Global equities had a volatile Q2 as investors priced in further interest rate increases and higher odds of recession. Across the globe, Value largely outperformed Growth, though both segments suffered steep losses. All eyes are now on Q2 earnings to see whether the corporate sector can maintain historically high profit margins.

Evidence seems to be pointing towards ‘No’ with inflation eating into consumer spending power, companies facing greater wage pressures, and cost of goods still on the rise. China was one of the few bright spots as some major cities saw extended lockdowns get lifted. However, China also remains far from being out of the woods given risks of future lockdowns, geopolitical tensions, and a shaky housing market, just to name a few.

Equity Markets	Q2 2022
US Large Cap (S&P 500 TR)	-16.1%
Nasdaq	-22.3%
US Small Cap (Russell 2000)	-17.2%
Japan (TOPIX)	-3.7%
Europe (MSCI Europe)	-8.7%
China (CSI 300)	7.3%
Global EM (MSCI EM)	-11.4%

Bond Markets	Q2 2022
US 2yr	61.9
US 10yr	67.5
US 30yr	73.5
German 10yr	78.8
German 30yr	94.9
UK 10yr	61.9
UK 30yr	80.1
JGB 10yr	1.1
JGB 30yr	30.5

Currency Markets	Q2 2022
DXY	6.5%
EUR	-5.3%
GBP	-7.3%
JPY	-10.3%
MSCI EM Currency Index	-4.4%

Commodity Markets	Q2 2022
Crude Oil (WTI)	5.5%
Nat Gas	-3.9%
Gold (Spot)	-6.7%
Steel (Rebar)	-12.0%
Ag & Livestock (Bloomberg)	-6.4%

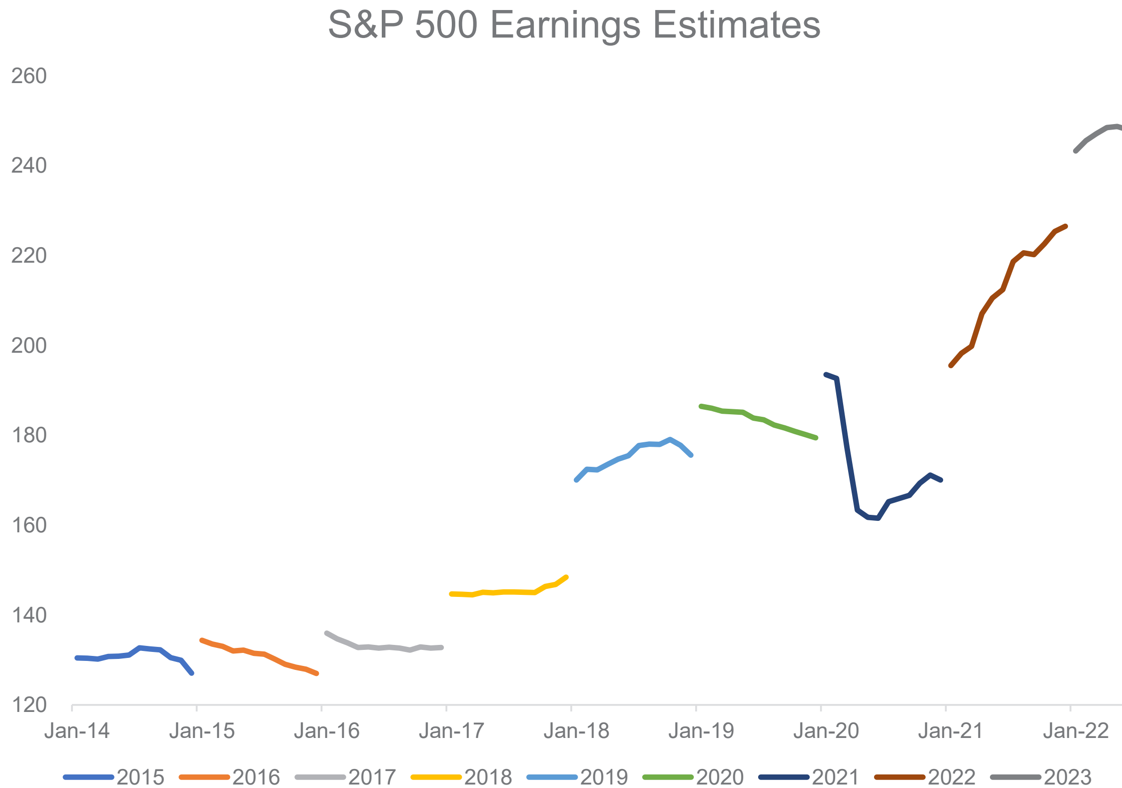
RCG HF Indices	Q2 2022
All Hedge Funds	-4.9%
Equity Hedge	-8.3%
Absolute Return	-1.1%
Equity Market Neutral	1.1%
Event Driven	-6.7%
Global Macro	2.1%

Source: RockCreek

The first half of 2022 was one of the worst starts for equity markets with the MSCI World down 20.5% year-to-date following a -16.2% return in Q2. US indices performed slightly worse in Q2 compared to Europe and Asia, but there was not much dispersion regionally as the strong US dollar served as a headwind for US investors' foreign equity holdings. The S&P 500 lost 16.1% in Q2 with each of its 11 underlying sectors in the red. Investors exhibited a clear preference for safety with defensive sectors down significantly less than consumer discretionary, technology, and other cyclical sectors. Even energy, which had been one of the few bright spots for investors in the first quarter, finally gave in to recessionary fears and began to fall out of favor in early June.

Despite all the carnage, there remain plenty of signs that things could get worse. Sentiment remains abysmal with little sign of improvement. There has been no shortage of negative news, capitulation is snowballing, and the market has yet to find a floor. And yet, sell side analysts are still reflecting a rosy earnings outlook. Despite the rising cost of goods, wage pressures, consumers eating into their savings, and the Fed's ongoing tightening cycle, the Street projects strong revenues and record-level profit margins into 2023.

EPS Trends Year-to-Year Have Been Sticky



Source: RockCreek, Bloomberg

As seen above, consensus future EPS expectations compare strongly to past years. P/E multiples have re-rated, but this earnings season will be a crucial one for markets as expectations remain high. Even if economic activity is robust enough to support current earnings, forward guidance will almost assuredly come down for the second half of the year and 2023. Nike and Restoration Hardware are the most recent examples where supply chain pressures or softening demand trends led to more conservative guidance from management. In addition, United Airlines recently agreed to give pilots a 14.5% raise through the end of 2023, and some regional pilots under American Airlines received 50% pay increases through August 2024. Rising wages will increasingly eat into profit margins, which could lead to earnings misses and increased negative sentiment.

The ratio of total stock market valuation to GDP is known as the Buffett Indicator, after Warren Buffet called it “the best single measure of where valuations stand at any given moment.” Every valuation metric has its advantages and shortcomings, but this one certainly provides an interesting perspective. The ratio doubled from 2012 to 2021 on the back of stimulus measures and record low interest rates, leading it to far exceed its historical average.

Source: RockCreek, Bloomberg

Assuming we have, in fact, entered a new regime of lasting inflation and tighter central bank policy, one can easily envision the Buffett Ratio correcting further, brought on by evaporating stock market valuation relative to GDP. This again points to the need for a reduction in earnings forecasts as P/E multiples have already collapsed to a large degree.

Source: RockCreek, Bloomberg

Source: RockCreek, Bloomberg

Earlier this year, Hartford Funds published an analysis showing the cyclicality of active versus passive management. In many ways, this dissipation of investor exuberance following a technology-led, decade-long bull market has strong echoes to the dot com bubble. Just as passive equity funds outperformed active funds for five straight years leading up to 1999, passive funds also outperform active funds in 10 of the last 11 years. It remains to be seen how well active strategies perform from here. But heading into 1999, nobody would have predicted that active strategies would outperform in 10 of the next 11 years.

This market environment will remain challenging until the current tightening cycle approaches its end and equity valuations better reflect a lower-growth environment. In the near-term, quality, durability, and margin of safety will be important investment criteria as the combination of inflation and higher interest rates impact companies' bottom lines in varying ways.

We also believe that concentrated, catalyst-driven strategies will play a valuable role, if they can differentiate themselves by identifying outsized earnings surprises, restructurings, and other corporate events in less crowded segments of the market. We have yet to see substantial buying into growth stocks, but in the coming quarters, investors who are willing to extend their time horizons will be rewarded. Some rotation toward beaten-down areas of technology is beginning, notably in software, where fast-growing companies can quickly mature into their price/sales multiples and soon become consistently profitable.

Emerging Markets

Index	QTD	YTD	1-Year	3-Year
MSCI Emerging Markets	-11.4%	-17.6%	-25.3%	0.6%
MSCI Emerging & Frontier Markets	-11.5%	-17.7%	-25.2%	0.5%
MSCI Emerging Markets ex-China	-17.9%	-20.8%	-21.5%	1.3%
MSCI EM Asia	-9.3%	-17.2%	-25.9%	3.1%
MSCI EM EMEA	-17.1%	-28.4%	-27.2%	-7.0%
MSCI EM Latin America	-21.9%	-0.6%	-16.1%	-6.3%
MSCI Frontier Markets	-13.8%	-20.6%	-17.3%	0.6%

Source: MSCI

Q1-2022 was characterized by the outperformance of EM ex-China, (specifically commodity related markets); Q2 saw China's equity market comeback.

Investors seem to be discounting the regulatory and geopolitical risks of investing in China, instead betting that the country's macro policy pivot will produce strong quarterly growth acceleration. The combination of renewed infrastructure spending (the highest since 2018), a relaxation of anti-speculative housing measures, tax incentives to spur domestic consumption, and softening regulatory pressures on China's tech platform companies are sending market participants an invitation to invest. It helps that current valuations are below the fifteen-year average, inflation is low, and the current account surplus is steadily growing.

Do these positive developments mean we are out of the woods on China risk? Not quite. The intrigue around President Xi's reconfirmation in October; ongoing tensions with the US, Taiwan, and its allies; and consumer confidence in the doldrums remain just a few of the reasons to be cautious.

EM Country Valuation Multiples

Index	FWD P/E	15 Year Avg. P/E
EM	10.8x	11.5x
China	11.6x	11.7x
South Korea	7.7x	9.8x
Taiwan	11.3x	14.4x
India	18.5x	17.0x
Indonesia	14.0x	14.1x
South Africa	8.2x	12.3x
Brazil	5.5x	10.8x
Mexico	11.9x	15.0x

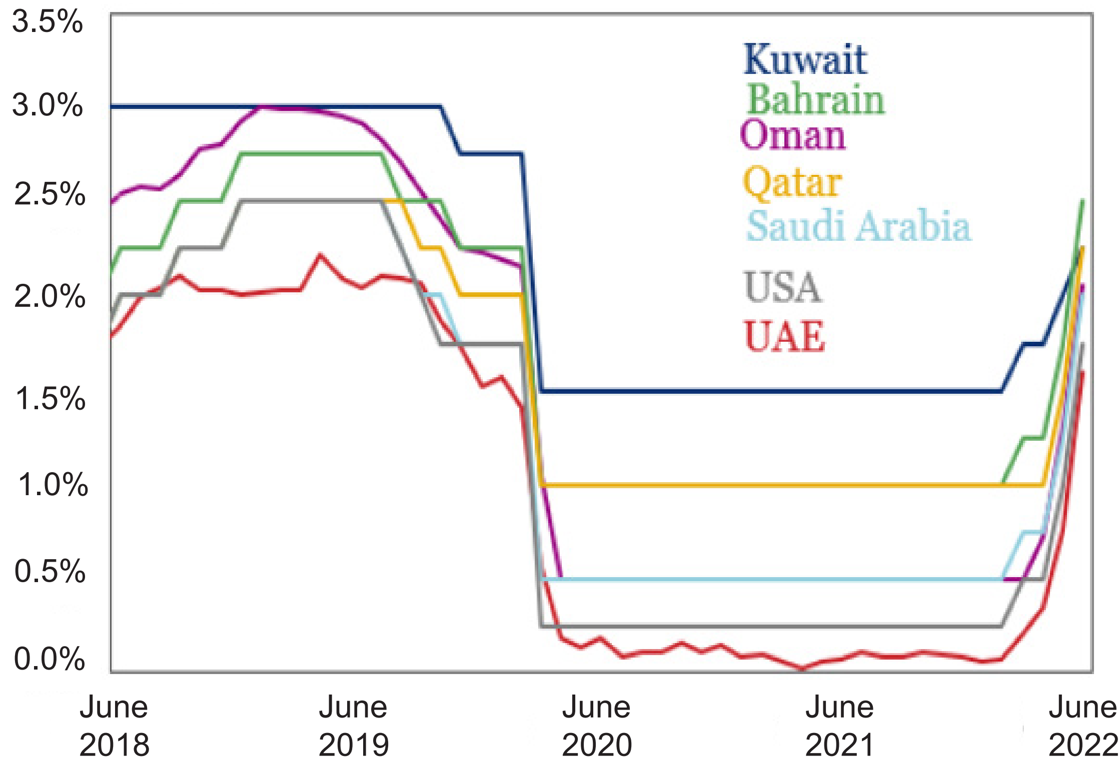
Source: RockCreek

Despite the macro uncertainty, China's recovery should be a tailwind to other emerging markets, including those with commodity links. Strong Chinese markets should help countries like Brazil, which in Q2 spectacularly lost all of the gains generated during Q1 and is currently trading at last year's low – one of the cheapest P/Es among major emerging markets.

Source: RockCreek

Indeed, most commodity exporters lost ground during the quarter, even though price action was mixed, and conditions of scarcity persist across all commodities. Of note – commodity exporters with a currency pegged or semi-pegged to the US Dollar fared significantly better than those with free floating currencies, a reminder that the higher 'beta' markets of Latin America and South Africa are more susceptible to eroding terms of trade once interest rate policy in the US begins to tighten. Gulf Cooperation Council (GCC) countries, on the other hand, maintain pegged currencies and are generally in lockstep with US policy moves.

US and GCC Policy Rates Move Together



Source: Haver, IIF

Recent election results in Colombia and upcoming elections and referendums in Brazil and Chile have added to a sense of lingering uncertainty over macroeconomic policy frameworks in the region. As the differential narrows between US and EM interest rates, we are paying special attention to countries' balance sheets and what they say about their ability to cope with the effects of a stronger greenback and higher financing costs. While many of the larger emerging market economies are in an arguably stronger position today than in past cycles of dollar strength, we are in the early innings; decisions made by policy makers now will influence outcomes later. Regional or country specific recessions may be the only real antidote to current inflation levels, but much will depend on developments in the US.

In other words, emerging markets cannot be buoyed by a resurgent China alone.