

SECOND QUARTER 2022 REVIEW & OUTLOOK

EXECUTIVE SUMMARY

July 13, 2022

PORTFOLIO THEMES

- We believe a recovery is likely in the back half of 2022 and high-quality companies that led the decline will likely lead the recovery.
- We remain constructive on global equities and believe that growth and Technology will lead when global markets recover.
- Economic growth and inflation expectations likely continue to moderate as supply and labor constraints subside, supporting our preference for growth equities.

MARKET OUTLOOK

- **Continued Negative Volatility is Not a Foregone Conclusion:** Global markets have likely priced in well-known fears including a mild recession, which is far from certain, in our view. Meanwhile, positive economic factors are largely ignored.
- **Investor Sentiment Supports an Unexpected Recovery:** Depressed sentiment, driven by concerns on inflation, global monetary policy, China's lockdowns and a variety of other factors has significantly lowered investor expectations, increasing the likelihood that markets realize a better-than-expected outcome.
- **Global Markets Typically Reward US Political Gridlock:** The incumbent party routinely loses power during the midterm year, reducing political uncertainty and the likelihood of extreme legislation. Increased gridlock likely acts as a tailwind for global markets in the back half of the year.

Equities' rocky, fear-filled first half intensified in Q2, with global developed markets approaching a -20% decline in May and piercing that threshold in mid-June. Emerging market equities have fared slightly better this year, but are in the midst of a protracted downturn as well. From a technical standpoint, history will recall this as a bear market, although we don't think that a backward-looking label has much forward-looking significance. The difference between a steep correction and a shallow bear market is not meaningful as both usually precede strong rebounds. Nevertheless, we recognize our bullish stance and related emphasis on growth has weighed heavily on absolute and relative returns in Q2.

The full Review will detail our perspective on the downturn and its many fears—including a potential recession, rising interest rates, inflation, supply chain issues, China's lockdowns, oil and gas prices, American political acrimony and more. What is important for investors now is to look forward. We believe capturing the bounce that typically follows sharp downturns is crucial. So is having the correct sector and style emphasis. Once markets breach -20% from a prior high, the low is generally quite near. Median returns for global developed markets 6 and 12 months from lows after -20% drops are 25.9% and 33.3%, respectively.ⁱ

ⁱ Source: FactSet, as of 06/30/2022. MSCI World Index price returns, 12/31/1969 – 06/30/2022.

As 2022 dawned, we expected the first half would likely be volatile, with moments of genuine fear, although we never expected a downturn of this magnitude. We also expected equities to rally in the year's second half as post-midterm political gridlock became apparent and uncertainty fell. We are now entering that period, and the stage looks set for big returns most can't fathom now. This might sound overly optimistic given where equities are, but global markets have made up big deficits in quick fashion before. In 2019, after equities endured a nearly -20% decline late in 2018, global developed markets were back at breakeven by mid-year. In 1998, equities were negative on the year in October—but a Q4 rally lifted full-year returns to 22.8%.ⁱⁱ While the exact timing of any recovery is only clear in hindsight, equities can flip bad years to good very quickly.

The vast majority of individual and professional investors can't fathom a recovery. Headlines continually emphasize bad news and ignore good—or obfuscate it with an abundance of objections. While a shallow recession is possible, equities are likely already pricing this in, and most indicators don't signal one is underway or imminent. In the US, durable goods orders have risen in seven of the last eight months, accelerating to 0.7% m/m in May from April's 0.4%.ⁱⁱⁱ The outlook for technology investment also seems bright. A recent JPMorgan survey of 142 chief information officers controlling over \$100 billion in annual enterprise spending suggested budget growth for corporate technology expenditures of 5.3% this year and 5.7% next year.^{iv} Of course, budget plans aren't written in stone, but the available evidence doesn't show Corporate America broadly cutting back investment. Elsewhere indicators also remain positive. Purchasing managers' indexes (PMIs) for the UK, eurozone and Japan remained expansionary in June, albeit with eurozone surveys signaling slower growth.

Yet as the full Review will show, headlines blare ad nauseam that we are in a recession. Some investors perceive falling business survey readings as recessionary, even though most officially registered expansion. Slower growth, but growth nonetheless. The occasionally inverted 10-year to 2-year US Treasury yield spread continues garnering attention while the more meaningful, wider 10-year to 3-month spread goes unnoticed. Ken Fisher has long called this fixation on negatives and dismissal of contrary evidence "the pessimism of disbelief." It often accompanies market lows, and it reigns now. The pessimism of disbelief helps markets pre-price worries, reducing their surprise power. Even if a shallow recession materialized, its market impact from here likely wouldn't be huge.

Usually, large downturns feature at most two or three scary stories—be it COVID-19 in 2020, tariffs and hedge fund liquidations in 2018 or China's devaluation in 2015. This time, we see no fewer than seven, possibly more depending on how you tally interconnected worries. Their sheer number amplifies uncertainty and increases downside volatility. However, it also primes markets for a big relief rally as these concerns fade. Lately, we have observed that it takes about four months for headline fears to drift out of the public consciousness.

ii Source: FactSet, as of 06/27/2022. MSCI World Index price returns, 12/31/1997 – 12/31/1998.

iii Source: Census Bureau, as of 06/27/2022.

iv "Despite Recession Fears, Companies Aren't Pulling Back on Technology Investments," Susan Caminiti, CNBC, 07/01/2022.

Our emphasis on growth equities worked against us during the downturn, as those were hit hardest while some fears benefited traditionally value-heavy sectors like Energy and Utilities. Now many tout value's leadership and extrapolate it far forward, arguing value normally leads after bear markets. Yet as the full Review will detail, value's leadership this year is heavily entwined with market direction amid sentiment-driven swings. On days when global stocks fell, growth routinely underperformed. Growth led 72.7% of the up days.^v So in an up environment, we think growth should lead. Further supporting that, what falls the most usually bounces the highest. Today that is growth equities in Tech, the Tech-like portion of the Communication Services sector, e-commerce and Luxury Goods. They are likely to be the recovery's biggest beneficiaries. The effect won't necessarily last forever, but it often does for at least six or more months after market lows.

Fears of a recession in the developed world also weighed on EM equities in Q2. This is perhaps most visible in EM Materials, which fell -20.6% in the quarter.^{vi} In our view, this is predominantly sentiment-based. Recession fears tend to have an outsized impact on commodity-oriented industries as people presume an economic downturn will hit demand for oil, copper, steel and other key growth-sensitive inputs hard. Yet Western economic indicators broadly don't indicate a significant recession is underway or imminent, which we think creates a bullish gap between sentiment and reality. If the developed world simply trends sideways, it should bring commodity exporters some relief.

China's emergence from this spring's COVID-19 restrictions—which helped it lead all EM nations with a 3.4% return in the quarter—offers another counterpoint to global recession fears.^{vii} Shanghai ended its two-month lockdown on June 1, with most activities returning. Beijing and several other locations followed suit, enabling some of the targeted stimulus measures announced in recent weeks to begin kicking in. Since then, some parts of Shanghai and Macau have reinstated restrictions, leading to concerns that any economic bounce will be short-lived, but we think this is too hasty. For one, policymakers announced they would cut quarantine timeframes for travelers late in the month, suggesting a lighter approach. Also, data already started improving in May despite restrictions remaining at the time, indicating Chinese businesses are getting better at managing restrictions. While consumption and residential real estate remain headwinds, strong activity at factories and ports—combined with targeted stimulus boosting money supply and velocity—points to continued modest economic growth this year. Additionally, there were further signs of China's Tech regulatory push easing in the June, with some apps previously banned from signing up new users will be allowed to resume, including Didi. China also approved about 60 video games in early June, the largest number seen July 2021—about when the regulatory push began.^{viii}

While the global economy shows pockets of weakness and strength, it is a better reality than the picture painted by increasing numbers of recession forecasts. Such a wide gap between reality and expectations indicates to us a bear market trough is near. When negativity drives fear and sentiment overshoots to the downside, markets are primed to rebound as uncertainty clears. We don't know when, but priced-in pessimism sets the stage for a growth-led recovery over the foreseeable future.

v Source: FactSet, as of 07/01/2022. MSCI World Growth Index frequency of outperformance versus MSCI World Value Index on days the MSCI World Index rose, 12/31/2021 – 06/30/2022.

vi Source: FactSet, as of 07/06/2022. MSCI Emerging Markets Energy and Materials Index returns in USD with net dividends, 03/31/2022 – 06/30/2022.

vii Ibid. MSCI China Index return in USD with net dividends, 03/31/2022 – 06/30/2022.

viii China's Regulators Exclude Tencent, NetEase as They Approve 60 Online Game Titles in June," Pearl Liu and Zhou Xin, South China Morning Post, 06/07/2022.

Should you have any questions about any of the information in the Second Quarter 2022 Review and Outlook, please contact us at (800) 851-8845 or FisherInstitutional@fi.com.

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