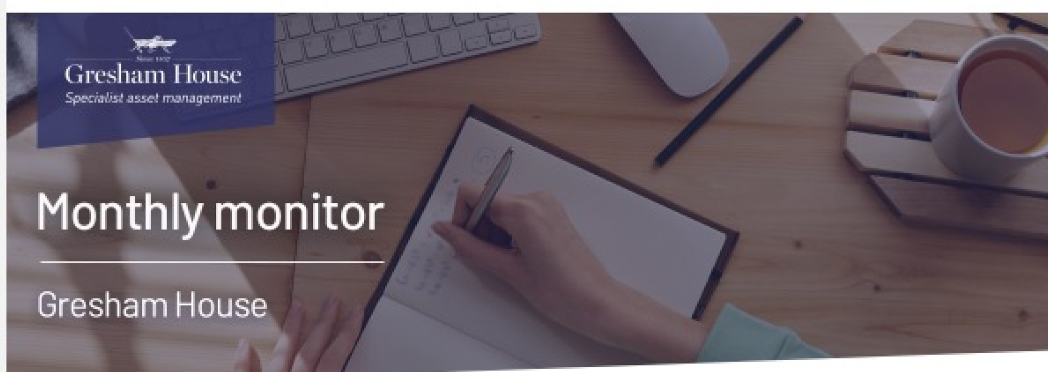

Formerly Appian Asset Management

Monthly Monitor

Is it time for equities to climb the wall of worry? 🧱

2022 has seen the global equity market engulfed in negativity. Rising bond yields, stagflation, increasing recession fears, war in Europe, another COVID-induced shutdown in China and the Central Bank tightening to tackle inflation are among the factors causing the negative backdrop for equities today.

With sentiment so weak in the market, it's prudent to ask the question, "Have equity markets reached the point where they have priced in the bad news and are they about to climb a wall of worry?"

It's not a straightforward question to answer but the starting point is to recognise that there are two distinct groups of equities that have suffered declines this year. The outlook for both groups is substantially different.

The first group of equities are ones that have experienced a severe valuation correction. This is being caused by the current inflationary environment and the higher interest rates that comes with this environment, which is leading to the repricing of these assets that rose to "bubble" valuations over the last decade. This repricing has started, as can be seen by the fall in the Nasdaq by over 30% from its all-time high and the collapse of crypto currencies, which never made sense to us.

We don't believe the impact of this repricing is over and we would not be surprised to see the Nasdaq another 20%+ lower this year as the repricing adjustment continues. This part of the market does not overly concern us as we have long recognised the bubble that was forming and avoided it. The equities we are invested in don't have a valuation problem. Our large cap equities today are trading on a price earnings multiple of 10.6 and a dividend yield of 4.4%, whilst our smaller companies are on even cheaper valuations - 9.6 times earnings and a dividend yield of 4%.

The second group of equities that have come under pressure this year are those whose profitability would suffer if economies went into a recession. The arguments for a possible recession are strong with higher levels of inflation continuing, rising interest rates and higher commodity prices. We think a recession over the next 12 to 18 months is a possibility but not a given.

The negatives are in the news headlines today but there are positives that may emerge as the year progresses. Consumer spending may be stronger than expected; inflation may ease, thereby allowing central banks to be less hawkish; the COVID lockdown in China will end; and the War in Ukraine may progress to a stalemate and become less of an issue for financial markets. More importantly however, is the fact that we believe a recession, when it comes, will be a mild recession and nothing that resembles the pain of the great financial crisis.

We believe large parts of the equity market are already pricing in this type of recessionary environment. Bank stocks are trading at valuations only seen once in the last 20 years, which was during the height of the pandemic. Many European industrial names such as Jungheinrich, which we hold, are down over 50% as fears of a global slowdown have taken hold. Stocks with exposure to the consumer have also seen significant falls, including homebuilders, who have seen falls in the region of 30% this year in response to rising interest rates.

We have increased our exposure to these areas of the market. While it is rarely possible to call the precise timing of the bottom of a market, we have reached a point where the valuation levels of these assets are very attractive for the long-term investor. As previous cycles have demonstrated, such attractive entry points represent a base from which strong returns can be built as these assets set about climbing a "wall of worries" over the next 6 to 18 months.

Please visit our website for further information. The latest views and insights from the team can be found here.

Investment team

Niall Dineen
Chief Investment Officer

John Mattimoe
Senior Fund Manager

Pat Kilduff
Senior Fund Manager

Derek Heffernan
Senior Fund Manager

Get in touch with our Client Relationship team

Patrick Lawless
Managing Director

E: p.lawless@greshamhouse.ie
D: +00 353 6624050

Kathryn Hannon
Head of Private Clients

E: k.hannon@greshamhouse.ie

Ian Naughton
Senior Relationship Manager

E: i.naughton@greshamhouse.ie
D: +00 353 6623986

Sean Breheny
Business Development Executive

E: s.breheny@greshamhouse.ie
D: +00 353 9693277

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