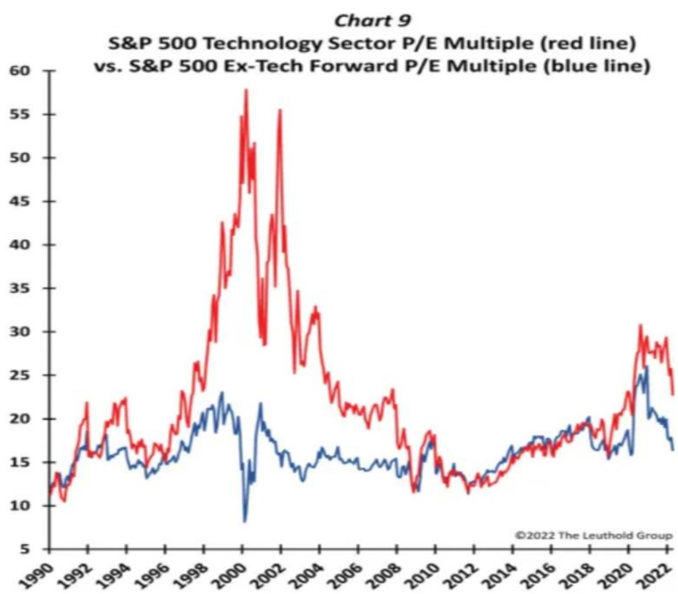
May 9th 2022

What are some of the signs of a market bottom and where do we see opportunities?

The S&P 500 is down now 13.5% as at Friday's close and Nasdaq is down 22.4%. The indices though are masking a lot of damage that has already been done to individual stocks. Furthermore, the generals of the bull market, namely Nvidia, Tesla, Netflix, Meta (formerly Facebook), Google, Apple, Amazon and Microsoft, are down 36.5%, 18.1%, 70%, 39.4%, 20.1%, 11.4%, 31.2% and 18.3%, respectively on a year-to-date basis. It is often said that the battle ends when the generals die.

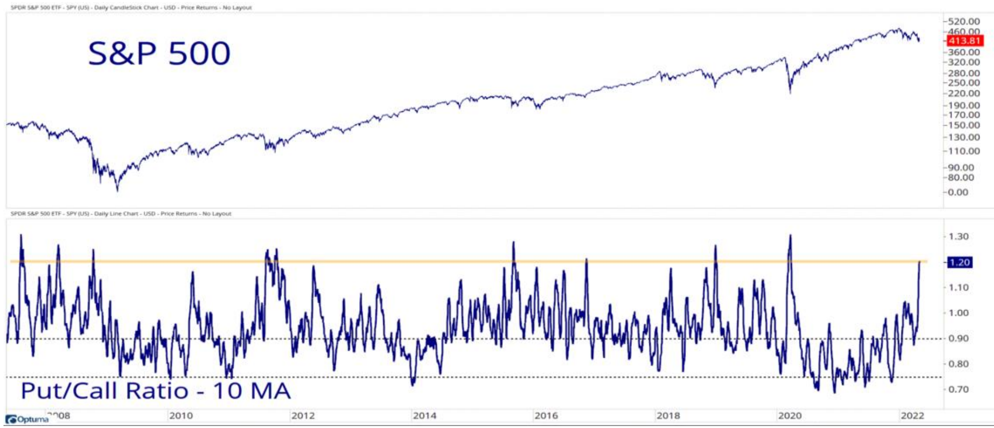


Tech sector valuations have deflated pretty dramatically, but they remain above historical average levels going back 32 years. **The multiple compression that we have been talking about for almost a year now will continue especially as the Fed is signalling a more aggressive tightening policy to tackle inflationary pressures.** The adage of ''Don't fight the Fed'' is as valid today as ever.

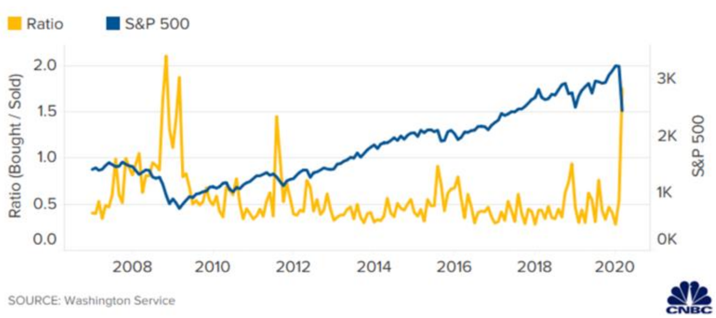
However, we are not in the business of timing markets, and we do not manage money this way. Being long-time observers and participants in markets we cannot help but have a view based on our many years of experience. Sir John Templeton once said: *"Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on Euphoria."* The Euphoria has clearly died and we can now argue that pessimism is spreading very quickly. For a market bottom to form we need few things to be in place:

1. **Negative sentiment (contrary indicator).** We are already seeing that in a variety of indicators such as the AAII readings which are at extreme levels (bears at 52.9% vs. 30% historical average, and bulls at 26.9% vs. 38% historical average). Since 1987, the S&P 500 has realized a 6 month average gain of 5.6% and a 12 month average gain of 8.1% following unusually high bearish sentiment readings. Good examples include the peaks in bearish sentiment in October 1990, March 2009 and March 2020, where the S&P 500 gained 25.6%, 52% and 57% (respectively) in the following 12 months. The put-call ratio, another contrary indicator, is also on the rise and approaching extreme levels (see chart below).

Additionally, BoA's Global Fund Manager Survey in April showed that global growth optimism is at an all-time low.

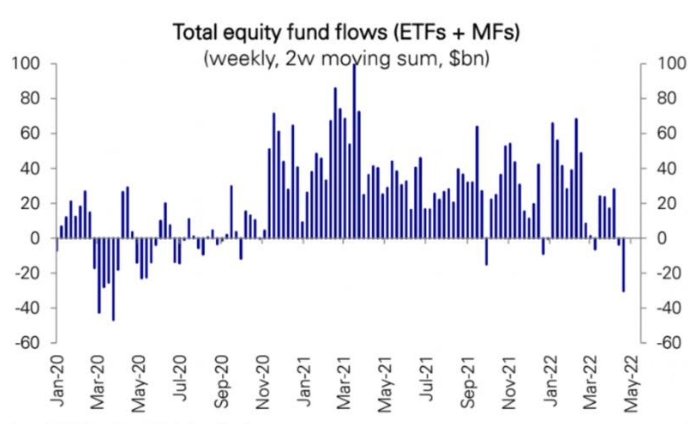


2. **Insider buying (or the ratio of insiders buy to sell at a high).** In March of 2020, around the time the market bottomed, the ratio of insider buying to insider selling was 1.75x, its highest level since March 2009 (see chart below). That proved to be a good market bottom predictor. The ratio has been rising since February 2021 but is still below extreme levels.



3. **Share buybacks (i.e. companies buying back their own shares).** We have started to see many companies announce major share buyback programs in recent weeks (e.g. Norfolk Southern, Macy's, Cisco, Devon Energy, etc…). In fact, a record $319Bn of share buybacks have been authorized so far this year according to Goldman Sachs.

4. **Significant equity outflows (contrary indicator).** According to Deutsche Bank, US equity funds have recorded $30Bn of outflows in the 2 weeks leading up to April 22, the most since the March 2020 sell-off.

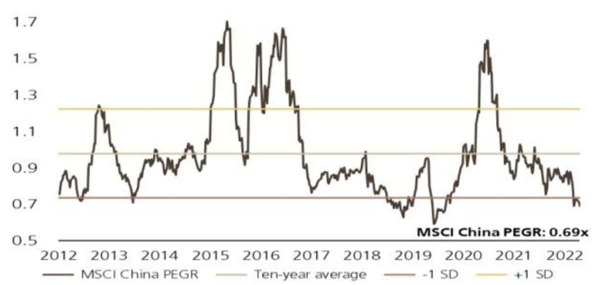


5. **Notable value investors start to deploy cash.** Warren Buffett, the ultimate value investors has started putting cash to work - $41Bn to be precise. While that's only about 1/4 of Berkshire Hathaway's massive $147Bn cash pile, Buffett's recent actions could reflect the long-term value he sees in stocks amid uncertainties.

Nobody ever made money on a consistent basis by timing markets. As we said above, we view this as a useless exercise and it is not what we do. This begs the question of where we see opportunities.

1. **China.** We view China as investable, as opposed to the consensus view now that it is uninvestable. It is the only major economy in the world where you have an easing monetary policy and expansionary fiscal policy. China has already been in a bear market for over a year now. The Shanghai index is down 17.5% year-to-date. Coming out of Covid lockdowns China is expected to increase the stimulus to its economy. Everyone has capitulated on China amid regulatory and political uncertainties. *''When the time comes to buy, you won't want to.''* - Walter Deemer. We acknowledge this risk but believe current valuations, especially in the tech sector, are attractive enough for us to be interested. China is the only market where you will find established high-quality global tech companies trading at very attractive levels. Furthermore, Chinese equities offer good portfolio diversification as they are often decorrelated from the rest of the world, especially now given that they are in a different stage of the economic cycle.

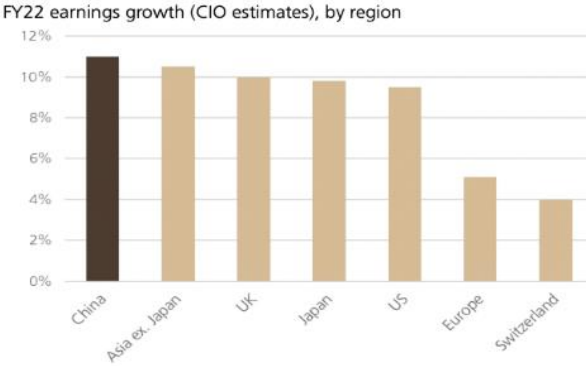
Fig. 2: MSCI China's PEGR valuation nearing trough
Historical PEGR trend



Source: Bloomberg, UBS, as of April 2022

Chinese equities are trading at 12.1x P/E and 7.3x P/CF vs. 10yr historical average P/E of 14.6x and P/CF of 13.1x. If we look at Hong Kong equities alone, the market looks even cheaper, trading at only 7.3x P/E and 3.3x P/CF vs. 11x historical P/E and 7.6x historical P/CF. Furthermore, despite forecasts being slashed, China is still expected to see decent earnings growth that is faster than Asia-Pacific peers, yet these peers trade at more expensive valuations.

FY22 earnings growth (CIO estimates), by region



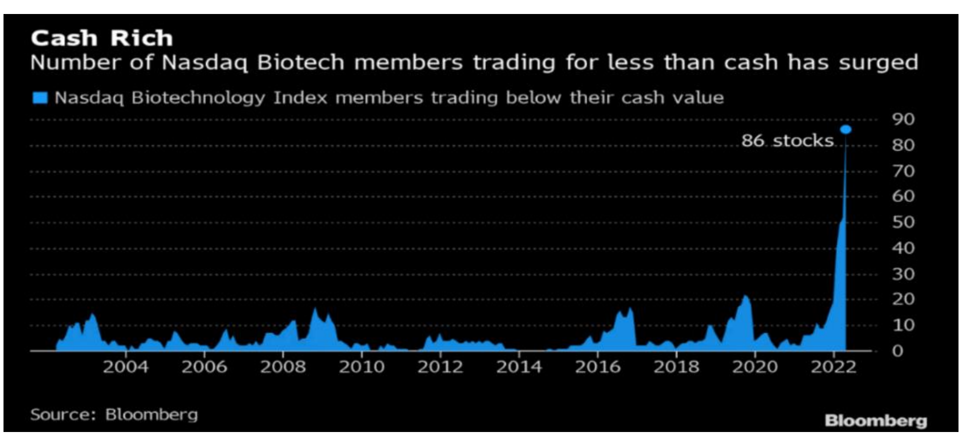
Source: UBS estimates, as of April 2022

2. **Brazil.** We have been long Brazil for over a year now through EWZ (the iShares MSCI Brazil ETF) which is up 11.7% year-to-date. We expect Brazil to continue to outperform as it is not only one of cheapest emerging markets around the world (P/E of 5.7x vs. 27.9x 5yr historical average P/E and 10.9x EM Index P/E), but it will also benefit from the rise in food and commodity prices since it is one of the largest producers of crude oil, soybeans, coffee, sugar, iron ore, cotton, etc...

As can be seen from the chart above, EWZ has massively underperformed the EEM (Emerging Market ETF), generating a total return of -24.4% vs. +23.8% for EEM, but the underperformance has been narrowing recently. We expect Brazil to continue to catch up going forward, especially since the index has a value bias, with financials, materials and energy accounting for more than 50% of the market.

3. **Healthcare.** The sector should do well in a world where global growth is slowing, inflation is very high and geopolitical risks are elevated. Healthcare stocks not only have strong pricing power and stable cash flows, but they are also trading at their cheapest level in years.

4. **Biotech.** Biotech in particular is interesting because it has been a huge underperformer in 2021 and so far year-to-date, with the XBI Biotech ETF down 21% in 2021 and 37.4% ytd. We believe this major pullback could prompt some M&A activity and help re-rate the sector. This is our long-duration asset play since we believe the bond market has largely priced in a lot of Fed tightening and many of those rate hikes will not materialize as the economy starts to slow down. Furthermore, there is an unprecedented number of Biotech stocks trading below cash (see chart below). In fact, more than 20% of the Nasdaq Biotech Index's 370 members are trading for less than cash, making them more attractive acquisition targets. If Big Pharma doesn't act now, then when? There's never been anything like this in data going back to 2002. Small and mid-caps in particular have been hit the hardest, with Biotech stocks in the Russell 2000 closing out their worst April since at least 1997. The XBI itself had its worst April since inception in 2006. To put the sell-off in a different perspective, Bristol-Myers Squibb, the world's 13th largest life sciences company by value, is worth substantially more than the EV of the 890 publicly-traded biotech companies combined. We think the risk/reward from here is asymmetric.



5. **Undervalued Event-Driven/Special Situation names.** These stocks often have low correlations with the broader market and could do well even as the investment landscape becomes tougher.