MACRO AND MULTI-ASSET

JULY 2022

MERGENCE
INVESTMENT MANAGERS

The first half of 2022 has seen a painful drawdown for equity investors and bond investors alike. The result is one of the worst periods for multi-asset investors in many years. To quantify this drawdown, we attempt to measure the performance of the global market portfolio, the multi-asset portfolio owned by the aggregate global investor. We use the work of researchers at Robeco Asset Management and the University of Rotterdam (Doeswijk) to measure the current drawdown in the market portfolio and to compare it to previous drawdowns.

We show that while the current bear market in equities is still moderate by historical comparisons, the first six months of 2022 have been close to the worst period of the past 80 years on a cross-asset basis. - And while the global market portfolio has experienced previous falls that have been larger in percentage terms, measured by the absolute value of capital loss relative to global GDP, the past six months losses been unprecedented.

Current views

UNDERWEIGHT	OVERWEIGHT	OVERWEIGHT	NEUTRAL	OVERWEIGHT
Risk Assets	South African equity vs Global equity	South African Fixed Income	Global Fixed Income	USD Cash

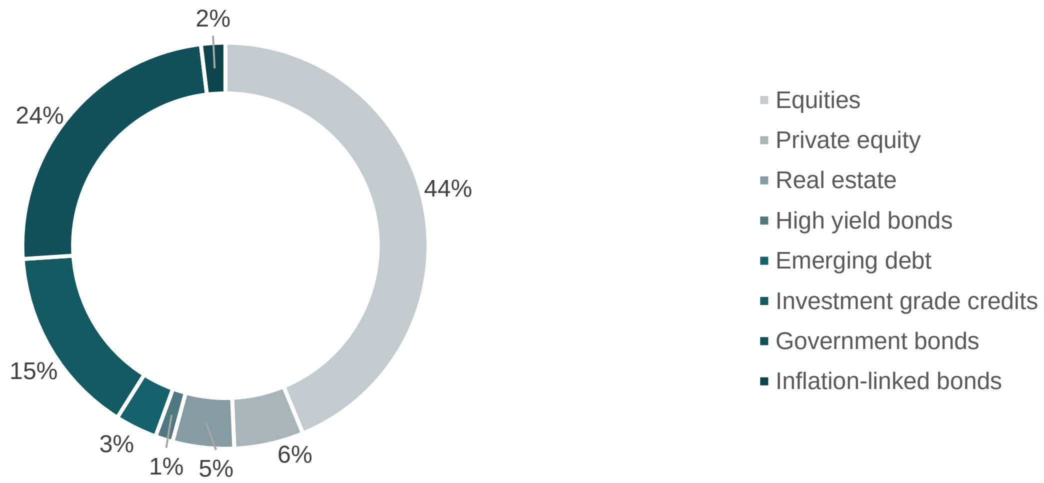
Asset allocation views

Asset Class	Underweight	Neutral	Overweight
SA Equity		Neutral	
SA Property		Neutral	
SA Fixed Bonds			Overweight
SA Inflation-Linked Bonds		Neutral	
Emerging Market Equity	Underweight		
Developed Market Equity	Underweight		
US Large Cap	Underweight		
US Mid Cap Value		Neutral	
UK Equity			Overweight
European Equity	Underweight		
Japanese Equity			Overweight
Global Bonds		Neutral	
USD Cash			Overweight

Source: Mergence calculation. All forecasts in ZAR

Global market portfolio

The market portfolio is the aggregate portfolio of assets held by all investors. If we just consider equities, this is the market cap weighted index of equities. The global market portfolio is the aggregate portfolio held by all global investors across all asset classes. The efficient market hypothesis implies that this portfolio incorporates the optimal view of all market participants and thus sits on the efficient frontier. In layman's terms, this is the portfolio that a completely passive cross-asset investors should hold, scaled by gearing to adjust for risk preference. Performance of headline equity indices are freely available and well publicised - when equity markets fall more than 20% and CNBC flights its markets in turmoil special, we all know about it. But the average investor is not solely exposed to equities and so the relevant benchmark for their overall portfolio and what should be keeping them up at night may be closer to the global market portfolio, the performance of which is often much harder to find.

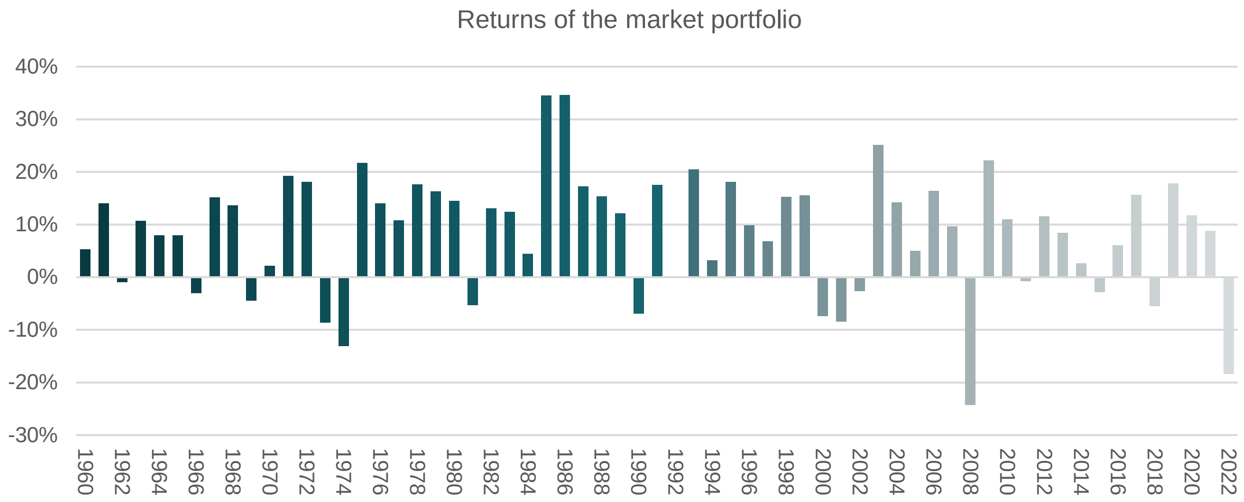


Source: Historical Returns of the Market Portfolio Doeswijk et. al

In Doeswijk et al the authors estimated the global market portfolio by aggregating the total market cap of investment assets across the globe. The results for December 2021 are shown in the chart above. This portfolio has an allocation of about 46% to equity, lower than the typical 60/40 stock bond portfolio.

Returns of the global market portfolio

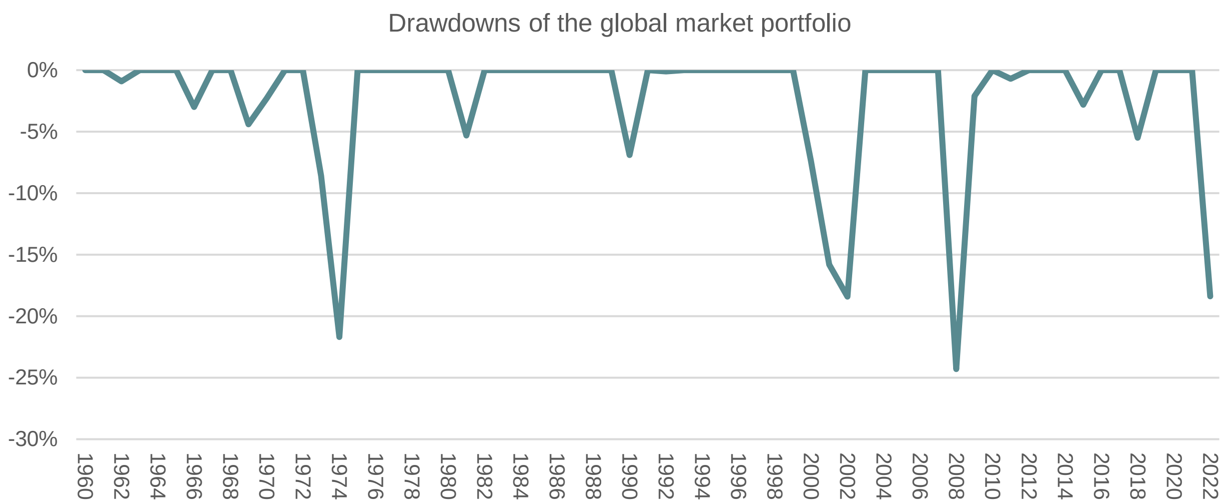
In addition to the composition of the market portfolio, Doeswijk et al also estimate historic returns of the portfolio. We show these returns below, updated to June 2022. Historically the market portfolio has delivered an average annual real return of about 4.5% in USD terms. Thus far 2022 is shaping up to be the second worst year since 1960 for this portfolio on a return basis, surpassed only by 2008.



Source: Historical Returns of the Market Portfolio Doeswijk et. al

Drawdowns of the market portfolio

Looking past annual returns, we examine drawdowns of the market portfolio over the past 80 years. We now see that consecutive negative performance over 1973 and 1974 and 2000 to 2002 have resulted in larger drawdowns than the current 2022 drawdown. This is of interest given the number of comparisons currently being drawn between the current economic environment and the 1970s. In both instances, rising inflation resulted in bond and equity prices falling at the same time, the main condition for poor returns for the market portfolio.



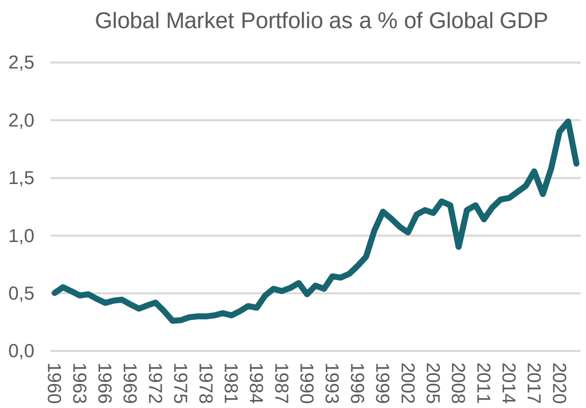
Source: Historical Returns of the Market Portfolio, Doeswijk et. al

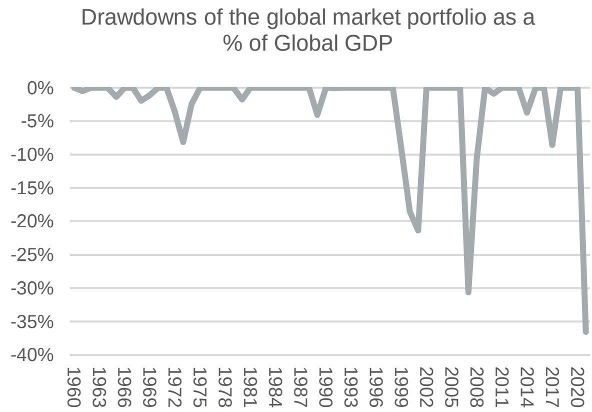
The market portfolio as a % of GDP

As at the end of 2021 the total value of the market portfolio sat at $718 Trillion. To put his into perspective we divide the market portfolio by global GDP. While some shun dividing a valuation metric by an annual run rate measure such as GDP, we think that if the “Oracle of Omaha” does it, it cannot be all bad (Buffett Indicator). This ratio bottomed at 0.26x in 1974 and has risen, consistently since then until 2021.

The rise in the ratio of the value of the market portfolio relative to GDP over the past four decades has coincided with lower discount rates and higher valuations across asset classes.

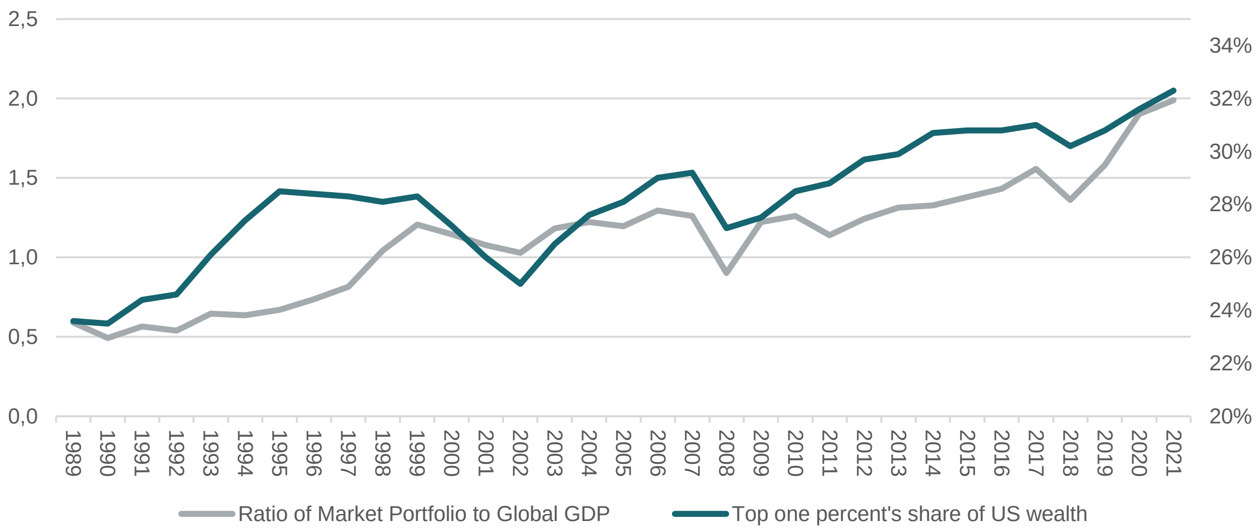
The result of this increase is that the year-to-date drawdown in the market portfolio is the largest ever when measured as a percentage of global GDP.





Source: Historical Returns of the Market Portfolio, Doeswijk et. Al, World Bank

This rise of asset values relative to GDP has also coincided with an increase in wealth inequality. Plotting the share of total US wealth held by the top 1% of US households against the ratio of the market portfolio to GDP suggests the increase in global asset valuations has driven increasing inequality.



Source: Historical Returns of the Market Portfolio, Doeswijk et. Al, World Bank

While real wages have been relatively stagnant over recent decades, asset values have increased on higher valuation multiples. The result is that the median earners, whose net worth is very dependent on their salary, has significantly lagged the increase in paper wealth of the top 1% (Fed). What this also means is that the past six months have likely seen one of the largest reversals in global inequality that we have seen over the past few decades. It is also a source of caution for holders of financial assets. Globally the political will to narrow the wealth gap has been increasing. Higher real wage growth, higher discount rates and falling corporate margins could deliver this decrease in inequality, but at the expense of cross-asset valuations.

How big are crypto losses?

Finally, we ask the question how big is cryptocurrency as part of the global market portfolio, and how significant are recent losses in this asset class? Crypto has been a source of large wealth creation and more recently large wealth destruction over the past decade. A detailed analysis of this market is outside of the scope of this article as well as our circle of competence, but for a back-of-the-matchbox approach, we use the total market cap of cryptocurrencies published by coinmarketcap.com.

According to this data, the total Cryptocurrency market cap peaked at $3 trillion late in 2021 and has fallen to below $1 trillion this year. At its peak Crypto was about 1.6% of the global market portfolio and while this may seem small, it is larger than the total high yield bond allocation and about 87% of the inflation-linked bond allocation of the market.

The decline in the Crypto currency market cap of $2 trillion is large in absolute terms but is only 6.2% of the total decline in value of the market portfolio.

Conclusion

The first six months of this year have been one of the worst periods of performance for global multi-asset investors. Losses have been experienced across asset classes as rising inflation has been challenged by equities and bonds. Despite the 18% fall in the value of the market portfolio, it is not obvious to us that global asset prices have derated enough to be considered cheap. We have recently reduced our underweight view on global fixed income after not holding exposure to the asset class for several years. While developed market bonds are still not cheap, the increasing probability of a global recession over the next 12 months increases the attractiveness of global fixed income, especially for a Rand-based investor.

In October 2021, our valuation approach was forecasting an annual Rand return of -3% per annum for US large cap equities, whereas we now forecast just over at 4% per annum, not attractive but less obviously overvalued than nine months ago. In contrast, our three-year valuation-based forecast for SA equity returns is above 20% per annum but faces the risk of commodity price downgrades should a global recession occur. On balance, we remain defensively positioned, with a relative preference for cheaper SA-based risk assets and more global bonds than we have held over the recent past.

References

Buffett Indicator. n.d. <https://en.wikipedia.org/wiki/Buffett_indicator>.

Doeswijk, Ronald Q. and Lam, Trevin and Swinkels, Laurens. " Historical Returns of the Market Portfolio." *Review of Asset Pricing Studies* (n.d.). <https://ssrn.com/abstract=2978509>.

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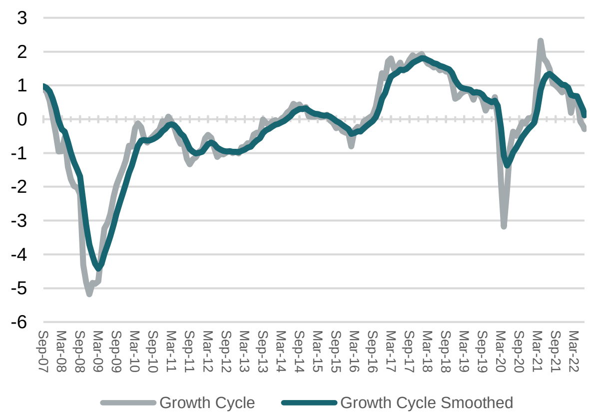
Key indicator forecasts

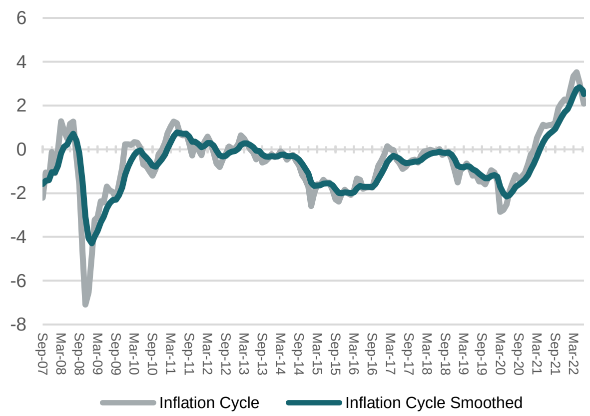
Indicator	Current	1 Year	3 Year	5 Year
USDZAR	17.0	14.5	15.3	16.1
EURZAR	17.1	17.5	18.6	19.8
GBPZAR	20.2	20.3	21.3	22.4
SA 10 Year Yield	10.8%	10.3%	9.1%	9.0%
SA Inflation	5.9%	5.2%	5.1%	5.0%
US Inflation	8.6%	3.3%	2.8%	2.5%
US 10 Year Yield	3.0%	3.2%	3.0%	3.0%
Fed Funds Rate	1.6%	3.7%	3.0%	2.5%
SA Repo Rate	4.8%	5.8%	6.0%	6.0%

Key macro charts

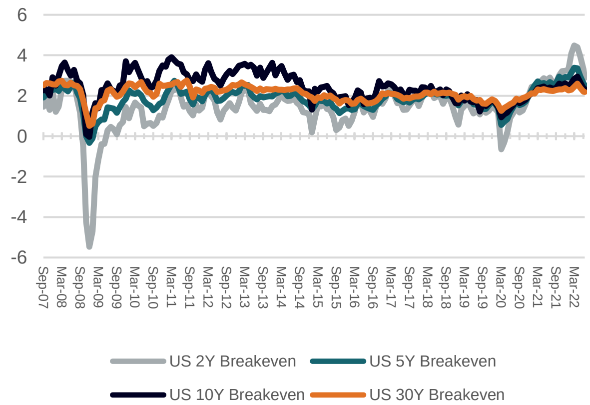
Mergence Growth Cycle



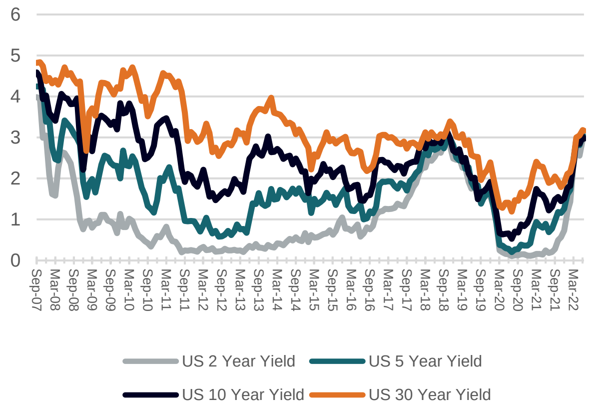
Mergence Inflation Cycle



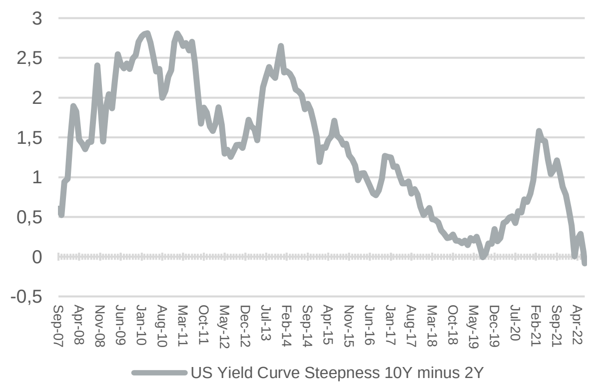
US breakeven rates



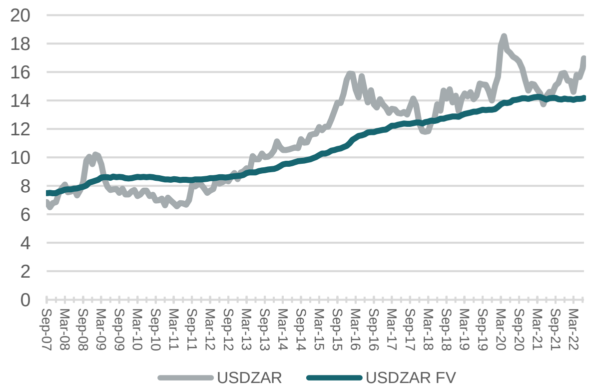
US bond yields



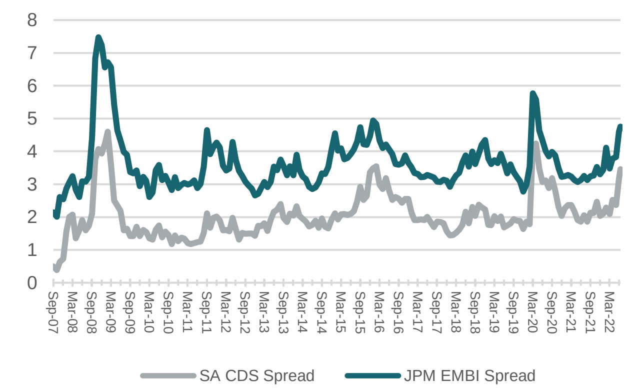
US yield curve



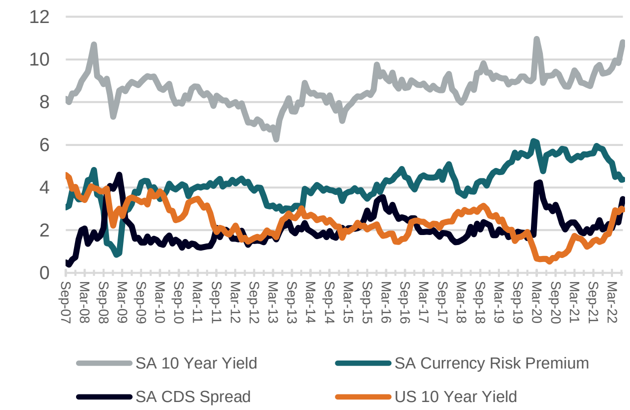
USDZAR



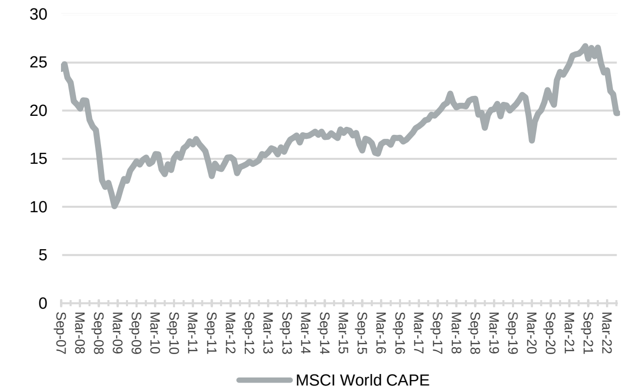
SA CDS



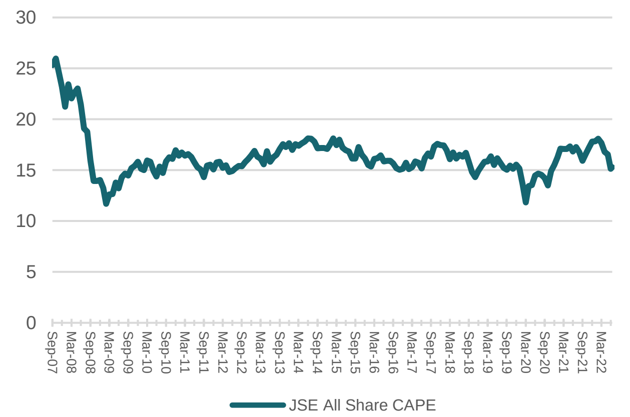
SA YIELD BREAKDOWN



MSCI World CAPE

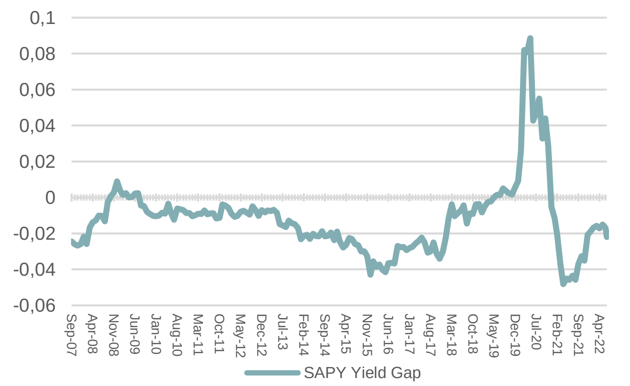


JSE All Share CAPE



SAPY price to book

SAPY yield gap



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