DIAMOND HILL

INVESTED IN THE LONG RUN

Macro Conditions Continued to Wallop Global Markets in Q3

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Global stocks continued their descent in Q3 as the economic outlook weakened primarily due to persistent inflationary pressures, the ongoing incursion of Ukraine and a slowdown in China driven by its strict zero-COVID policies.

Following a brief respite in the second quarter, Chinese stocks fell -22% in Q3, bringing year-to-date declines to more than -30%. China's zero-COVID policies continue to wreak havoc on the economy. Consumer spending fell sharply during a recent seven-day national holiday compared to last year, and the strengthening US dollar has put increasing downward pressure on the yuan. The People's Bank of China has responded to the currency's slide with various tools it has used over the years to manage the country's exchange rate.

Elsewhere in the Asia Pacific region, stocks in Japan fell -7.5% in Q3, with most of the declines occurring in the final month of the quarter. The assassination of former prime minister Shinzo Abe in early July overshadowed economic and market headwinds, though recent data showed some improvements. The Japanese economy expanded in the second quarter. While inflation remains a concern, with rising energy and food prices, consumer spending was strong in Q2 and was expected to be resilient in Q3 as Japanese consumers enjoyed their first summer without extensive COVID lockdowns. Perhaps the most pressing concern currently is the strength of the US dollar and the rising cost of imports. In September, Japan intervened in the currency market for the first time in 25 years by buying yen after a sharp decline in the currency, which was precipitated by the Bank of Japan's confirmation that it would maintain ultralow interest rates.

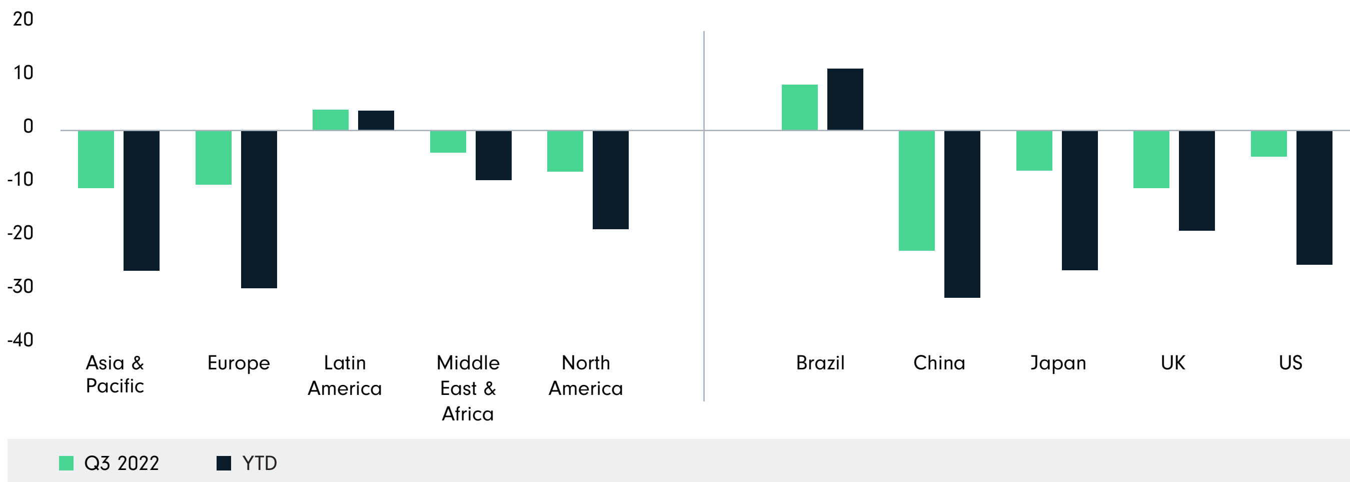
In the UK, stocks closed the quarter down nearly -11%, after an extremely volatile trading environment that was driven by an unexpected announcement of the largest tax cuts the country would have seen in decades. The announcement of the ill-advised tax cuts resulted in a massive disruption in the gilt (English government bonds) and currency markets. The subsequent meltdown forced the Bank of England (BOE) to step in and announce the resumption of bond purchasing as some British pension plans were allegedly on the cusp of failure due to the dramatic rise in rates across the curve. As we write this commentary, the government has since reversed course on most of the tax cuts, though damage has been done to the financial markets and to confidence in newly appointed prime minister Liz Truss.

In Europe, weakness was broad-based with stocks in Germany down -12%, stocks in France down -8% and stocks in Switzerland down -7% in Q3. During the quarter, the euro hit a new 20-year low against the dollar after Russia shut down a major pipeline into Europe, further deepening the energy crisis that the region has been dealing with since the start of Putin's war in Ukraine back in February. In early September, the European Central Bank (ECB) announced a 75-basis point (bps) increase in its key interest rate, the largest increase since the turn of the century, bringing its key rate to 0.75% from zero. This is on the heels of a 50-bps increase in July, as the ECB acts aggressively to curtail inflation.

Turkey was the best performing European country in Q3, with stocks up 16%. Its gains are largely attributable to the fact that President Erdogan has responded to the country's 80% inflation rate by cutting interest rates, not raising them. Consequently, Turkish investors responded in kind by buying stocks in an attempt to beat inflation.

Following a -24% selloff in Q2, stocks in Brazil advanced 8.5% in Q3. The Q2 selloff largely stemmed from concerns about the country's presidential election (in October), double-digit interest rates and weakness in commodity prices. Stocks bounced back in July and August and traded range-bound in September as investors took advantage of the share price weakness.

Exhibit 1 — Q3 and YTD Total Returns for Major Markets (USD) (%)



Source: FactSet, as of 30 Sep 2022.

In the MSCI ACWI ex USA Index, the consumer staples and energy sectors held up the best with -6% declines. The materials, financials and industrials sectors followed with -7% losses. The worst performing sectors were communication services (down -16.4%), real estate (down -14.4%) and consumer discretionary (down -12.9%). The remaining sectors posted losses in the -10% to -11% range.

After a decade of extraordinary market returns, it can be easy to forget that drawdowns are a part of long-term investing. And while the current environment has been a challenging one — with a 20% selloff in global markets in the first nine months of the year — it is not out of the ordinary for long-term investors. As active managers, we believe this type of environment and volatility offers opportunities for us to add value for clients who are able to withstand these types of drawdowns and stay invested over the long run.

MSCI ACWI ex USA Index measures the performance of large- and mid-cap stocks in developed (excluding the US) and emerging markets. The index is unmanaged, market capitalization weighted, includes net reinvested dividends, does not reflect fees or expenses (which would lower the return) and is not available for direct investment. Index data source: MSCI, Inc. See diamond-hill.com/disclosures for a full copy of the disclaimer.

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