2022 in Review

Rising interest rates in response to stubborn inflation has been a dominant theme this year. Equities have come under sustained valuation pressure as bond yields have risen. Corporate earnings have held up surprisingly well despite higher input costs and waning consumer sentiment. Consumers have run down cash reserves built up over the pandemic but received higher wages in the tightest labour market for decades.

Geo-politics impacted markets with energy prices sharply higher on strong demand and higher again after Russia invaded Ukraine. While China's covid-zero policy continued to disrupt supply chains, regulatory crackdowns, a failing property sector and sabre rattling over Taiwan at times spooked markets.

2022 has been one of the worst years on record for the passive 60/40 Equity/Bond portfolio, returning -16% to 30 November (USD). It is a year that reinforced the need to be active and be diversified, including assets with low or no correlation to equities.

2023 Outlook - Recession is not the risk, it is likely to be the policy

Equities: The rally in risk assets towards the end of 2022 looks premature – making it more unlikely that there is any material upside in 2023. With central banks lifting rates and corporate margins under pressure, we expect the Q1 2023 earnings season to be particularly soft. We expect the second half of the year is likely to be more constructive for risk assets with equities recovering. Overall, our view is that global equities are likely to be relatively flat for 2023.

Inflation: Supply chain issues should moderate in the coming year, and result in easing goods inflation. However, a fall in services inflation is likely to be more stubborn as labour remains in relative short supply and wages play an element of catch up.

Economic Growth: The world economic growth rate should moderate further in 2023 but be supported somewhat by a China reopening after their winter.

Interest Rates: Central banks are likely to raise rates a little further but hold rates for an extended period – even in the face of slowing economic activity. Markets that are pricing rate cuts in 2023 are likely to be disappointed. We expect the discount rate to rise from current levels and put downward pressure on equity valuations.

Volatility: with liquidity continuing to be withdrawn from markets, financial conditions tightening and the path to lower inflation to be bumpy, we expect 2023 to continue to be volatile for both equities and bonds.

Corporate Earnings: A materially slower growth rate is likely to see corporate earnings fall in 2023 – which is yet to be fully priced by analysts.

Positioning: We end 2022 underweight equities and fixed income on the expectation that equity markets are in for a weak few months and bond yields rise to meet cash rate expectations. We believe it is too early to add to fixed income and prefer to allocate funds to credit given spreads are more attractive, cash yields are higher, interest rate sensitivity is much lower.

With equities likely to be range bound over the next 12 months it is critical that investors remain active, taking advantage of pullbacks and utilising changes in volatility to their advantage (to hedge or generate income). Investors should look to selectively add on market pullbacks to initially more defensive sectors, then as an earnings recovery starts to be priced in, a rotation back into cyclical names around the middle of next year.

The need to maintain investments that have low or negative correlation with major asset classes is critical. We remain overweight both Growth and Defensive Alternatives and expect to maintain this positioning into 2023.

The recent rally in emerging market equities is encouraging, however the path from here is unlikely to be smooth. Despite taking profits on an Asian Equity position on the back of a strong rally, we believe longer term investors should have an allocation to this space as it is likely to be the global growth engine over coming years.

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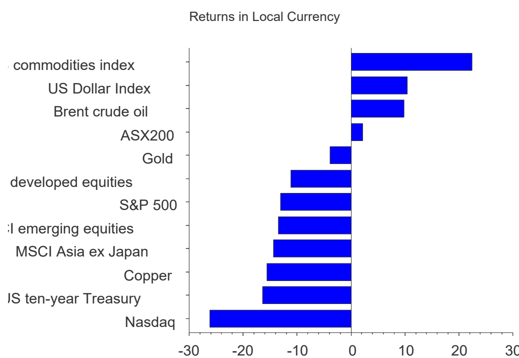
2022 in Review

The way equity markets violently bounced back from their pandemic lows in 2020 and 2021 showed us the impact of modern monetary policy in action, pared with fiscal stimulus. 2022 has shown us what happens when this is reversed, plus stubbornly high inflation and heightened geo-political tensions.

Chart 1: YTD Asset Class Performance (as at 30 Nov)

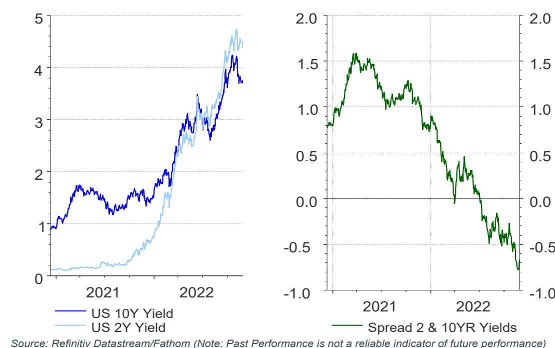


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

On a total return basis (including dividends) the S&P500 ended November down over 13% in USD terms, the Nasdaq faring considerably worse. Yet the ASX200 was modestly positive – supported by mining and energy stocks, as well as recovering dividend payments.

Bond yields are sharply higher for the year, reflecting the large amount of monetary policy change that has occurred in such a short period of time and driving a large downward shift in equity valuations. The US Treasury curve is the most inverted in over 40 years.

Chart 2: US 2&10yr Govt Bond Yields & 2s10s Curve

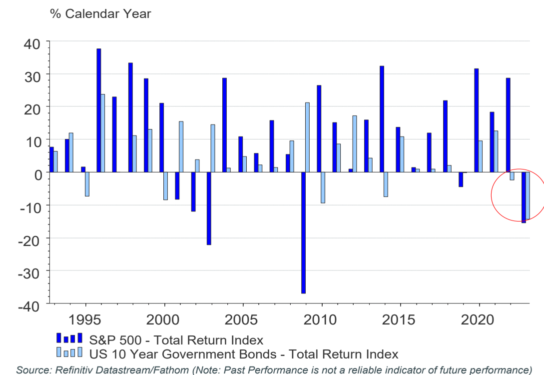


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The strength of the US economy has been a dominate theme this year, as Europe and China have struggled through energy crises and conflict for the former, and an economy yet to re-emerge from a strict covid-zero policy for the latter. The US Dollar has been one of the few places to hide in 2022 as US interest rates have increased rapidly.

Traditional inflation and risk hedges like Gold have underperformed this year, largely due to a strong USD, however commodities have proved to be a hedge of sorts despite the economic woes and faltering demand from China. Oil too has gained strongly, with Russia's exclusion from the global oil market as well as strong demand from recovering economies and European nations bolstering energy supplies ahead of the European winter.

Chart 3: US 10yr Bonds & S&P500 Calendar Yr Returns



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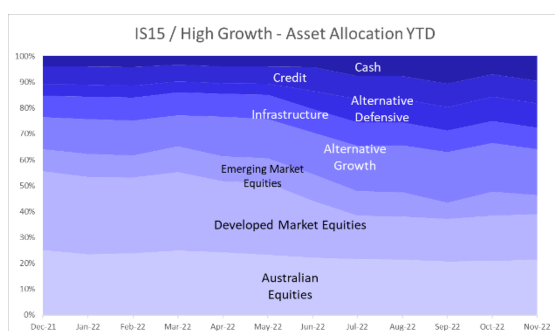
2022 Positioning

We began reducing our overweight to risk assets and banking profits in the second half of 2021. Overall, we have continued to reduce our risk allocation this year as markets have sold off. Deploying this capital into alternatives, income generating strategies and cash has preserved capital well.



We were well positioned in Alternatives with a large allocation to a systematic FX Trading strategy (up 24% YTD) and adding an active credit fund with a derivate and inflation hedging overlay in April (up 6.4% to 30 Nov).

We took the opportunity to hedge some of our global equity exposure in October, which has outperformed unhedged by ~5% to the End of November.

Given the large swings in equities we have traded some pullbacks and rallies to generate further returns. For example, we reduced our Asian equity exposure in early September, staying in cash for about a month while markets sold off, we added this exposure back in October before reducing again in late November after a 15% rally in Chinese equities in a short period of time.

With the benefit of hindsight, we did not anticipate the pace of the style shift that occurred in the equity market from growth to value in early 2022 and stayed long growth equities for a little too long.

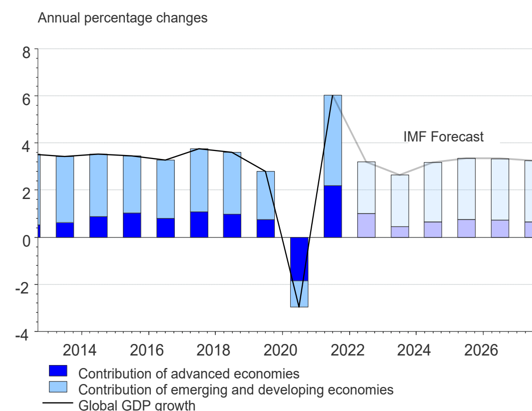
With equity markets rally at present our current underweight is impacting performance, however we remain of the view that this is the right call given our outlook for next year is a weak first half and a sideways year overall.

2023 Outlook

Living with Covid is becoming mainstream, despite new variants and waves across different countries. We believe that China will progressively ease movement restrictions in 2023. The notion that China may reopen in early to mid-2023 has been positive for risk assets, however the economic impact is unlikely to be over, with any reopening likely to put pressure on the Chinese health system and cause further labour shortages and supply chain disruptions.

Our working assumption is that the rest of the world will get on with the living with the virus – although any worrying new strain has the capacity to derail confidence and add further downside to our base case view. Economic growth is likely to moderate further in 2023 as fiscal support is removed and monetary policy tightening works its way through the system. The liquidity pumped into the markets from 2020 continues to be unwound and progressively withdrawn.

Chart 4: Global GDP (IMF Forecast)



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

There have been occasions this year where central banks have had to intervene to ensure the smooth operation of markets – notably large-scale intervention by the Bank of England in the long end gilt market and more subtle liquidity management from the US Federal Reserve. This one foot on the brake and one foot on the accelerator approach may likely increase in 2023 as volatility persists and liquidity from other sources dries up. Market stresses and contagion often come from low liquidity periods and central banks will be alert to support markets in the case of market dislocation and panic. The crypto

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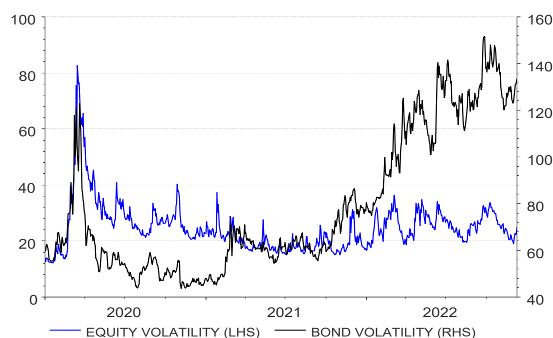
issues from this year – including the most recent failure of FTX - continue to ripple across markets and we are watching for the signs of it becoming more systemic.

Chart 5: US Equity & Bond Volatility

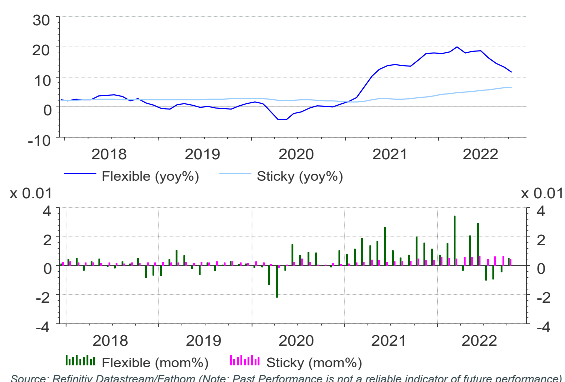


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The moderation in aggregate demand is reducing pressures on stretched supply chains and easing goods inflation. A range of raw materials and lead indicators have been falling for months, providing relief that the worst of the inflation surge has passed.

However, history shows that once the non-discretionary (needs based) inflation rises and spills over into wages demands it is harder to get under control. In the US, the Atlanta Federal Reserve produce CPI measures of baskets of items that change price quickly and another with items that change relatively slowly. Those that change quickly are rolling over, but those with less flexible or sticky prices continue to rise. Therefore, a hard landing may be required to produce enough slack in the economy to bring services and more "sticky" inflation back under control. Recession is not the risk – it is likely to be the policy.

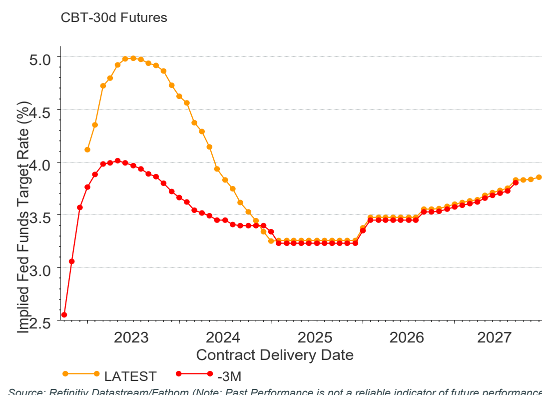
Chart 6: Atlanta Fed Flexible v Sticky Inflation Measures



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Our base case and how we plan to approach the management of portfolios is that the most recent rally in the S&P500 is overdone. We believe that central banks will hold rates higher than markets are anticipating – and the chance of an early interest rate cut in 2023 remains very low.

Chart 7: US FED Funds Futures Curve

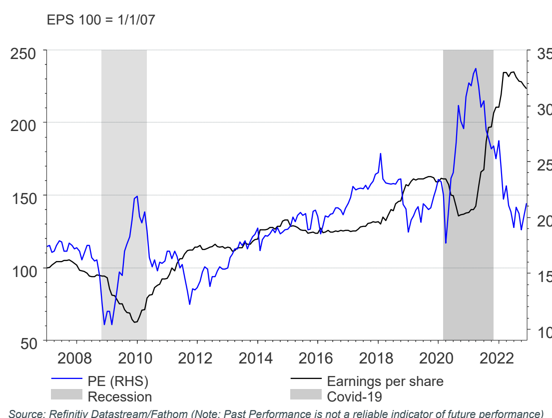


Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Global interest rate curves are highly inverted – and we believe that this will be moderate somewhat with the long end bonds yields rising to be closer to the cash rates. Moderating growth and rising bond yields will be difficult for equity markets to absorb. After a phenomenal corporate earnings recovery in 2021 where S&P500 earnings per share moved $100 from trough to peak, we believe that corporate earnings growth is likely to be flat in 2023 as both fiscal and monetary stimulus continue to be removed from the financial system and economic growth weakens. A sharper downturn or deep recession in the US could see earnings fall as much as 20 per cent.

Chart 8: S&P500 Earnings and P/E

Combined with higher bond yields, we see considerable grounds for weakness in global share



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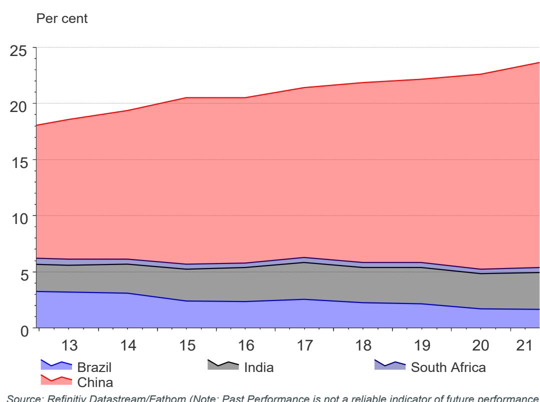
markets in early 2023. However, we believe that markets are likely to finish the year broadly unchanged as investors look forward to 2024 and beyond and a modest earnings recovery.

While emerging markets have remained challenging for some time, the most recent rally, particularly in Asia, has been encouraging. Despite taking some more recent profits on our Asian positions on the expectation of China reopening, we continue to be strong believers in the long-term potential of the region with it severly under-represented in global equity indicies and portfolios alike given its share of global GDP. Demographics, strong growth rates, and a more moderate US dollar are likely to provide support for the region in 2023. We will continue to monitor geo-political tensions in the regions and will change positions quickly should things deteriorate.

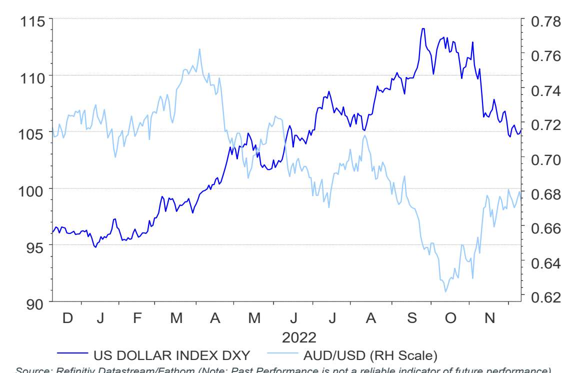
Chart 9: EM Share of Global GDP (%)



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

With our view that equity markets will be weaker in the first half of 2023, we continue to increase our exposure to alternative strategies that have small or negative correlation with equity markets. This is likely to include strategies that take advantage of periods of higher volatility and multi-strategy funds that focus on producing returns around event driven trading strategies.

Chart 10: USD Index and AUD/USD



Source: Refinitiv Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Foreign exchange markets are likely to remain volatile in 2023 and will look for opportunities in this area to add value. We moved to hedge part of our global equity positions when the $A reached US$0.62 which has worked well. Should a sell-off in risk assets occur in 2023, we would likely re-enter equities with a currency hedge to ensure a recovering AUD does not reduce potential for capital gains.

James Wright and Luke Hansen
Sayers Capital Solutions Group

15 December 2022

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