MARKET COMMENTARY

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Executive Summary

Somewhat fittingly, 2022 finished on a whimper, with December's lacklustre performance for global equity and bond markets ensuring that investors were keen to leave the year firmly in the rear-view mirror. The year Russia invaded Ukraine, the year asset class dislocations became extreme, and the year that the cost of capital returned – regardless of the angle, 2022 will be remembered unfavourably by many.

The psychology and hope associated with the turning of a new year on the desktop calendar has seemingly had some effect already, with major asset classes starting 2023 brightly. I wrote at length last year about all sorts of negative landmarks being reached, whether it be the dismal run of form for UK gilts, or the double-digit losses of some of the largest equity markets in the world. Whilst thus far analysts remain relatively cautious for the year ahead, with a defining lack of annus mirabilis predictions, there is some evidence to support that investors are right to dissociate one year from the next. For example, there has only been one occasion in the last 75 years where a 15% plus loss on the largest US equity market has been followed by a loss in the following year. Using this example, you would need to go back to 2002 for the last time there were investors suffered consecutive years of decline. As it happens, global equities returned 4.6% (in sterling terms) during January, with gains registered in all major regions.

Of course, this is not simply about history. I wrote last month that investors are now having to digest what the reopening of the Chinese economy will mean for markets, as well as the fact that a peak in US inflation last summer has all but been priced in. As the mindset moves to a recessionary one more globally, analysts are desperately trying to work out what next steps the US Federal Reserve (Fed) will take. Despite hopes that interest rate hiking will slow, the rhetoric continues to strike a now familiar hawkish tone. This difficult balancing act is likely to continue for some time, with each US corporate earnings season being touted as some form of a recessionary trigger and investors naturally remaining avid watchers of any economic indicators they can hang their hats on. The upshot is, inflation remains high almost everywhere, most significantly in the largest economies in the world, and thus central banks will almost certainly continue to tighten for the time being. How 'sticky' will inflation be? (i.e. how long will it linger?), how long will there be a need for interest rates to remain higher than usual? And of course, how close to the broad 2% target will inflation eventually 'normalise'? There is now an expectation from many that there will be a sizeable downward shift in US inflation rates at some point this year, with the above multi-trillion-dollar questions now being associated more with 2024 and beyond, when trying to come to some sense of what the other side will look like.

Markets

Whilst the base case for the US appears to point to a relatively short-lived and cyclical recession at some point this year, rates remaining higher for longer will, of course, likely dictate the depth and length of any pain. There are so many moveable feasts to contend with that it is impossible to predict anything with certainty and investors will naturally be required to continue to be flexible as the story unfolds. There has undoubtedly been a shift in rate expectations over the last few months too. Towards the tail end of last year, US rates were generally predicted to ramp up to as high as 5% before swiftly being reduced. Fast forward to now and it looks more likely that although rates might remain slightly lower, there is a lack of evidence of any obvious cutting cycle in the not-too-distant future. Markets are likely to continue to be sensitive to any indicators emerging throughout Q1, as investors look desperately for any form of gauge. Another ahead-of-consensus bout of corporate results or any sign of a 'pivot' from the Fed (i.e., leading to a reversal of the recent and current tightening), could see a rally in US equities, but of course, will also likely shine a light on the state of play for the subsequent period. In January specifically, US economic data was broadly encouraging, with ahead-of-consensus GDP growth and a slight improvement in both manufacturing and services productivity seeing all three major US markets register strong gains, in what was notably a strong month for 'growth' stocks.

Despite activity in the US likely to heavily influence other developed nations, there is a regionality to inflation rates, particularly given the differing need for overseas energy. Europe, for example, benefited tremendously from the milder winter towards the end of last year, as the price of natural gas plummeted. However, when European Central Bank (ECB) President, Christine Lagarde, confirmed in December that "interest rates will still have to rise significantly at a steady pace", she gave the impression that the hiking cycle in Europe was only just getting started. If the ECB continues with its modest and steady increases, this will likely see the deposit rate at 3.5% by the end of 2023. Both manufacturing and services output experienced a significant uptick in January, with the continued warmer-than-usual weather and a second consecutive decline in eurozone inflation also being favourably received by investors. Despite obvious headwinds and the prospect of a looming recession, the improvement in sentiment from September's lows saw Europe as the best performing developed region in January, with aggregate returns of 5.9%.

There were also strong gains in the UK in January, returning 4.5% on aggregate, with a relatively even distribution across the market cap spectrum. The positive month for sentiment towards global equities more broadly saw investors typically begin the year with more of a 'risk on' attitude, generally favouring sectors such as consumer discretionary over the more defensive areas of the market, such as healthcare. Financials also benefited from the optimism surrounding the Chinese government's decision to ease restrictions, given the sector's exposure to emerging markets. I wrote last month that the inflation pattern for the UK appears to be somewhere between that of the US and Europe, with December's 10.5% figure representing the third consecutive monthly decline. The same can be said of the UK's energy dependence on overseas energy too, which will almost certainly remain a factor throughout 2023. As per the US, recent corporate earnings have remained more robust than anticipated, to a degree fuelling hopes for a milder recession and an ability for central banks to be able to reduce interest rates at some point this year. Despite a seemingly slightly improved sentiment towards the region, it remains relatively subdued. 2022 represented the worst year for inflows into UK-listed mutual funds in a decade, with all UK equity sectors experiencing net outflows during the year. At time of writing, the market already appears to be pricing in further interest rate hikes from the Bank of England for 2023, however there is now an expectation, as per the US, that they may not end up as high as initially anticipated, particularly given the structure of the UK mortgage market, instead rising to circa 4.5% by mid-year.

Asia & Emerging Markets

Japan is experiencing their highest level of inflation in more than 30 years, at 4.0%. I wrote last month that the Bank of Japan (BoJ) announced that they are no longer averse to increasing the yields on long-dated government bonds by up to plus or minus 0.50% of the zero target, rather than the previous range of plus or minus 0.25%. I also highlighted that news was viewed as significant by global investors given the country's reputation for being the only remaining developed economy with extremely loose monetary policy. Despite the BoJ immediately denying the move represented a tightening of policy, they felt forced to intervene again in January, stating that they do not intend to relax the limit further. Whilst events led to the relative underperformance of Japanese Government Bonds during the month, equity markets reacted well to some robust early corporate earnings announcements and the generally improved sentiment towards equities globally, returning 3.7%. The outlook for the region appears modest, despite the potential for more accommodative government policy and apparent pent-up demand for consumer spending. Although lower than in other major developed nations, the inflation level remains high and is likely to persist for the time being. Despite the yen appreciating circa 4% following December's announcement (broadly disinflationary itself) the change has been viewed by some as a potential policy mistake, given the impact on central bank balance sheets. Should there be a significant global slowdown, there is potential for the currency to appreciate further, given its traditional safe-haven status. Even if real GDP evades negative territory this year, slow wage growth remains another factor.

Following a volatile final quarter of 2022, Asian equities performed strongly during January, underpinned by the beginning of the reopening of the Chinese economy. With an aggregate return of 6.2%, it was the standout performer during the period. Investors reacted favourably to the lifting of strict post-pandemic restrictions that had been in place, in some cases, for more than two years, with the ability to travel internationally also returning during the month, aiding markets further. Despite fears of a dramatic spike in infections, investors generally preferred to focus on the benefits of a pickup in economic activity. Pent-up demand and supportive government stimulus both strengthen the case for a more sustained recovery, however significant potential headwinds remain, such as geopolitical issues, the questionable efficacy of the domestic vaccine, and the pace and scale of the reopening. The broader emerging markets asset class was a major beneficiary of the developments, given China's significant inclusion. In addition to the strength of Asian markets, there was also notable contribution from Chilean, Czech, Mexican and Peruvian equities. The aggregate gains for emerging markets were somewhat misleading given the number of detractors from the index during January, such as Brazil, India, Turkey and major energy exporters such as Qatar and Saudi Arabia.

Fixed Income

Turning attention to fixed income, January was also a good month for global bond markets. The encouraging inflation pattern emerging from the US saw yields broadly decline (meaning prices increased), and except for Japan, major global government bond issues finished the month positively with an aggregate return of 1.03%. Corporate bonds typically outperformed their government counterparts, which was unsurprising given the 'risk on' backdrop, returning 2.1% on average, with no obvious divergence in the performance of High Yield and Investment Grade credit qualities. Despite the correlation between fixed income and equities generally being unwelcomed during 2022, investors appear to see this as an attractive entry point , regardless of the recent bond market rally and indeed January's 'risk on' sentiment. I wrote about duration (i.e., a bond's sensitivity to interest rate changes) at length last year, with those typically at the long end of the yield curve suffering tremendously during the first half of the year. Despite the recent change of sentiment seeing some of the losses recouped, the reward per unit of risk of short-duration assets remains attractive, given the level of yield available. After experiencing one of their worst selloffs in decades in 2022, bonds have experienced a resurgence in popularity of late, largely under the notion that, even if there is not much growth in price available, then at least they may be able to offer their traditional low-risk income-paying traits for the time being.

And Finally...

As for our portfolios, we continue to benefit from our bond allocation, which generally favours high-quality credit and market-neutral duration positioning. On reflection, we introduced several defensive positions relatively early last year, which we are yet to remove despite the apparent change in investor sentiment. We continue with our preference for seeking alternative sources of capital appreciation and income for clients, as opposed to holding large, uninvested cash balances. To this end, we recently increased our position in a short-term money market fund yielding circa 3% p.a. Whilst we have benefited from the recent market rally in both equities and bonds, we remain cautious for the year ahead, given that we see multiple short and medium-term headwinds to overcome before any semblance of a clear pathway for significant global growth. On the equity side, we reduced our exposure to Europe marginally towards the end of 2022 after a strong period of performance, given the degree and rapidly changing political uncertainty for the region. We redistributed some of the proceeds into existing, selective global equity income mandates. We spent time during H2 of last year focusing on the quality of the underlying fund holdings in anticipation of any global slowdown this year. Of course, as part of the exercise, valuation i.e., not overpaying for quality was at the forefront of our minds too. Our neutral allocation to UK equities has been one of the early beneficiaries of 2023. Elsewhere, we have maintained our relative underweight allocation to commercial property and continue to hold positions in alternatives, such as global infrastructure, storage and renewable energy.

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