TALARIA

CERTAINTY EMPOWERS YOU

February flash note

February 8, 2022

Summary

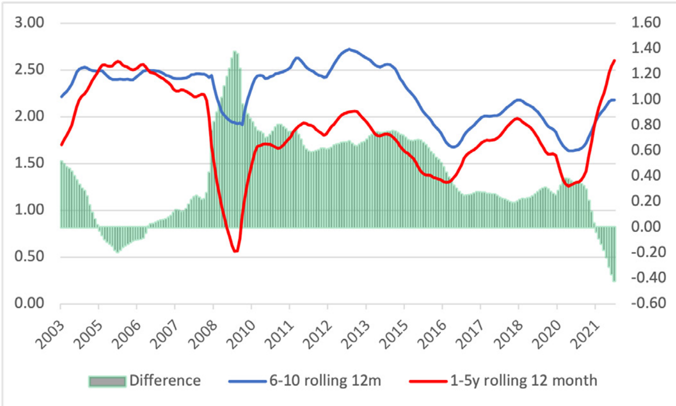
- What matters is not whether the market cycle will change but how an investor is positioned if it does.
- Judging by US bond prices, markets are expecting little or no variation from the status quo, confident of low average inflation over the next decade.
- In a related point, concentration risk through over-exposure to US, Tech and Growth equities remains high when there are good opportunities outside the US, away from Tech and in Income.
- January's weakness was a reminder of the implications of a failure to diversify.
  We continue to advise diversification by region, sector and return type, amongst others.
- It may seem oxymoronic to talk of forty years of recency bias, but that's how long investors have been conditioned to buy the dip – adding further danger if things have changed.
- Talking of conditioned behaviour, the default portfolio has been suffering; the Bloomberg US 60:40 Index had its worst month since March 2020.

US bonds price in low average inflation for the next decade

There is good evidence that financial markets remain largely unmoved by the idea that a pick-up in US inflation will be anything other than modest.
This view is supported by twenty years of data from the St. Louis Fed which provides measures of average expected inflation over the next decade. Highlights from the chart (next column):

- Average inflation priced into US bonds for years 1-5 is 2.6% and years 6-10 is 2.2%
- Although 2.6% is the highest (just) over the period, the 10 year is well within the range.
- It's unusual for near-term to be priced higher than long-term inflation and the difference between the two has not been wider over the period
- This suggests that the market is confident of the Fed correcting a modest short-term policy error.

US Treasury Market average inflation expectation for years 1-5, 6-10 and the



Source St. Louis Federal Reserve, Talaria

Diversify…

Despite a strong rally in global equity markets at the end of the month, January's overall weakness and pronounced volatility were an effective reminder of why it pays to diversify.
We're pleased to have been a broken record on this theme since April 2021: diversification has been called the only free lunch in investment and taking advantage of it is vital.
Despite selling on good volume, too many investors are still over-exposed to US Tech in particular and US equities in general. Concentration risk, the risk of loss from everyone owning too much of the same thing remains high and whilst a lot of energy is spent on forecasting, not enough is spent on positioning (who owns how much of what).
Using one of our favourite diversification analogies, don't ask yourself if it's going to rain, ask yourself if you have an umbrella in case it does. January was only a light shower in the context of the benign climate for equity investors since the GFC, but it was uncomfortable enough to show that umbrellas serve a purpose.

TALARIA

CERTAINTY EMPOWERS YOU

February flash note

February 8, 2022

...By region, sector, and component of return

There are numerous ways to diversify but within equities and for the purpose of this brief report we want to highlight three: by region, sector and return type. There are good opportunities outside the US, away from Tech, and in income rather than capital growth.
Looking at local currency performance in January (table to the right):

- European stock markets outperformed the S&P 500 whilst the Nasdaq Composite underperformed, having its worst month since November 2008.
- Information Technology and Consumer
- Discretionary (includes Amazon) were the worst sector performers whilst heavily under-owned Energy and Finance were both strong.
- The US Value Line Dividend Index, an income rather than a growth basket, also outperformed the S&P 500 and the Nasdaq.

Our investment process is bottom-up but, reflecting where we are finding opportunities, it is underweight US and overweight Europe and Japan, underweight Tech and overweight Health Care with exposure also to a range of other sectors. It goes without saying that we are heavily exposed to income, though we would humbly highlight that we delivered capital growth over January as well.

Selected Performance* and Valuation Data Region, Sector, Return Type

	January Change	Change relative to S&P 500	Current Year PE x (est)
REGION			
NASDAQ COMPOSITE	-9.0%	-3.7%	28.9
NIKKEI 225	-6.2%	-1.0%	16.7
S&P 500 INDEX	-5.3%		20.4
STXE 600 (EUR)	-3.9%	1.4%	14.9
SECTOR			
CONS DIS	-11.3%	-6.1%	23.3
INF TECH	-11.2%	-6.0%	27.6
TELCO	-8.3%	-3.0%	18.6
HLTH CARE	-8.2%	-3.0%	16.8
INDUSTRL	-8.0%	-2.7%	18.6
MATERIAL	-5.2%	0.0%	12.3
UTILITY	-4.5%	0.8%	18.6
CON STPL	-3.6%	1.7%	20.8
FINANCE	-0.4%	4.9%	12.8
ENERGY	15.0%	20.2%	10.4
RETURN TYPE			
VALUE LINE DIVIDEND INDEX	-2.8%	2.5%	n.a
BLOOMBERG 60:40 portfolio	-4.2%	1.1%	n.a
Talaria Global Equity ETF			
TLRA	2.9%	8.2%	n.a

Source Bloomberg, FactSet, Talaria *In local currency

Buy the dip risk: recency bias forty years in the making

We see danger for investors inclined to use the heavily favoured ‘buy the dip’ strategy to take advantage of weakness in broad US indexes. It may seem a contradiction in terms to talk of forty years of recency bias, the behavioural tendency to believe the future will reflect the recent past.
But in the context of financial markets, forty years is not long and in the last forty years investors have been conditioned to expect falling interest rates and an accommodative Federal Reserve to underwrite buying on weakness.
The result is that the S&P 500, for example, is now in the perilous position of being at an exceptionally high valuation at a time when interest rates, and indeed the so-called Fed put, can no longer be relied upon to come to the rescue (chart overleaf).

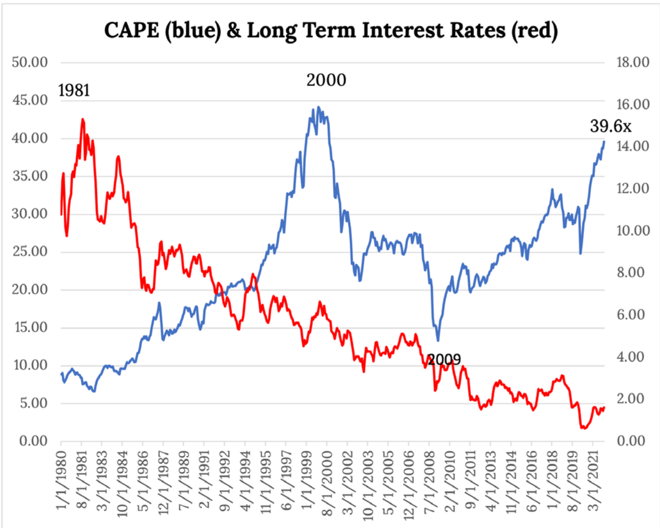
TALARIA

CERTAINTY EMPOWERS YOU

February flash note

February 8, 2022

Shiller Cyclically Adjusted Price Earnings Ratio (CAPE) & Long Bond Rates (Jan 1980 – Dec 2021)



Source: Robert Schiller Yale University, Talaria

Conclusion

In two of the last four months (September and January), global equity markets have reminded many equity investors that they need to be prepared for change. This is not because we or they are necessarily forecasting change but because of the implications of not being ready for it. Diversification is fundamental to this view.