INSIGHTS & PERSPECTIVES

from MacKay Shields Fundamental Equity Team

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# Thoughts on Equity Market Sell-off

After two years of strong returns, equity markets have faced a challenging start to 2022. The S&P 500 and the MSCI ACWIxUS Index are both down 16% year to date, and growth stocks have fared worse, with the Nasdaq and the ACWIxUS Growth Index both down roughly 25%.

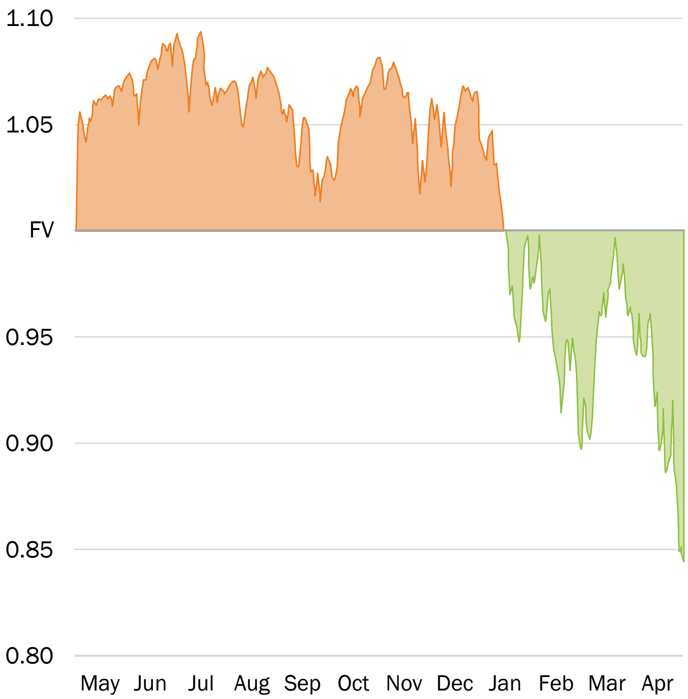
This performance marks a major reversal, as growth stocks performed extremely well in 2020 and 2021 as COVID-induced lockdowns drove business acceleration for growth oriented companies that enable online advertising, e-commerce and digital payments. In addition, these faster growing companies that are considered long duration investments disproportionately benefitted from the decline in interest rates as central banks tried to stimulate economic activity in the midst of the pandemic. While we were not surprised to see growth stocks outperform in 2020 and 2021, we felt that the degree of outperformance was excessive, implying both that COVID era growth rates and low interest rates could be sustained indefinitely.

This year's market movements have brought an unwinding of the dynamics described above, with companies that were COVID beneficiaries now experiencing slower growth rates against tough year-ago comparisons, at the same time as their stocks are feeling the negative impacts of rising interest rates. While such a reversal seemed inevitable, we feel that the magnitude of the recent sell-off may be another over-reaction driven by investors extrapolating recent dynamics into the future. One obvious example of the slowdown being felt by COVID beneficiaries is Amazon's recently reported 1Q22 sales growth of 7%, after having reported 44% sales growth in 1Q21. As comparisons ease later this year, Amazon and its international competitors will likely see an acceleration in revenue growth. The stocks of faster growing companies have also been hurt by the belief that the Federal Reserve and other central banks will need to keep aggressively raising interest rates to combat inflation. However, investors may reassess their views on the future path of rates if:

- Less restrictive COVID policies in China lead to an easing of supply chain pressures,
- The war in Ukraine shows signs of concluding,
- Oil prices decline, or
- Recent interest rate hikes slow economic activity more than expected.

One indicator we monitor that suggests the recent sell-off may be excessive is Morningstar's Market Fair Value estimate, which is shown in Figure 1 below. This metric looks at the universe of 1,800 global stocks covered by Morningstar and where those stocks trade relative to their analysts' fair value estimates. It shows that the average stock under coverage has gone from roughly 7% overvalued to 15% undervalued in the last 12 months.

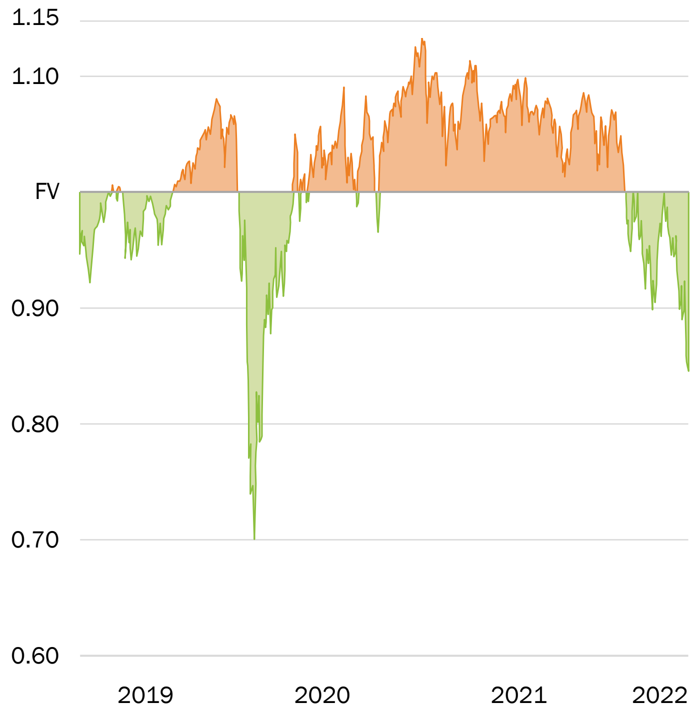
FIGURE 1: MORNINGSTAR MARKET FAIR VALUE ESTIMATE | 1 YEAR




May 12, 2021 – May 11, 2022
FV = Fair Value
Source: Morningstar

Looking at this same data point over the last 3 years suggests that the level of undervaluation in the market is not as great as it was in March 2020, but it does suggest that the risk reward for global equities has become more attractive.

FIGURE 2: MORNINGSTAR MARKET FAIR VALUE ESTIMATE | 3 YEARS




May 12, 2019 – May 11, 2022
FV = [Fair Value]
Source: Morningstar

A closer look at the data also suggests that wide moat stocks, those of companies with meaningful competitive advantages, are trading at bigger discounts than narrow moat stocks or stocks of companies with no moats at all, and that small cap stocks are trading at larger discounts than mid and large cap stocks. A narrowing of these valuation anomalies may be beneficial for our portfolio, which is typically comprised of what we believe are competitively advantaged small and mid-cap companies likely to experience above average earnings growth backed by long term secular trends.

After keeping pace with our peer group average in 2020, reducing our exposure to richly valued growth companies in late 2020 helped us to meaningfully outperform our peer group in 2021. We have slightly underperformed our peer group thus far in 2022 but we feel that the current market environment is providing us with opportunities to increase our exposure to high quality companies with attractive growth prospects that are now trading at reasonable valuations.

## SOURCE INFORMATION

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