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Investment Views

DECEMBER 2022

Annus Horribilis

As if to coincide with the sad departure of our Monarch, it has been nothing short of an 'annus horribilis' as inflation, war and recession fears have triggered major price falls and surging volatility across a host of asset classes. With traditionally defensive investments also experiencing equitytype drawdowns there have been few hiding places.

According to Bloomberg, the Vanguard USD 60/40 model is down almost 20% for the year (as at 31st October), the worst return in a generation for the classic equities and bonds 'balanced' portfolio.

Yet as this tumultuous year draws to a close, there are some grounds for optimism with inflation pressures starting to ease. This is especially true in the US, which has the greatest influence on global monetary policy and markets. Whilst inflation remains quiescent in Asia and stubbornly high in the UK and Europe, there is growing evidence that US price trends have peaked; a pre-requisite for the Federal Reserve to halt rate hikes at some stage which, in turn, should halt the US dollar's advance. The greenback remains one of the biggest drivers of global risk appetite; if conviction grows that US rate hikes are fully priced in, this should presage a high for the dollar and a more conducive risk-taking environment.

Headline US CPI is still printing a punchy 7.7% y/y but the monthly rate has collapsed to a much lower range between 0-0.4% m/m. If the recent pace holds, the annual figure will fall back below 3-4% y/y by the middle of next year, allowing the Fed to adopt a less hawkish policy stance by early 2023. A prolonged pause is then the core scenario unless a deep recession comes to pass. Whilst the latter would encourage the swift return of aggressive rate cuts, risk assets would struggle as economic distress trumps cheaper money.

US goods inflation has already slowed considerably as covid supply bottlenecks have diminished and demand for rate-sensitive, "big ticket" items (like autos and property-related purchases) has struggled in the face of surging borrowing costs. Used car prices have declined at a 20% annualised pace over the past 6 months, whilst the average 30-year mortgage rate has doubled to 6.5% this year.

On the other hand, services costs remain elevated as rising shelter inflation (which represents over 30% of headline CPI) is yet to fully reflect the past 18 months' upturn in property prices and rents; this CPI component tends to lag. However, the nascent decline in national house prices suggests much weaker rental growth (and overall services inflation) lies ahead. If current "spot" rents were used in the CPI calculation core inflation would now be below 3%y/y (source: @jasonfurman, twitter) compared to October's uncomfortably high 6.3%y/y print.

Energy costs have already tumbled with the WTI oil price down 40% from its March high of U$123/bl. At current levels, its annual rate of change will flatten out by February 2023, removing one of the main drivers of this year's inflation shock. Energy prices are inherently unpredictable and could yet return as a major source of inflation, particularly if Ukraine-related disruption resurfaces or a rapid retreat from its zero-covid policy sees resurgent Chinese demand. For now, slower price momentum suggests market expectations for a peak Fed Funds rate of 4.5-5% early next year are about right. This infers the Fed will hike by another 75-100bps before it calls time on one its most aggressive tightening cycles ever.

At face value, the end of US rate hikes should be well received by markets. It implies inflation is under control (at least for the time being) and it means rising discount rates will no longer be such a headwind to long-duration assets, like long-term bonds and growth equities. Indeed, the bulk of the S&P 500's forward P/E decline, from a late-2021 peak of 28x to its current 18x, can be attributed to higher interest rates depressing the value of future cashflows and profits, rather than weaker corporate earnings.

Which brings us to the key question for investors heading into next year; can a prolonged US recession be avoided? If so, with inflation easing and peak interest rates priced in, equities are unlikely to revisit the summer lows. With expectations for 2023 profits growth revised down to zero, an economic "soft landing" would allow companies to meet increasingly subdued earnings forecasts. In short, stagnation or a mild recession would set the scene for equites to grind higher next year.

Conversely, if a deep and protracted downturn emerges the outlook for equities and other risk assets is gloomier. Whilst any lingering concerns over inflation and interest rates should dissipate (as both tend to fall sharply during recessions), share prices would need to adjust lower to account for an earnings contraction; profits tend to shrink by around 15% even during relatively mild recessions. Furthermore, the current 18x P/E would look stretched as forward multiples tend to trough below 15x during a recession.

So what are the odds of a US recession? Judging by the inverted Treasury curve (where long-dated yields have fallen well below those at the short-end) it seems all but guaranteed. Inversions have predicted the last 11 US recessions with only one 'false positive' (source: Mauldin Economics). Corroborating evidence stems from the marked decline in purchasing manager indices, that show shrinking order books and weak production, and a sharp downturn in housing activity; sales, prices and construction activity are all now falling at an accelerating rate. This typically augurs badly for the broader economy as the housing sector has an outsized influence on consumer spending and the labour market.

Several other data points provide a more balanced take and caution against extreme pessimism. US households continue to spend freely on discretionary services (like travel and eating out) and the Atlanta Fed nowcast is projecting c. 3% annualised GDP growth for the final quarter; such trends are typically not seen during a major economic downturn. In addition, the jobs market is holding up despite rising lay-offs in the tech sector and beyond; at 3.7%, the unemployment rate is just 0.2% above its recent low and would likely be well north of 4% if a recession were underway. Absent a marked deterioration in the employment picture, the US consumer should remain a key prop to the economy offsetting, at least in part, depressed property and manufacturing activity.

So whilst growth is clearly slowing, it could be well into next year before a more definitive recession call can be made. Until then, it is prudent to view any equity market bounce (like the one currently underway) as a "relief rally", offering opportunities to trim equity positions into cash and short-dated bonds. As noted at the top, the latter now offer much higher yields. We are thus modestly reducing risk across multi-asset portfolios as we head towards year-end.

That said, with headline stock markets already down 20-30% there is no reason to cull equity allocations. If equity indices revisit or breach prior lows, it is likely due to a major economic and earnings downturn. Under that scenario, bond prices should rally, helping to offset equity market downside. With yields having risen so sharply this year, they are once again offering an effective hedge. Conversely, equities should catch a bid if the more benign low growth/low rate scenario comes to pass, but bond market downside should be limited assuming price pressures do not resurface. Ironically, after one of its worst year's on record, the traditional equities/bonds 'balanced' strategy could well see a return to form in 2023.

POLICY MATRIX SUMMARY

The matrix below is a summary of our current 12-24 month outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high-level guide on where we stand at this time.

12-24 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives	Gold Miners China A Shares UK Small Companies Japan ESG & Impact funds	Inflation linked US Treasuries	Gold, Volatility Strategies
-		European	European Japanese	

MARKET PERFORMANCE

All performance numbers show % changes except for bond yields which show yield changes.

	30th Nov 22	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.2058	5.1%	3.8%	-9.3%
CHF	1.0574	5.9%	3.4%	-2.9%
AUD	0.6788	6.1%	-0.8%	-4.8%
JPY	138.0700	7.7%	0.7%	-18.0%
EUR	1.0406	5.3%	3.5%	-8.2%
BOND YIELDS (10 yr)				
UK	3.16	-0.35	0.36	2.35
US	3.61	-0.44	0.41	2.16
Germany	1.93	-0.21	0.39	2.28
Australia	3.53	-0.23	-0.07	1.84
Japan	0.25	0.01	0.03	0.20
EQUITIES				
US. S&P 500 (USD)	4,080.11	5.4%	3.2%	-10.7%
UK. FTSE 100 (GBP)	7,573.05	6.7%	4.0%	7.3%
MSCI Eur ex UK (Local)	1,530.02	6.8%	7.0%	-7.5%
Japan. Topix (JPY)	1,985.57	2.9%	1.1%	3.0%
China. Shangai Comp (RMB)	3,151.34	8.9%	-1.6%	-11.6%
HK. Hang Seng (HKD)	18,597.23	26.6%	-6.8%	-20.8%
Australia. All Ords (AUD)	7,480.65	6.0%	3.5%	-1.4%
MSCI Pac ex Jap (USD)	1,304.78	14.1%	1.4%	-7.3%
MSCI World (USD)	2,720.89	6.8%	3.6%	-12.3%
MSCI World (GBP)	2,278.23	2.5%	0.8%	-2.6%
COMMODITIES				
Oil (WTI)	80.55	-5.7%	-8.0%	29.6%
Gold	1768.52	8.3%	3.4%	-0.3%

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