

# 2022 – Bouts of Volatility and Mean Reversion

- It is Likely You Will Need to Prepare for a More Normal Equity Market in 2022
- Sector heatmap highlights longer term mean reversion
- Expensive growth companies feel the heat of higher rates

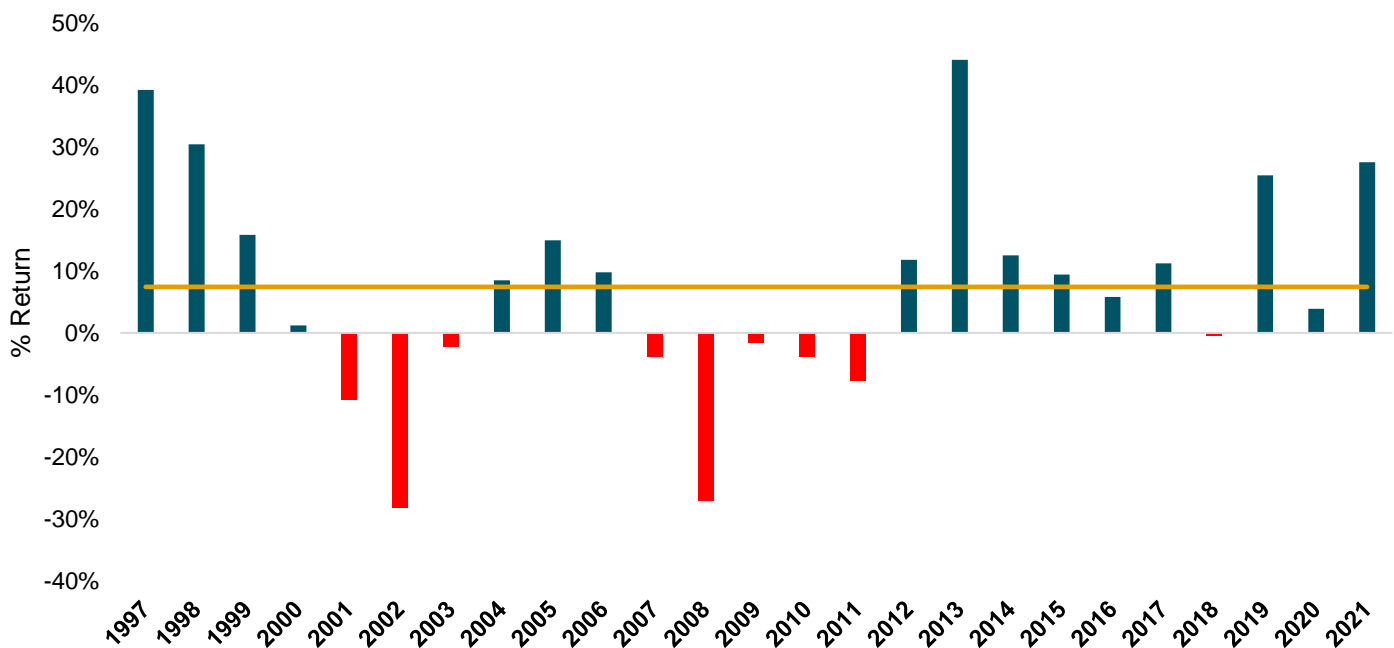


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## It is Likely You Will Need to Prepare for a More Normal Equity Market in 2022

The last few years have been so atypical you can be forgiven if you need a refresher on normal. Figure 1 below places the recent equity market returns against the 25 year average. In the last 3 years global equity market returns have averaged +18.4% per annum which is 3 times the average 6.1% return per annum experienced over the last 25 years. As Government and Central Bank pandemic policy settings begin to unwind investors should readjust their expectations for less bullish returns and a few bouts of volatility.

**Figure 1: MSCI World Index Annual Returns (AUD) for the Last 25 Years**



Source: State Street Global Advisors, Factset, Annual returns for the MSCI World Index in AUD terms for the last 25 years as of 31 December 2021. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

## Sector Heatmap Highlights Longer Term Mean Reversion

In figure 2 below we highlight the divergent sector performance over the last 25 years as well as the recent extremes. Not surprisingly the technology and consumer discretionary sectors have generated the largest returns in the last 3 years. More importantly the heatmap shows that no sector remains positive consistently. Often a period of outperformance is followed by a period of underperformance and vice versa.

**Figure 2: MSCI World Sector Return Heatmap**

Year	Defensive				Cyclical					
	Consumer Staples	Telecom	Health Care	Utilities	Consumer Discretionary	Financials	Materials	Industrials	Energy	Technology
1997	50%	49%	65%	34%	31%	43%	8%	23%	43%	49%
1998	28%	59%	44%	28%	32%	18%	4%	13%	9%	78%
1999	-22%	34%	-17%	-20%	23%	0%	18%	18%	12%	87%
2000	28%	-31%	48%	41%	-11%	28%	0%	15%	23%	-31%
2001	-2%	-20%	-7%	-18%	-3%	-11%	1%	-10%	-1%	-24%
2002	-13%	-37%	-26%	-26%	-30%	-25%	-15%	-30%	-17%	-44%
2003	-14%	-8%	-12%	-7%	1%	1%	6%	2%	-8%	10%
2004	6%	10%	1%	19%	9%	10%	11%	13%	20%	-2%
2005	11%	-6%	15%	17%	7%	16%	25%	18%	35%	11%
2006	10%	19%	1%	22%	11%	13%	17%	9%	8%	1%
2007	4%	6%	-8%	6%	-14%	-20%	18%	2%	14%	3%
2008	-5%	-19%	-3%	-14%	-28%	-44%	-38%	-30%	-24%	-30%
2009	-8%	-16%	-10%	-21%	6%	-1%	23%	-4%	-5%	17%
2010	-3%	-8%	-12%	-16%	8%	-10%	5%	6%	-4%	-4%
2011	6%	-4%	7%	-7%	-6%	-21%	-21%	-10%	-2%	-3%
2012	9%	0%	14%	-3%	21%	24%	8%	12%	-2%	11%
2013	38%	47%	55%	26%	59%	44%	17%	50%	34%	48%
2014	15%	4%	27%	22%	12%	10%	2%	8%	-6%	25%
2015	17%	12%	18%	2%	17%	6%	-7%	8%	-16%	17%
2016	0%	3%	-8%	3%	2%	10%	21%	11%	23%	11%
2017	6%	-5%	9%	2%	13%	11%	17%	14%	-5%	27%
2018	-2%	-4%	12%	10%	4%	-10%	-10%	-7%	-9%	7%
2019	20%	26%	22%	19%	25%	22%	20%	26%	8%	46%
2020	-4%	11%	2%	-7%	23%	-13%	7%	0%	-40%	30%
<b>2021</b>	<b>18%</b>	<b>20%</b>	<b>26%</b>	<b>14%</b>	<b>24%</b>	<b>33%</b>	<b>20%</b>	<b>22%</b>	<b>43%</b>	<b>37%</b>

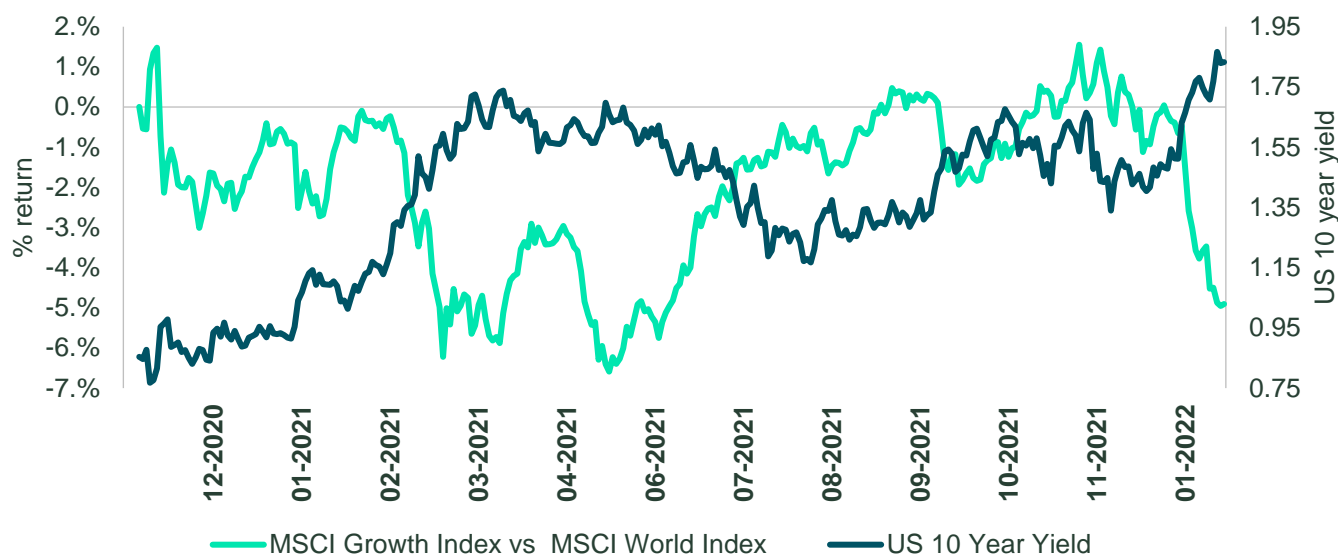
Source: State Street Global Advisors, Factset, Annual returns for the MSCI World GICS sectors for the last 25 years as of 31 December 2021. Sectors and Weights are as at the date indicated, are subject to change, and should not be relied upon as current thereafter. This information should not be considered a recommendation to invest in a particular sector or to buy or sell any security shown. It is not known whether the sectors or securities shown will be profitable in the future.

The heat map is a timely reminder to have a diversified portfolio and to take some profits after excessive windfall gains.

## Expensive Growth Companies Feel the Heat of Higher Rates

As the economy has rebounded and inflation has been surprising on the upside we have seen investors reprice longer term interest rates higher. As this has been occurring the growth companies, especially the expensive growth companies, have tended to underperform. See figure 3 below, which highlights the underperformance of the MSCI World Growth Index. The relationship is partly due to the longer duration cashflows of these companies, partly due to rising rates reducing the speculative elements in the market and partly due to the improving prospects of many other companies.

**Figure 3: Higher Longer Term Interest Rates have Coincided with Expensive Growth Underperformance**



Source: State Street Global Advisors, Factset as of 20 January 2022. Relative performance of the MSCI World Growth Index calculated by MSCI World Growth Index relative to MSCI World Index. Past performance is not a reliable indicator of future performance. Index returns are unmanaged and do not reflect the deduction of any fees or expenses.

**The Bottom Line – Less Bullish, More Volatility and Continued Rotation**

As the pandemic policy settings are unwound we should expect equity market returns to return more in line with history – think single digits with bouts of volatility. As economic activity normalises and inflation and interest rates rise we continue to see investors rotation from expensive growth to value. The most expensive parts of the market are the most vulnerable to this change in the market environment.

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