

## Turning away from the glass-half-empty mentality

## Global Matters Weekly

30 January 2023

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As we turn the page on 2022 and look with cautious optimism at 2023 for some respite in markets, investors are appraising the investment landscape with an understandable degree of trepidation. Indeed, following the macroeconomic and geopolitical events of 2022, losses in fixed income markets were on par with those in equities making it one of the worst years on record for balanced portfolios. Conflating this with the prospects of a global recession, the amplitude of which is yet to be fully appreciated, pessimism in markets has led investors to position themselves incredibly bearishly at the end of 2022. This was demonstrated by recent spikes in the Chicago Board Options Exchange Put/Call Ratio which went haywire in November before spiking to its highest level on record in December. This normally contrarian indicator might therefore be pointing to a significant regime shift and things might in fact not all be doom and gloom.

Let's start with the good news. It seems, inflation has likely peaked and is expected to fall materially this year. Looking at the data in the US, the contribution to headline Consumer Price Index from prices of goods has come right off, as the supply and demand shocks from the global pandemic recovery have dissipated. In addition, commodity prices have fallen significantly from their peaks in 2022, some to pre-invasion levels. The one thorn in the side is core inflation, which strips out food and energy prices, and is expected to remain sticky, in part due to a resilient labour market (low unemployment and unwavering wage growth) coupled with a robust consumer.

Turning to monetary policy the US Federal Reserve (Fed) has already hiked rates to a range between 4.25% and 4.5% with expectations for terminal rates at around 5%, so arguably, the majority of hikes have already been priced in<sup>1</sup>. Monetary policy operates with a lag, with services, jobs, and inflation being in general the last to respond to policy impulses. However, the early effects of last year's tightening on activity and inflation are clear. Growth in the US is cooling as illustrated by a raft of economic data. In fact, the latest flash

**It seems, inflation has likely peaked and is expected to fall materially this year.**

Purchasing Managers Index's for January, while showing a slight improvement from December, still indicated a seventh consecutive month of contraction in the private sector. The one outlier is the strong US labour market, but even there we are seeing signs of weakness starting to materialise. High frequency indicators are flashing recessionary signals as evidenced by the growth over the last six months of weekly jobless claims. Additionally, looking at the rate of change of the (admittedly high) job openings over the last six months reveals a clear contractionary trend. Qualifying all of this with the decline in hiring intentions, as suggested by the National Federation of Independent Businesses survey data, one can only expect an imminent cooling in the labour market. This would vindicate the market pricing of a Fed pivot as illustrated by the Fed Funds futures and the Fed dot plots. However, risks remain as the Fed will absolutely want to regain credibility after previously beating the 'transitory-inflation' drum for so long and in doing so, will tolerate an economic slowdown and higher unemployment to bring inflation down to its 2% target.

So, how have markets reacted? Focusing on valuations, these have rerated substantially last year with equity markets having returned closer to their long-term averages and bond markets now offering attractive yields without the need to take on significant interest rate or credit risk. Interestingly, strongly inverted yield curves are signalling an imminent recession, but credit spreads aren't pricing this in at all. What the higher yield levels do afford is a greater degree of reassurance as investor bearishness has been baked-in to prices, effectively discounting a substantial level of downside potential. Similarly, whilst equities aren't yet discounting a significant earnings recession, we can perhaps take comfort in the realisation that last year's

equity market drawdown was exclusively driven by multiple contraction resulting from higher interest rates, whilst earnings growth remained positive. Given markets imply we are about 50bps from peak rates in the US, we can therefore reasonably expect a mild earnings recession to have a less dramatic effect on markets, especially if the outlook is more positive for 2024. Finally, if we consider a best-case scenario where fixed income markets are right and we do see a true Fed pivot this year, we could then reasonably expect a reversal of the multiple contraction seen last year.

Wishful thinking? Perhaps, but investors should turn away from the glass-half-empty approach and instead take solace in the fact we are entering a new regime where government bonds are offering positive 'risk-free' rates once again. Whilst a mild recession seems the widely expected outcome this year, markets have repriced closer to fair value (with some cheap valuations in areas) hence, we are starting the year from a more attractive base to generate long-term returns. Something positive to look forward to, then, amongst all the doom and gloom?

## The Marketplace

- Global equities returned 2.2% last week
- Following Germany's promise of military support, the US announced that it would be sending 31 M1 Abrams tanks to aid Ukraine's battle against Russian forces
- Brent crude fell by 1.1% to \$86.66 per barrel
- Gold rose 0.1% to \$1928.04 per ounce

## Market Focus

### US

- US equities returned 2.5% last week
- The US composite Purchasing Managers Index (PMI) remained beneath the expansionary 50-mark for its 7th consecutive month as it came in at 46.6 (vs. 46.4 expected)
- The Q4 Gross Domestic Product (GDP) release from the US showed the economy grew by an annualised 2.9% at the end of last year (vs. 2.6% expected)
- A breakdown of the GDP growth showed the key drivers being inventory growth, net exports, and government spending. Domestic consumption showed signs of grinding to a halt

### Europe

- European equities returned 0.9% last week
- Flash composite PMI came in at 50.2 (vs. 49.8 expected). The first time it's been above 50 since June
- Both services (50.7 vs. 50.1 expected) and manufacturing PMIs (48.8 vs. 48.5 expected) saw upside surprises in their figures
- European Central Bank President Lagarde, reiterated the bank's focus on tackling inflation saying: "We will stay the course to ensure the timely return of inflation to our target"

### UK

- UK equities returned -0.1% last week
- Composite PMI fell to 47.8 (vs. 48.8 expected), the lowest reading on that measure since the economy last went into a lockdown in 2021
- Nadhim Zahawi was sacked from Rishi Sunak's government after an enquiry revealed the former chancellor failed to disclose investigations into his tax affairs

### Asia/Rest of The World

- Global emerging market equities returned 1.4% last week
- Japanese equities rose by 2.9% last week
- Tokyo's Consumer Price Index for January came out with an upside surprise as headline inflation advanced to +4.4% year-on-year (vs. +4.0% expected), hitting a four-decade high
- Japanese composite PMI moved back into expansionary territory at 50.8, following two months beneath the 50-mark, driven by services which saw a strong move higher to 52.4
- Meanwhile in Australia the composite PMI rose to 48.2 (vs. 47.5 previously), below the expansionary 50-mark but a change from three consecutive declines.

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Asset Class/Region	Currency	Currency returns			
		Week ending 27 Jan. 2023	Month to date	YTD 2023	12 months
<b>Developed Market Equities</b>					
United States	USD	2.5%	6.1%	6.1%	-4.8%
United Kingdom	GBP	-0.1%	4.0%	4.0%	7.9%
Continental Europe	EUR	0.9%	7.8%	7.8%	-0.9%
Japan	JPY	2.9%	4.8%	4.8%	10.6%
Asia Pacific (ex Japan)	USD	1.7%	10.7%	10.7%	-3.7%
Australia	AUD	0.6%	6.5%	6.5%	14.7%
Global	USD	2.2%	7.1%	7.1%	-4.2%
<b>Emerging markets equities</b>					
Emerging Europe	USD	0.2%	5.6%	5.6%	-67.2%
Emerging Asia	USD	1.5%	11.1%	11.1%	-7.9%
Emerging Latin America	USD	2.2%	9.4%	9.4%	12.4%
BRICs	USD	1.4%	10.6%	10.6%	-9.6%
China	USD	3.2%	17.2%	17.2%	-4.2%
MENA countries	USD	0.6%	1.8%	1.8%	-11.8%
South Africa	USD	1.1%	7.8%	7.8%	-0.8%
India	USD	-3.0%	-1.4%	-1.4%	-3.8%
Global emerging markets	USD	1.4%	10.0%	10.0%	-9.2%
<b>Bonds</b>					
US Treasuries	USD	0.0%	2.5%	2.5%	-8.4%
US Treasuries (inflation protected)	USD	0.6%	2.5%	2.5%	-7.8%
US Corporate (investment grade)	USD	0.3%	3.7%	3.7%	-9.6%
US High Yield	USD	0.4%	4.0%	4.0%	-5.4%
UK Gilts	GBP	0.0%	2.7%	2.7%	-20.2%
UK Corporate (investment grade)	GBP	0.6%	4.2%	4.2%	-14.5%
Euro Government Bonds	EUR	-0.6%	2.9%	2.9%	-15.7%
Euro Corporate (investment grade)	EUR	0.0%	2.2%	2.2%	-11.3%
Euro High Yield	EUR	0.4%	3.3%	3.3%	-7.7%
Japanese Government	JPY	-0.4%	-0.1%	-0.1%	-5.3%
Australian Government	AUD	-1.0%	3.0%	3.0%	-6.1%
Global Government Bonds	USD	-0.2%	3.0%	3.0%	-13.1%
Global Bonds	USD	-0.1%	3.4%	3.4%	-12.3%
Global Convertible Bonds	USD	1.3%	5.7%	5.7%	-9.1%
Emerging Market Bonds	USD	0.1%	4.1%	4.1%	-18.1%

Source: Bloomberg. Past performance is not indicative of future returns

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<b>Property</b>					
US Property Securities	USD	3.6%	9.8%	9.8%	-8.2%
Australian Property Securities	AUD	2.3%	8.6%	8.6%	-5.3%
Asia Property Securities	USD	2.3%	5.4%	5.4%	-4.8%
Global Property Securities	USD	2.9%	8.8%	8.8%	-10.0%
<b>Currencies</b>					
Euro	USD	0.2%	1.5%	1.5%	-2.4%
UK Pound Sterling	USD	0.0%	2.4%	2.4%	-7.3%
Japanese Yen	USD	-0.1%	0.9%	0.9%	-11.2%
Australian Dollar	USD	2.1%	4.2%	4.2%	1.0%
South African Rand	USD	-0.2%	-0.7%	-0.7%	-9.8%
Swiss Franc	USD	0.1%	0.0%	0.0%	1.1%
Chinese Yuan	USD	-1.2%	1.7%	1.7%	-6.5%
<b>Commodities &amp; Alternatives</b>					
Commodities	USD	-0.4%	0.3%	0.3%	11.6%
Agricultural Commodities	USD	1.8%	1.2%	1.2%	7.3%
Oil	USD	-1.1%	0.9%	0.9%	-3.0%
Gold	USD	0.1%	5.7%	5.7%	7.6%
Hedge funds	USD	0.3%	1.7%	1.7%	-0.7%

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