulk of the excesses was localized in the most speculative parts of the financial markets, such as SPACs, non-profitable companies, meme stocks (see AMC, Tesla, Bed Bath and Beyond, etc.) and, most notably, cryptocurrencies (a few more words on these later on). It also helped that, although substantial, all these investments taken at their peak valuations were nowhere near big enough to cause a systemic failure in financial markets, as subprime mortgages did back in 2008. So, while the damage was substantial, it was not so severe as to impact the real economy too violently.

In fact, none of the big developed economies are currently in a recession, with the US posting impressively strong economic numbers. One could argue the US economy is desperately short of workers, due to excess deaths, low immigration, Covid-19, and the ongoing child-care crisis. Meanwhile, there are 10.5 million open jobs. In this context, low unemployment claims and continued job growth shouldn't surprise anyone.

A majority of economists and investors now expects a coming recession combined to relatively high and sticky inflation. Never mind that, twelve months ago, the exact opposite was expected for 2022. It seems that, if a recession were to happen, it would be the most anticipated and pre-announced recession of all times. It also seems that, contrary to expectations inflation is, in fact, less sticky than expected, even in Europe.

We therefore still believe we continue witnessing the aftershocks of the pandemic that started in March 2020 and that upended most of the world economy. For those who are, for example, wondering how inflation can be falling when the unemployment rate is still so low, we believe this is because the tight labor market wasn't the primary cause of the surge in inflation in the first place.

But then how about the yield curve inversion, which is generally seen as a clear indicator of a coming recession and one with a perfect track record? Just to track back, an inverted yield curve means short-term interest rates (in particular the 3-Month and the 2-Year rates) are at higher levels than long-term interest rates (in particular the 10-Year rate). This inversion implies that bond investors, who are supposedly much more astute than equity investors, are betting on a near-term recession. They therefore want to secure their assets and buy long-term government bonds. This increase in demand pushes long-term bonds’ prices up, and since a bond’s rate is an inverse function of its price, long-term rates drop and go below short-term rates.

This is a signal we pay very close attention to, as it has helped us navigate the tricky markets of 2000-2002 and 2008-2009, when similar inversion occurred beforehand. Nonetheless, we could not be convinced that this signal, this time, was as powerful as the preceding ones, because of our analysis that this was a very specific situation due to the pandemic. It is still difficult to ignore such a powerful signal and it rarely pays to believe that "this time is different", but we were encouraged to see that none other than the creator of this indicator, US economist Campbell Harvey, is on the same side ("Economist Says His Indicator That Predicted Eight US Recessions Is Wrong This Year", Bloomberg). As always, time will tell. It would be surprising, however, to witness a recession when everyone is expecting one.

As for cryptocurrencies, the FTX fiasco has probably not escaped your attention. As a reminder, FTX was the second biggest exchange in the world for cryptocurrencies and, for a brief period of time, its founder, Sam Bankman-Fried, was among the richest men in the world. Venture capital firms competed to fund the company without much due diligence and politicians vied for the contributions the firm was so generous in making. However, the collapse was not long in coming. For the collectors among you, we suggest buy the Mercedes AMG Formula 1 Team hat with the FTX logo on the side, they will probably become as much sought after as the Enron or Lehman Brothers hats in the future.

It seems astounding that Sam Bankman-Fried had explicitly stated back in spring 2022, in a Bloomberg podcast, that what he was offering was basically a Ponzi scheme. The most striking part of the whole story is that, although this scam happened in the supposedly high-tech world of crypto, it is a scam that could have happened 300 years ago. As always, people will wonder after the fact how something so unbelievable could have happened with so little due diligence done by investors (among which were all the biggest venture capital firms of the world) but this is a story as old as financial markets, whatever the underlying may be. As Charlie Munger (Warren Buffett's partner) has said many times, "greed doesn't drive the world, envy does". Nothing could be truer in this case.

So, yes, some people will go to prison but, essentially, this blowup should mark the end of the current era's exaggerations. Sure, there is still some mopping up left to do, such as Tesla, which is down 72% from its highs (but probably still way too high) but, all in all, the majority of the purge has already happened.

As for the equity markets, we had noted three months ago that:

> *"at some point, markets have digested most of the bad news and start to rebound well before good news start to show up."*

Well, now that Q4 is done, we can actually fact check this and note that, broadly speaking, the October bottom was, in fact, the bottom for now. What is more surprising is that European markets rebounded much more strongly than US markets since then and that this trend continues in the new year. Interestingly, the weakest performer since the October bottom is the Nasdaq 100, which is still pretty close to those levels (but hasn't breached them). This is not necessarily surprising as most tech mega caps are struggling and also because Tesla has lost almost 50% of its value since the October bottom (so, not a bottom for Tesla) and Apple has also been acting very weak since then.

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The surprising European outperformance just goes to show, if that was needed, that financial markets are utterly unpredictable, since many investors decided, last year, to adopt a more US-centric investment to skirt weak European economic performance and most banks strategists adopted the same approach.

Markets are chaotic and non-linear, which makes them by definition unpredictable, in particular over the short-term. We know that, historically, the companies we invest in generate an economic return of about 12 to 18% per year. Now, let's be very clear: over the short-term the stock performance, which is chaotic, can differ widely from the underlying economic performance, both up and down. In 2021, stock performance overshot economic performance and, in 2022, stock performance undershot economic performance. 2021 had been, if such a thing exists, "too good" and that this meant a somewhat lower performance for a while in order to digest these gains. We didn't expect this would happen in just nine months and so violently, but the digestion is now done and more normal returns should be expected going forward.

So, we now begin a new year with just as many questions, unknowns and dangers as the one before that. As we have seen last year, short-term moves in the markets are unpredictable and so we will not try to forecast much. What we do see is that the exuberance of late 2021 is completely gone and instead has been replaced by fear, loss aversion and very low risk appetite. In such circumstances, 2023 could surprise to the upside…