

# Investment Views

MARCH 2023

## Cloudy with a chance of sunshine and showers

A number of readers got in touch about last month's article in which we outlined the impact of prior pandemics and wars on economies and markets. Several asked if we put much store in past analogues to inform future trends. Others queried if the focus on such multiyear, "big picture" scenarios are a sign that we lack conviction in how events may unfold over the next few months. The answer to both is "yes".

Short-term market predictions are always fraught with difficulty. This is especially so with the global economy still adjusting to the twin shocks of covid and the Ukraine war. As such, an unusually wide dispersion of outcomes remain possible over the coming months; anyone claiming otherwise should be treated with a healthy dose of scepticism.

Market performance this year is a case in point. In January, risk assets surged on the belief that economic growth would be sufficiently weak to reduce inflationary pressures, yet strong enough to prevent a deep global recession. This "soft landing" narrative drove equities higher with the FTSE All-World gaining 7% in dollar terms, whilst the prospect of no more rate hikes helped precious metals catch a bid; gold rallied 6%. It also buoyed fixed income markets with the FTSE World government bond index adding 3%. Taken together, this helped the classic 60/40 Balanced model to its best start to the year since 1991 (source: Bank of America).

However, the mood soured by mid-February with equities suffering a sharp pullback. Bond and commodity prices followed suit as stronger-than-expected growth and inflation data sparked fresh concerns that Central Banks will need to hike borrowing costs a lot more (and for longer) to contain cost pressures. By the end of January, US money markets implied a 5% peak Fed funds rate this summer, just 0.25% above the current target. They now forecast a rise to at least 5.5% during the second quarter.

This rolling uncertainty over where GDP and inflation rates will ultimately settle is unlikely to be resolved anytime soon. This suggests that market volatility will remain elevated, both on the up and downside, as we head into the summer.

Towards the end of last year, we argued that the depth and duration of any slowdown would be a key driver of 2023 returns. If a global recession took hold, equities would inevitably struggle as a concurrent slump in corporate profits was yet to be priced in. Conversely, last year's 20-30% index losses would likely mark the bear market low if a more benign growth backdrop transpired.

Turning to the recession debate, there have been some encouraging developments, with the end of China's zero-covid policy helping to shore up global activity and counter ongoing fragilities in Western economies.

The Lunar New Year saw a surge in domestic travel and leisure spending, although total consumption has yet to fully recover. If consumer confidence improves, Chinese households have RMB 8trn of lockdown savings to fuel a more pervasive spending spree, akin to the post-covid US and European experience. Counteracting this, the property sector remains troubled. Whilst prices and construction activity are stabilising after two years of steep declines, progress remains gradual. With the Government nervous of any debt-fuelled revival there are, as yet, no signs of a real estate boom akin to those that spurred domestic and global growth during the past two decades.

Overall, China's reopening is a bullish development, but is it enough to offset recession fears in the US and Europe? Importantly the latter concerns have moderated. Just a few months ago a Western recession was the consensus view. However, unseasonably warm weather has helped avert a major EU energy crisis (until next winter at least) and a resilient labour market is confounding the US economic bears. In fact, January's blockbuster US non-farm payroll report (that showed more than 500,000 new jobs created during the month) was the trigger for February's rate repricing. Whilst the inverted US Treasury curve implies a slowdown remains imminent, major US recessions typically only occur if the consumer stops spending. This seems unlikely if unemployment remains at or near its current 50-year low.

In arriving at this view, we note that there is a lot of statistical noise in the January data, borne of the unusually mild weather and the fact most of the US economy was in lockdown during the past two winters. This has distorted the seasonal adjustment of data, as current outcomes are compared to economic behaviour during the recent past. Put simply, January activity was revised higher when compared to the disrupted activity of prior periods. This distortion is temporary. Indeed, US indicators could well surprise on the downside over the next couple of months as the anomalies wash through, reigniting recession fears.

For now the global economy is holding up better than expected, although not well enough to justify the 15%+ rebound in stock markets that began last October. Instead, we attribute that, in part, to short covering by equity bears and a covert Central Bank pivot. The latter has resulted in a marked improvement in global liquidity despite the ongoing rate hikes and hawkish policymaker rhetoric.

The Asian authorities have led the way with the Bank of Japan maintaining large-scale bond purchases despite growing doubts about the sustainability of its low rate, yield-curve-control policies. It bought a record U\$182bn of bonds during January and now owns more than 50% of all Japanese government debt. Nearby, the People's Bank of China (PBoC) has been ramping up monetary support to reinforce the reopening recovery and to buttress the property sector. In recent weeks cash injections into the banking system have regularly exceeded RMB 400bn (approx. U\$70bn) each day. To set that in context, the Fed's quantitative tightening (QT) program removes around U\$100bn of liquidity per month. The PBOC's funding is likely to moderate going forward but should persist for as long as domestic inflation remains quiescent, around its current 2%/y. In turn, this pro-growth stance boosts the outlook for global growth and risk assets as local demand and excess liquidity leak into international markets.

As significantly, many Western Central Banks have been quietly loosening in recent months. The ECB's balance sheet contraction has stalled this year and, since late October, the Fed has injected around U\$130bn of cash into domestic money market funds via its reverse repo operations. This offsets over a third of the U\$340bn it has removed via QT. It is no coincidence that this policy 'volte face' began shortly after last September's LDI crisis, which brought parts of the UK Gilt and pension markets to their knees, forcing the Bank of England to intervene. Time and again, the authorities have evidenced a willingness to act if market and financial stability are threatened, regardless of the underlying trends in growth and inflation.

The Biden administration has also joined the fray, transferring almost U\$200bn from its General Transaction Account (the government's 'current account' at the Fed) to the commercial banking system. This is part of the "extraordinary measures" used to fund expenditure since the Federal debt-ceiling was reached in mid-January. The Treasury is unable to increase its borrowing until there is bipartisan agreement to raise the limit above the current U\$31.4trn. Based on past episodes, Congress will agree to a higher limit having secured policy concession from the administration, but the impasse may last for several months. Until then, the resulting collapse in Treasuries issuance is a net positive for markets and the economy as it frees up liquidity that would otherwise be used to buy the new bonds.

Pulling all of this together, liquidity conditions have improved significantly over the last 3-4 months with Citibank estimating that Central Banks have injected an additional U\$1trn into financial markets (source: FT). This has boosted asset prices and reduced the likelihood of a severe global recession; the liquidity cycle tends to lead the economy by around 6 months, underpinning GDP growth as we move into the summer (albeit from a low base).

On balance this offers grounds for optimism for equity investors. If economic activity holds up and we avoid a meaningful profits recession, the October lows could well mark the bottom for this cycle. The counterargument is that despite the February pullback, those lows are at least 10% beneath current index levels and they are likely to be retested if lingering inflation fears encourage the Fed to end its backdoor policy support. These near term risks become more acute if the jobs market and wider economic news flow remain resilient as the first quarter draws to a close.

### 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 US	European Japanese	

**MARKET PERFORMANCE**

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

	28th Feb 23	-1 Mth	-3 Mth	-12 Mth
<b>CURRENCIES (VS USD)</b>				
GBP	1.2022	-2.4%	-0.3%	-10.4%
CHF	1.0613	-2.8%	0.4%	-2.7%
AUD	0.6729	-4.6%	-0.9%	-7.4%
JPY	136.1700	-4.5%	1.4%	-15.6%
EUR	1.0576	-2.6%	1.6%	-5.7%
<b>BOND YIELDS (10 yr)</b>				
UK	3.82	0.49	0.67	2.42
US	3.92	0.41	0.32	2.10
Germany	2.65	0.37	0.72	2.52
Australia	3.85	0.30	0.32	1.71
Japan	0.50	0.01	0.25	0.31
<b>EQUITIES</b>				
US. S&P 500 (USD)	3,970.15	-2.6%	-2.7%	-9.2%
UK. FTSE 100 (GBP)	7,876.28	1.3%	4.0%	5.6%
MSCI Eur ex UK (Local)	1,616.44	1.2%	5.6%	1.7%
Japan. Topix (JPY)	1,993.28	0.9%	0.4%	5.6%
China. Shangai Comp (RMB)	3,279.61	0.7%	4.1%	-5.3%
HK. Hang Seng (HKD)	19,785.94	-9.4%	6.4%	-12.9%
Australia. All Ords (AUD)	7,458.03	-3.0%	-0.3%	1.8%
MSCI Pac ex Jap (USD)	1,325.52	-6.8%	1.6%	-5.3%
MSCI World (USD)	2,714.57	-2.5%	-0.2%	-8.8%
MSCI World (GBP)	2,243.45	-0.7%	-1.5%	0.9%
<b>COMMODITIES</b>				
Oil (WTI)	77.05	-2.7%	-4.5%	-2.5%
Gold	1826.92	-5.3%	3.3%	-4.3%

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