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THE ALLOCATOR’S ANGLE

A Quarterly Newsletter from *IOR*isk Aware

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IOR | The New Option
Investment Office Resources

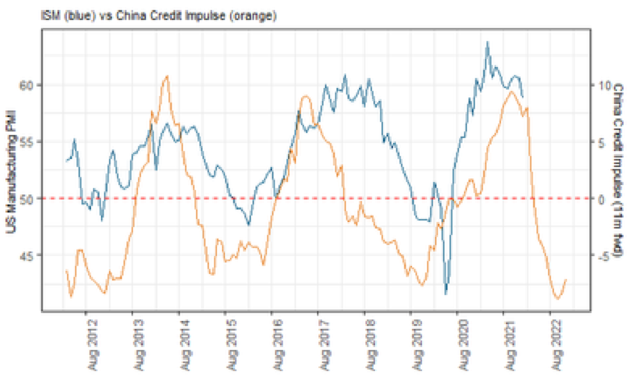
SUMMARY IN BRIEF

- We’re seeing mounting signs that economic momentum has peaked, historically that has ushered in a change in market leadership whereby lower-Beta, defensive themes outperform.
- The Valuation dispersion between Growth and Value remains historically wide. While we don’t see a clear catalyst for this to normalize, the current setup for Value to outperform appears provocative. **Investors that have significant allocations to Growth managers may consider rotating capital to more Value oriented managers.**
- Equities continue to trade near all-time highs, but signs of erosion under the hood suggest the risk/reward appears less favorable. **Allocators that have been overweight Equity risk may consider bringing risk in-line with their policy portfolio.**

PEAK ECONOMIC MOMENTUM:

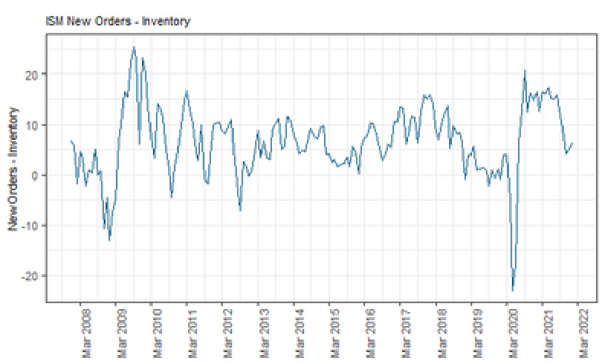
After a furious rebound from the COVID induced nadir of 2020, we're seeing mounting signs that economic Momentum has peaked. The US manufacturing PMI remains above 60 indicating that the US economy continues to grow apace, but further acceleration appears challenging. The current reading suggests economic growth is in the 98th percentile over the past 15 years, and the China Credit Impulse, which leads the ISM PMI by approximately 11 months, suggests we may be on the precipice of an economic slowdown.

Exhibit 1*:



Moreover, ISM New Orders vs Inventories is beginning to normalize, which suggests the tailwind from inventory restocking may be abating.

Exhibit 2*:



Add in concerns about the Omicron variant, and the overall economic outlook appears to be moderating.

The implications of this deceleration are manifold. For one, the tide that lifted higher-Beta, risk-on themes may be receding, thus creating an environment where defensive posturing may be rewarded. **Exhibits 3-6** plot the US Manufacturing PMI vs several market variables. Note we scale (z-score) each variable to make apples-to-apples comparisons. **Exhibits 3-4** suggest that economic deceleration would provide a tailwind for non-Cyclical/lower-Beta themes, while **Exhibits 5-6** suggest economic deceleration may cause inflationary pressures to moderate and support a stronger US Dollar.

Exhibit 3*:

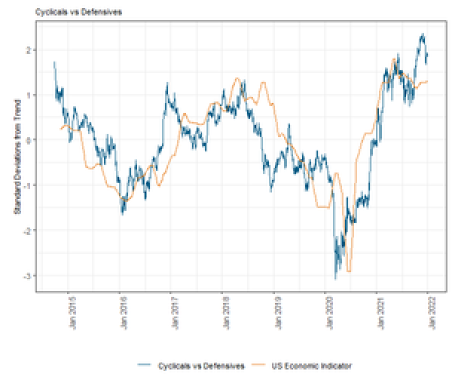


Exhibit 4*:

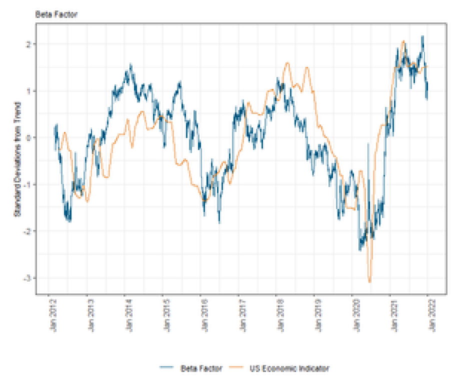


Exhibit 5*:

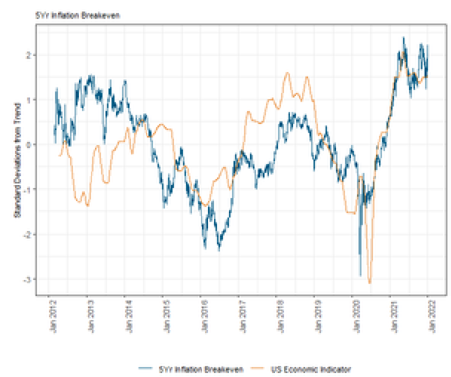
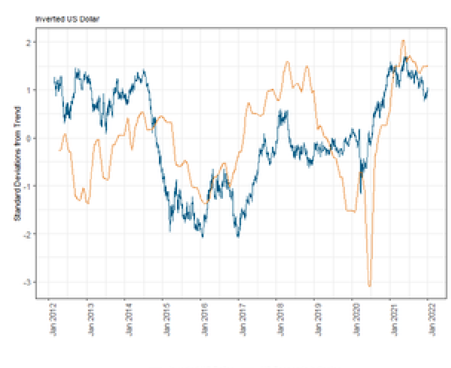


Exhibit 6*:

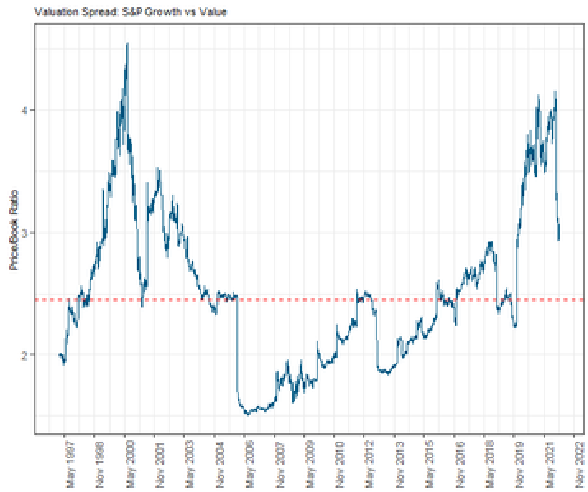


*Source: Bloomberg, Investment Office Resources calculations as of 31 December 2021

IS IT (FINALLY) VALUE'S TIME TO SHINE?

Value investors have felt considerable pain in recent years as investors feverishly chased Growth stocks to ever-higher multiples. We're sympathetic to these frustrations as Value's underperformance reached levels not seen since the Dotcom mania. Then, as now, the value dispersion between Growth and Value stocks reached extraordinary levels as the Price/Book of Growth stocks was more than 4x the multiple paid for Value stocks.

Exhibit 7*:



This is certainly a provocative starting point and suggests investors will eventually be compensated for exchanging Growth darlings in favor of Value laggards.

Timing the exact moment that Value's resurgence is a fool's errand, but we see signs that the period of frustration may soon come to an end. **Exhibits 8-9** fit a linear regression to the long-term of the Growth and Value factors. The dashed lines represent the upper and lower 2 standard deviation bands – a breach of these bands would suggest the prevailing trend is getting stretched. These charts suggest persistent outperformance of Growth may be exhausted, and it may (finally) be Value's time to shine.

Exhibit 8*:

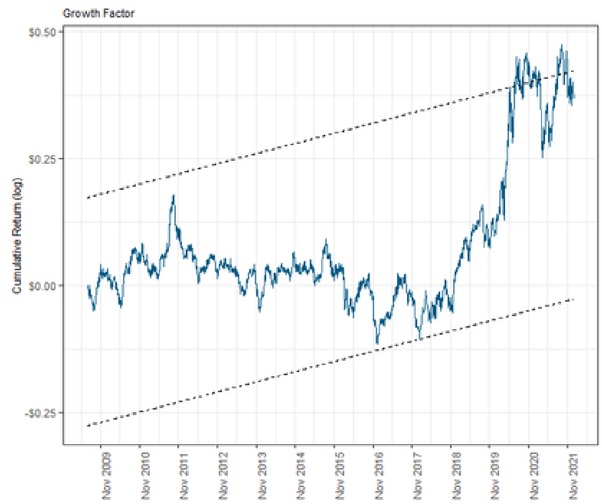
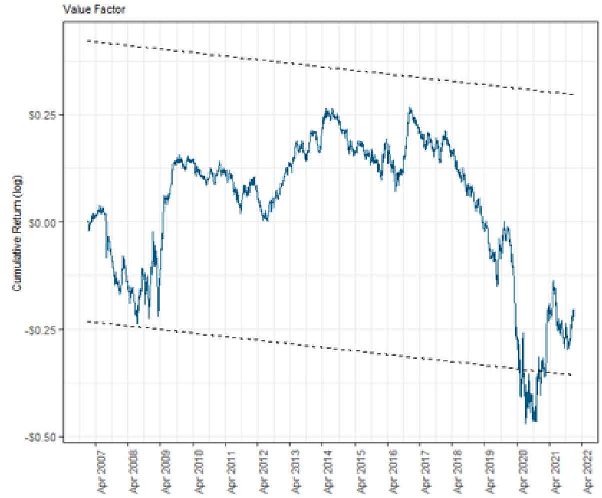


Exhibit 9*:

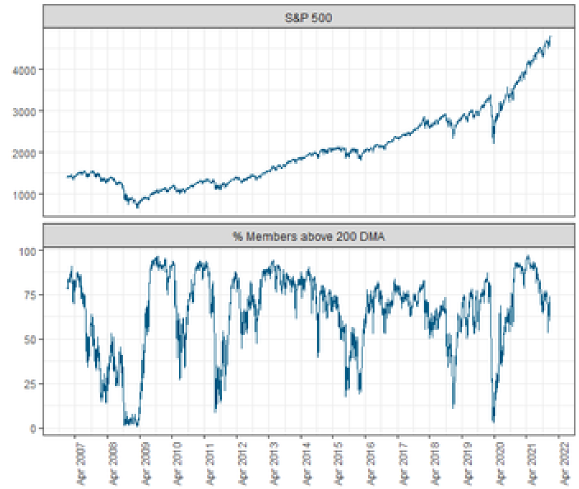


*Source: Bloomberg, Investment Office Resources calculations as of 31 December 2021

TROUBLE UNDER THE HOOD:

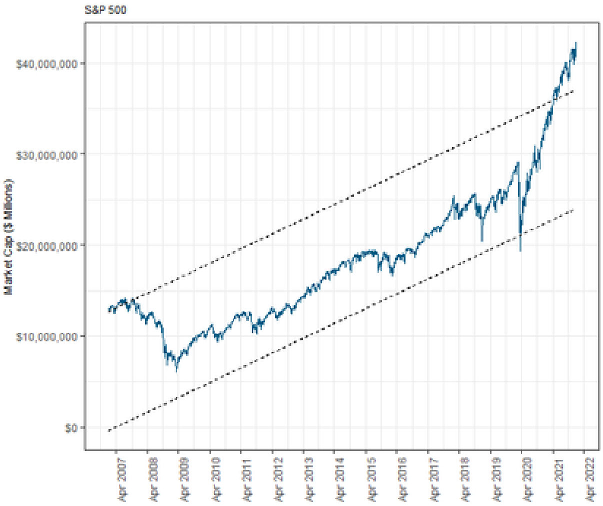
With equity markets continuing their assault on all-time highs, we remain vigilant of trouble that may be lurking. under the surface. **Exhibit 10** plots the S&P 500 and the % of members trading above the 200-day moving average.

Exhibit 10*:



Currently we're seeing extraordinary deterioration in breadth, as a small fraction of stocks is leading the S&P to new highs. Divergences such as these are often, but not always, resolved via market corrections. This, coupled with the fact that the S&P 500's market cap is well above its historical trendline, has us nervous.

Exhibit 11*:



While we don't see an abundance of evidence that the market is due for a correction, we are cautious of periods when generals lead but soldiers don't follow.

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*Source: Bloomberg, Investment Office Resources calculations as of 31 December 2021