

Investment Views



DECEMBER 2022

PRODUCED BY BUTTERFIELD

Strategy:

Prediction is Difficult

Fixed Income:

All I Want for Christmas is Bonds

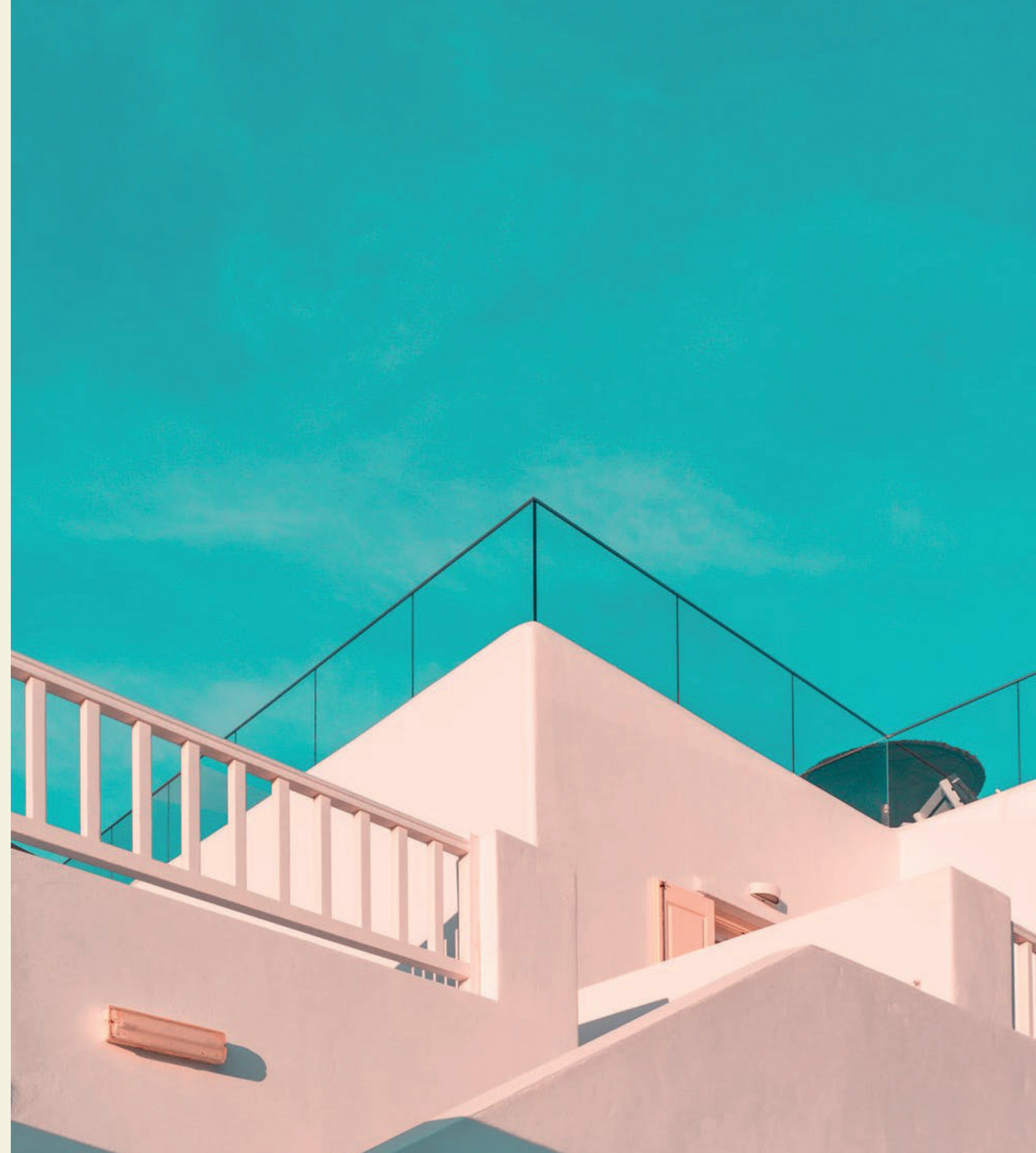
Equities:

European and Emerging Markets Rally

Prediction is Difficult

As the saying goes “prediction is very difficult, especially if it’s about the future”. This is particularly pertinent after a global pandemic, unprecedented monetary and fiscal stimulus and a war between two major commodity exporters. The combination of these events has given much of the world a major inflation problem, which has forced central banks to hike interest rates faster than they have done in decades.

The consensus expectation at the start of the year was that interest rates were going to rise in 2022, but it is fair to say that the magnitude of the interest rate hikes took almost everyone by surprise. Harvard University professor Jeremy Stein, who previously served on the Federal Reserve Board of Governors, recently described it as “astonishing”. He continued: “If you told any one of us a year ago, we’re going to have a bunch of 75 basis-point hikes, you’d have said, are you nuts? You’re going to blow up the financial system.”



STRATEGY

The good news is that the financial system didn't blow up. There were stresses in the UK government bond market in September but the irony was that these were triggered by misguided fiscal policy rather than interest rate rises. As both bonds and equities suffered losses simultaneously, something we have not seen for two decades, financial markets have had a very challenging year but overall remain very orderly.

Something that did "blow up" was the crypto currency market although crypto is largely outside of the mainstream banking system and traditional financial markets. The pain was therefore felt by relatively small numbers of private businesses and individual holders and it has not been a wider systemic risk for markets or economies.

November and December are when many investment banks and independent research providers release their outlooks for the year ahead. The consensus is that the US will experience a mild recession next year, but that recessions outside of the US, particularly in Europe and the UK will be a little more severe. China had a challenging 2022 due to very restrictive covid-19 policies and troubles in their property market. However recent signs that pandemic restrictions have loosened and more will be done to support economic growth has provided some optimism that China will have a better year next year.

The theme of many of these outlooks is how quickly inflation will fall back towards central bank targets of around 2% and how much damage inflation and higher interest rates have already inflicted on the global economy. Thankfully there is ample evidence that headline inflation has peaked, from commodity prices, durable goods, rents and favourable base effects for comparison next year. However, this has to be balanced with a starting rate that is very high and the way in which higher labour and energy costs take time to work their way through supply chains and the extent to which business are willing and able to pass price rises onto consumers.

2%

The central bank's
inflation target.

...financial markets have
had a very challenging
year but overall remain
very orderly.



4.3m

The number of new jobs
in the US in the first
eleven months of 2022.

STRATEGY

A notable dynamic in economic data over recent months is that forward looking indicators, such as sentiment and surveys covering activity and purchasing intentions, have been a lot weaker than actual economic data. Forward looking indicators should by definition lead actual activity data and this has meant future prediction models point to weakness next year. Capital Economics' proprietary indicator now suggests there is a 90% probability that the US will be in recession in six months' time – the probability has never been this high without a recession following.

In the first eleven months of 2022 the US added 4.3 million new jobs, as measured by the payroll survey. It is therefore fair to say that the economy had a better year than financial markets. Next year could see a reversal as financial markets have repriced ahead of the real economy. There is a lot of cautious commentary out there surrounding the outlook for next year, and it is difficult at this point to argue that this is misplaced. We therefore continue to focus on risk management within our portfolios, rather than on maximising return in an uncertain environment.

All I Want for Christmas is Bonds

The Fixed Income market continued to rally during November as momentum from an expectation of a monetary policy pivot gained traction. More importantly, the Federal Reserve did not actively attempt to dissuade markets from this narrative. With the effective green light from Powell to add risk, the market did just that, which led to positive returns in both equity and fixed income markets.

The 5-year US Treasury rallied from 4.23% to 3.74% over the course of the month as the market's estimate of long-term US base rates fell to 3%. Inflation expectations also declined, but only marginally, signalling that the rally in bonds was driven more by weaker growth fears than deflation pressures.



As we approach the final month of the year, one which has been packed with historic levels of fixed income volatility, December will prove to be nothing but calm as ten major central banks – notably the Fed, the European Central Bank and the Bank of England – meet mid-month and key inflation and activity data will be released.

Positive risk sentiment boosted the allure of corporate credit, with duration sensitive US investment grade tightening by -25 basis points (bps) outperforming US high yield, which ended the month at 448bps versus US Treasuries, as the latter had already rallied in October. Current pricing indicates that the market is projecting a default rate over the next 12 months of approximately 5%, equal to a shallow recession in 2023. With company balance sheets still solid there is no cause for any immediate concern, however, the US growth outlook is deteriorating and this is a headwind for corporate credit. The rally at the long end of the yield curve, which has been seen globally apart from in China, has removed some of the value from the market. We therefore favour 1-2 year maturities as a way of generating substantial carry of 4.5% with very little risk.

The macro outlook in China weakened during November as protests and Covid-19 restrictions interrupted the gradual improvements we have seen since the second quarter. One of the most important drivers of global growth in 2023 will be China and this winter the authorities will have some very difficult decisions to make which will dominate the inflation narrative over the coming months.

On a positive note, European and UK growth was better than expected in November with inflation pressures also moderating slightly in mainland Europe.

4.5%

1-2 year maturities are generating substantial carry with very little risk.

5%

The US bond market rose to a 15-year high.

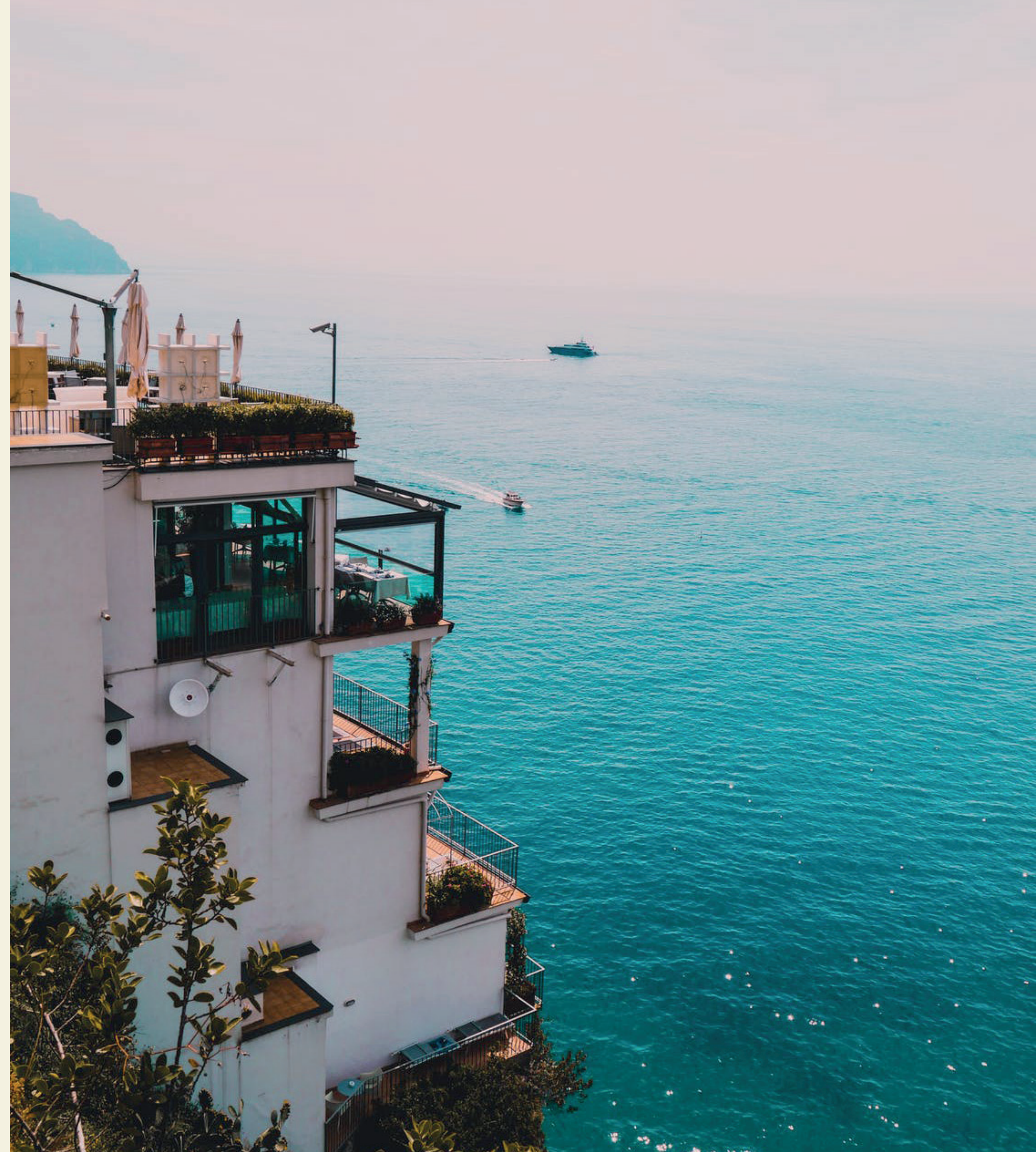
The outlook, however, remains challenging over the coming months. The weather remains an important factor for energy prices and therefore impacts confidence and demand.

If we look at the world as a whole, growth remains weak but trends have improved slightly. Activity in the US remains buoyant for now, but only now are we seeing the impact of +375bps in policy rate tightening, which occurred over a short period of just nine months. There is an additional +100bps of further tightening fully priced into the bond market by May 2023, taking the terminal rate to a 15-year high of 5%.

This recent rally in risk provided us with a further opportunity to reduce risk in our US dollar bond funds where we are not fully compensated. As a result, we are using the opportunity of a -70bps inversion between the 2-year and 10-year part of the US yield curve to sell richly valued long dated bond holdings in sectors such as Energy and Consumer Discretionary – both historically volatile and sensitive to growth. The proceeds of which are being used to re-establish a hedge in TIPS (Treasury Inflation Protected Securities) with portfolio sensitivity to growth declining. While we believe that we have seen the peak in inflation, the easing of financial conditions since October together with the level of ‘sticky’ inflation in the US and cheaper valuations, lends us some conviction that inflation may well remain higher for longer – so a small position to hedge inflation provides some portfolio insurance at fair value.

European and Emerging Markets Rally

Equity markets performed strongly in November with Emerging Markets leading the way, returning 14.8% in US dollar terms. European equities followed closely behind, returning 11.7%. A lower than expected US inflation reading for October gave impetus to the view that the Fed would shortly be able to slow the pace of rate hikes and this was supportive for equity markets. Higher interest rates have been a major headwind for the equity market this year, so any signs of softer inflation are very helpful to ease the pressure on central banks and therefore interest rate expectations.





11.7%

The figure European equities returned in November.

EQUITIES

Events in China were another important driver of equity markets in November. Investors have struggled with the news flow from China as, broadly speaking, they have downgraded the importance of economic growth in their priorities. Statements around the easing of Covid-19 restrictions and more proactive steps to support the property market were positive for equity markets. This was particularly the case for large cap technology orientated companies in the Consumer Discretionary and Communication Serves sector, where Alibaba and Tencent are respectively the largest stocks.

Historically, equities have performed well when interest rates are rising, but this cycle has been very different. In recent decades, demand has been the primary driver of inflation so rate hiking cycles have been associated with periods of good economic growth. With supply side inflation more of an issue this cycle, particularly outside of the US, interest rates are rising while economic growth forecasts have been cut. This has provided an unusual backdrop where company earnings have actually held up quite well, but equity valuations, as measured by price/earnings ratios have come under significant pressure. Multiples for the closely followed S&P 500 index have fallen from 22.0x at the start of the year to around 18x now. Multiples outside of the US have also compressed to varying degrees, with European equity valuations falling from 16.5x to 12.3x and Emerging Markets from 13.0x to 11.8x.

As we head into 2023, one positive relative to the past year is that starting valuations for equities are more attractive. However, higher interest rates and bond yields at more attractive levels than we have seen for many years means that the opportunity cost of holding equities is higher. This has seen a wide degree of dispersion where investors have shunned companies promising cash flows in future for those generating profits today. Valuations matter more in a world of higher rates.

EQUITIES

One of the most important factors for markets is therefore the resilience of corporate earnings. Twelve-month forward earnings estimates in Europe have been cut by around 4.7% in euro terms, however, the “average” peak to trough cut during earnings downgrade cycles, which were not deep recessions, would require another 7%-9% cut. In the US, forward earnings estimates have been cut by around 2.9%. With nominal GDP growth still relatively strong (real growth + inflation), the outlook for corporate revenue growth is okay, however, corporate margins have started to come under pressure so this is a headwind to profitability. Many companies have demonstrated resilient pricing power and have been able to pass higher costs onto customers, but as economic growth weakens this will get more difficult.

Sentiment in Europe remains extremely depressed. There have been consistent net outflows from European equity funds since 2016 and there has been a further \$100bn net outflow in 2022. In contrast, US equity funds have received incredibly strong inflows since the end of 2020, and have seen net inflows of \$200bn in 2022. This depressed sentiment outside of US equities has helped markets rally in the fourth quarter, but markets typically make lows around 2-3 months before earnings cuts trough. As we head into 2023, we will be watching earnings revisions closely.



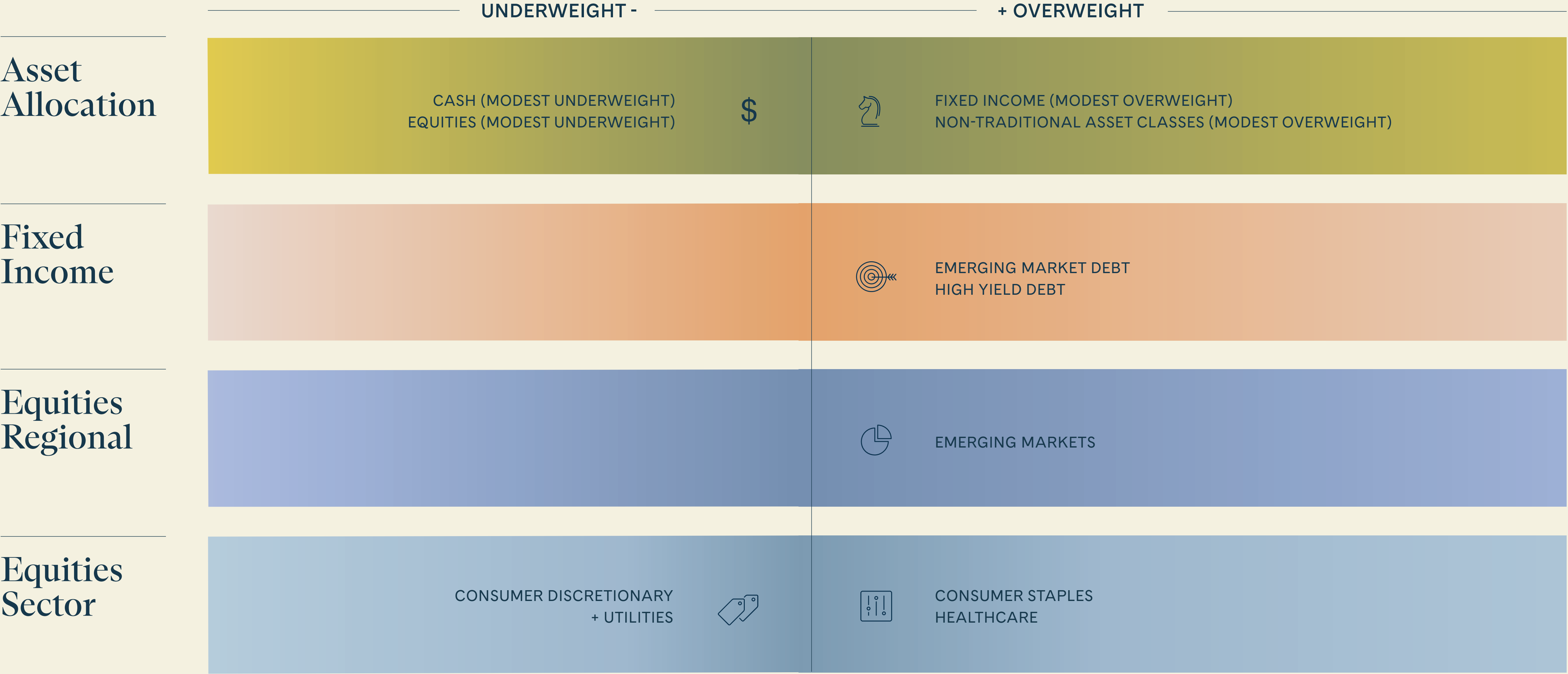
\$200bn

US equity funds net
inflows in 2022

One of the most
important factors
for markets is...
the resilience of
corporate earnings.

Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy



Disclaimer

This document and the information contained herein has been prepared and issued by Butterfield Asset Management Limited, Butterfield Bank (Cayman) Limited and Butterfield Bank (Guernsey) Limited and is for illustrative purposes only. It neither constitutes investment advice nor is it an offer or an invitation to acquire or dispose of any securities and should not be relied upon as such. Prior to making any investment decision a financial adviser should be consulted. Products and services are available in the respective home jurisdictions and only in those other jurisdictions where they may be legally offered or obtained.

The data source for this document is Bloomberg unless explicitly stated otherwise and is believed to be accurate as at the date of publication and may be subject to change without notice. Whilst every care has been taken in producing this commentary, neither the author nor Butterfield Asset Management Limited, Butterfield Bank (Cayman) Limited, nor Butterfield Bank (Guernsey) Limited shall be liable for any errors, misprints or misinterpretation of any of the matters set out in it. Past performance is not necessarily a guide to future performance. The value of investments, and the income from them, can go down as well as up, and you may not recover the amount of your original investment. Where an investment involves exposure to a foreign currency, changes in rates of exchange may cause the value of the investment, and the income from it, to go up or down. In the case of some investments, you should be aware that there is no recognised market for them and that it may therefore be difficult for you to deal in them or to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain investments carry a higher degree of risk than others and are, therefore, unsuitable for some investors. Before contemplating any transaction, you should consider whether you require financial advice.

Any copying, duplication or reproduction of part or all of this commentary and/or its content in any form without the express written consent of the copyright owner is prohibited and will constitute an infringement of copyright unless expressly agreed to by Butterfield Asset Management Limited, Butterfield Bank (Cayman) Limited, or Butterfield Bank (Guernsey) Limited, or as otherwise permitted by the Copyright (Bailiwick of Guernsey) Ordinance 2005. You may not, without our express written permission, distribute or commercially exploit this work.

This commentary and/or its content is copyright of Butterfield Asset Management Limited, Butterfield Bank (Cayman) Limited and Butterfield Bank (Guernsey) Limited. All rights reserved.

Butterfield Asset Management Limited is licensed to conduct investment business by the Bermuda Monetary Authority.
Registered Office Address: 65 Front Street, Hamilton HM12, Bermuda.

Tel +(441) 299 3817
www.butterfieldgroup.com/Investments

Butterfield Bank (Cayman) Limited is licensed to conduct securities investment business by the Cayman Islands Monetary Authority.
Registered Office Address: Butterfield Place, 12 Albert Panton Street, George Town, Grand Cayman KY1-1107, Cayman Islands.

Tel +(345) 949 7055
www.butterfieldgroup.com

Butterfield Bank (Guernsey) Limited is licensed and regulated by the Guernsey Financial Services Commission under the Banking Supervision (Bailiwick of Guernsey) Law, 2020, The Protection of Investors (Bailiwick of Guernsey) Law, 2020 and the Regulation of Fiduciaries, Administration Businesses and Company Directors, etc. (Bailiwick of Guernsey) Law, 2000, each as amended from time to time. Registered Office Address: P.O. Box 25, Regency Court, Glategny Esplanade, St Peter Port, Guernsey, GY1 3AP. Company registered in Guernsey No. 21061.

Tel +44 (0)1481 711521 Fax +44 (0)1481 714533
www.butterfieldgroup.com

Telephone calls are recorded for training, regulatory and security purposes.

