Syntax

Syntax Quarterly Commentary: Second Quarter 2022

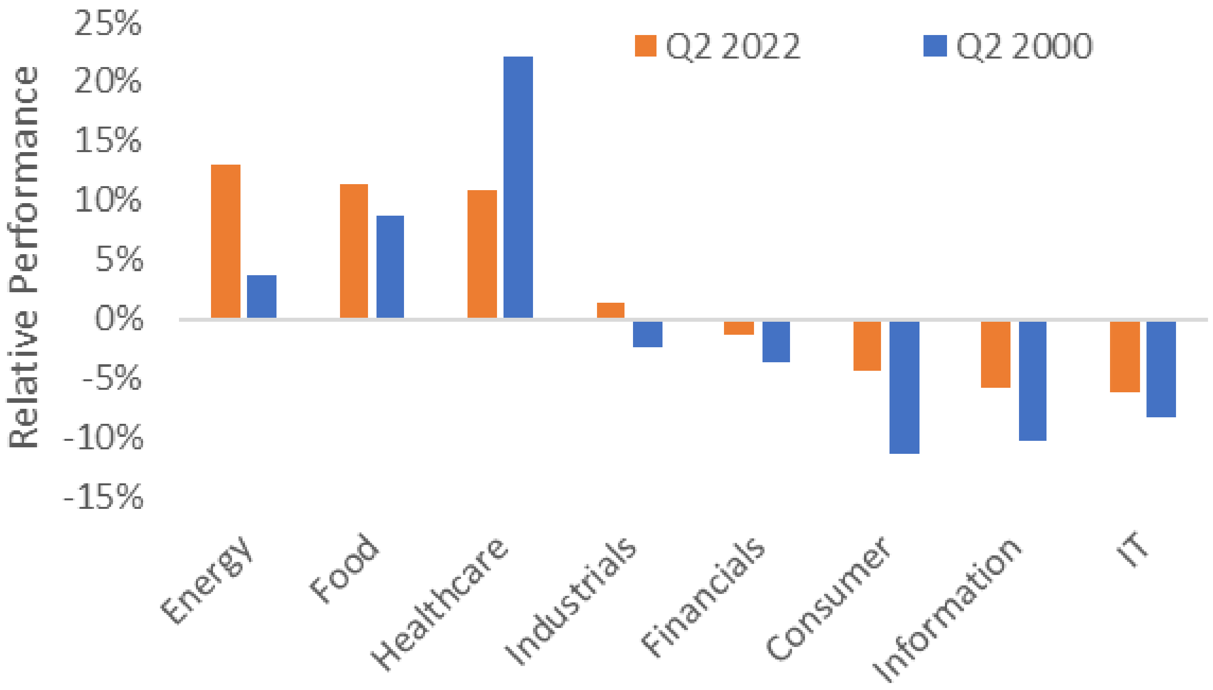
Simon Whitten July 27, 2022

2022 Follows the DotCom Road

The S&P 500 fell 16.10% in Q2 2022. In historical context, the market had its 9th worst quarter in post-war history, claiming its spot on the Worst 10 Quarters list by displacing the quarter containing 9/11/2001. By comparison, the Stratified LargeCap index, which holds the same stocks as the S&P 500, but with more diversified weights fell 12.98%, outperforming the cap weighted index by 3.12% and the equally weighted S&P 500 by 1.37%.

In Q2 2022, the US LargeCap Consumer, Information and IT sectors (49.2% of the S&P 500) underperformed the market by over 4%, whereas Energy, Food and Healthcare all outperformed significantly. This pattern of sector performance within the US LargeCap universe highlighted the similarities between the current market regime and that of the market environment surrounding the bursting of the DotCom Bubble in mid-2000.

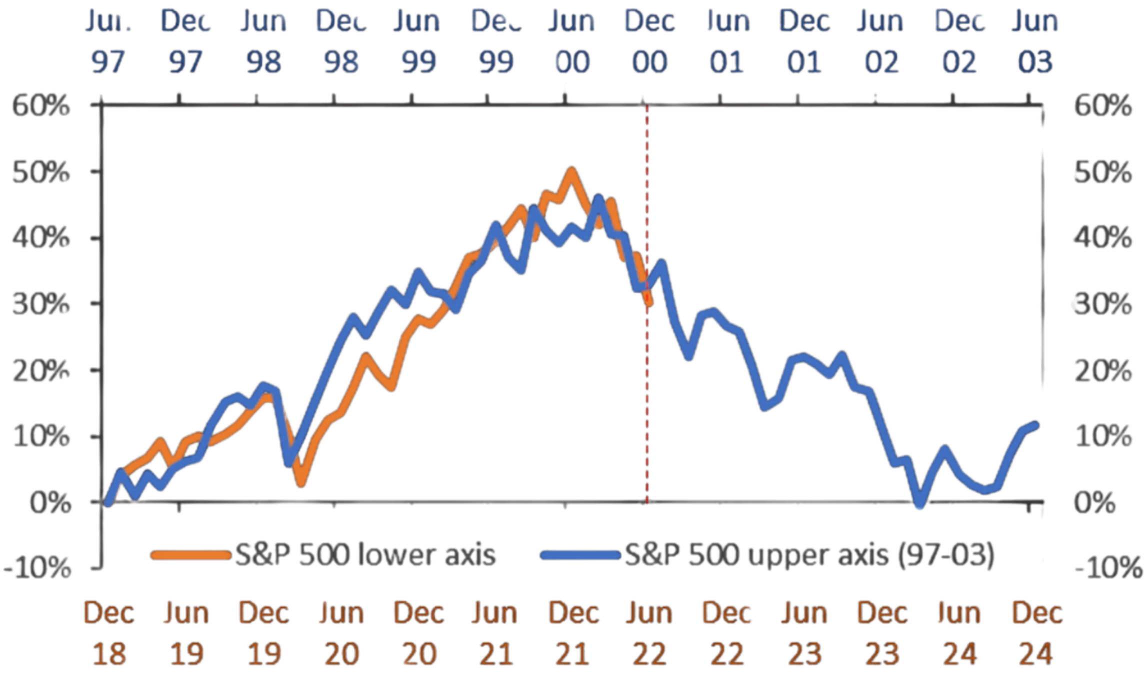
Q2 2022 compared with Q2 2000



Source: Syntax, S&P Dow Jones Indices, MSCI.

The similarities in the broad market performance have also mirrored the performance in 2000. Note that the correction in H2 2000 persisted for over two years.

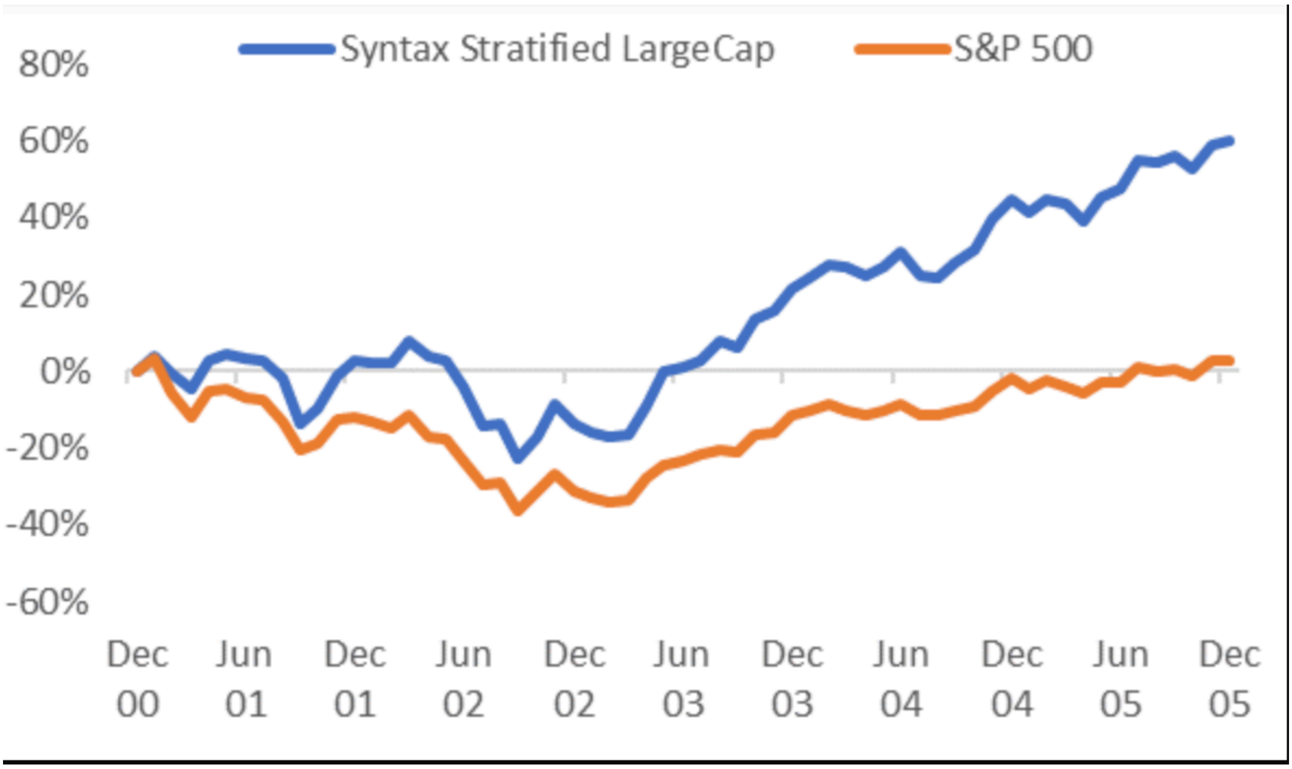
DotCom market unwind compared with current sell-off



Source: Syntax, S&P Dow Jones Indices.

After the bubble burst, technology stocks fell out of favor with investors and their unrealistic valuations and high levels of institutional ownership persistently unwound. Cap weighted indices consistently underperformed alternatively weighted products such as the Stratified LargeCap index in the US, due to their outsized weight in the technology sectors.

Stratified LargeCap consistently outperformed from 2000-2005



Even in light of the significant underperformance of IT and Information stocks this year, the S&P 500 is more heavily skewed towards technology than it was in December 2000, fueling concerns that the recent market environment could persist as it did back then.

Despite 8.3% decline, markets showed signs of order in June

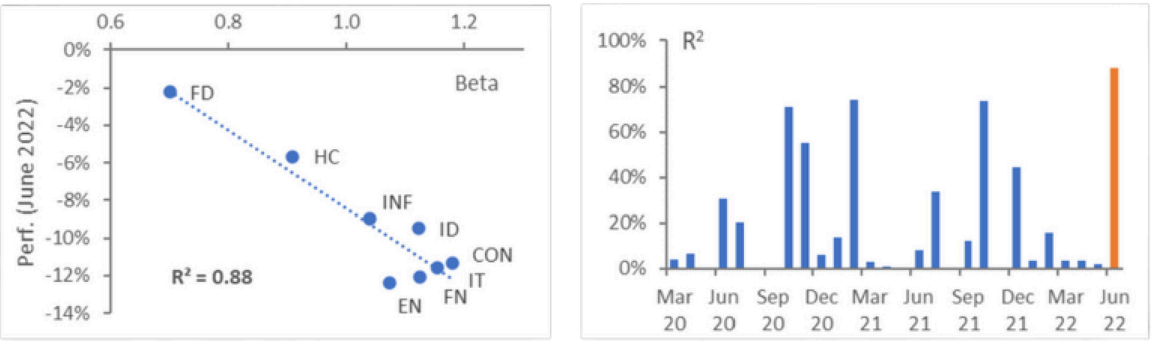
Even though the S&P 500 officially entered a bear market in Q2, the declines were not met with the same pandemonium that we saw during September 2001, or the early days of the Pandemic. In Q2, the market declined for more traditional reasons, namely that high inflation, rising rates and waning growth raised the probability that the US will enter a recession. Despite being disastrous for risk assets (as reflected by a 16%

decline in the S&P 500 in Q2), a cyclical recession is usually easier to price than the impact of a war or a pandemic. Hence, we saw a reassuring sign in the dismal stock performance of June 2022 – a resurgence in the efficacy of the CAPM.

The CAPM is one of the most basic tenets of equity market analysis, basically stating that the expected return of an asset depends on how risky it is relative to the broad market. In other words, higher risk (beta) should lead to higher returns. However, the CAPM hasn't had the best track record since the Pandemic took hold as the market has been driven by different risks.

In June, beta reasserted itself as the key driver of return as shown by the correlation of sector betas with sector performance. The R-squared between sector beta and sector return was 88% in June, suggesting that sector risk explained 88% of the variance of sector returns that month. This was the highest the R-squared has been since the Pandemic began in 2020.

Relationship between sector risk and return in June and since Pandemic began



Source: Syntax. The charts show the relationship between sector performance and sector beta (one month lagged). FD=Food; HC=Healthcare; INF=Information; ID=Industrials; CON=Consumer; IT=Information Technology; FN=Financials; EN=Energy.

Though this observation is likely to be little consolation to most investors, it does represent a vote of confidence to those of us who believe in the Foundations of Finance. Namely that risk drives return, earnings drive prices and diversification is the only free lunch. In a world previously driven by a herd oftentimes agnostic to value or risk (GameStop anyone?), signs that the market is reverting to a more rational regime are welcome, even when they are painful to endure.

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