

# Investment Views



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# A Year to Forget and to Remember

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# China to the Rescue?

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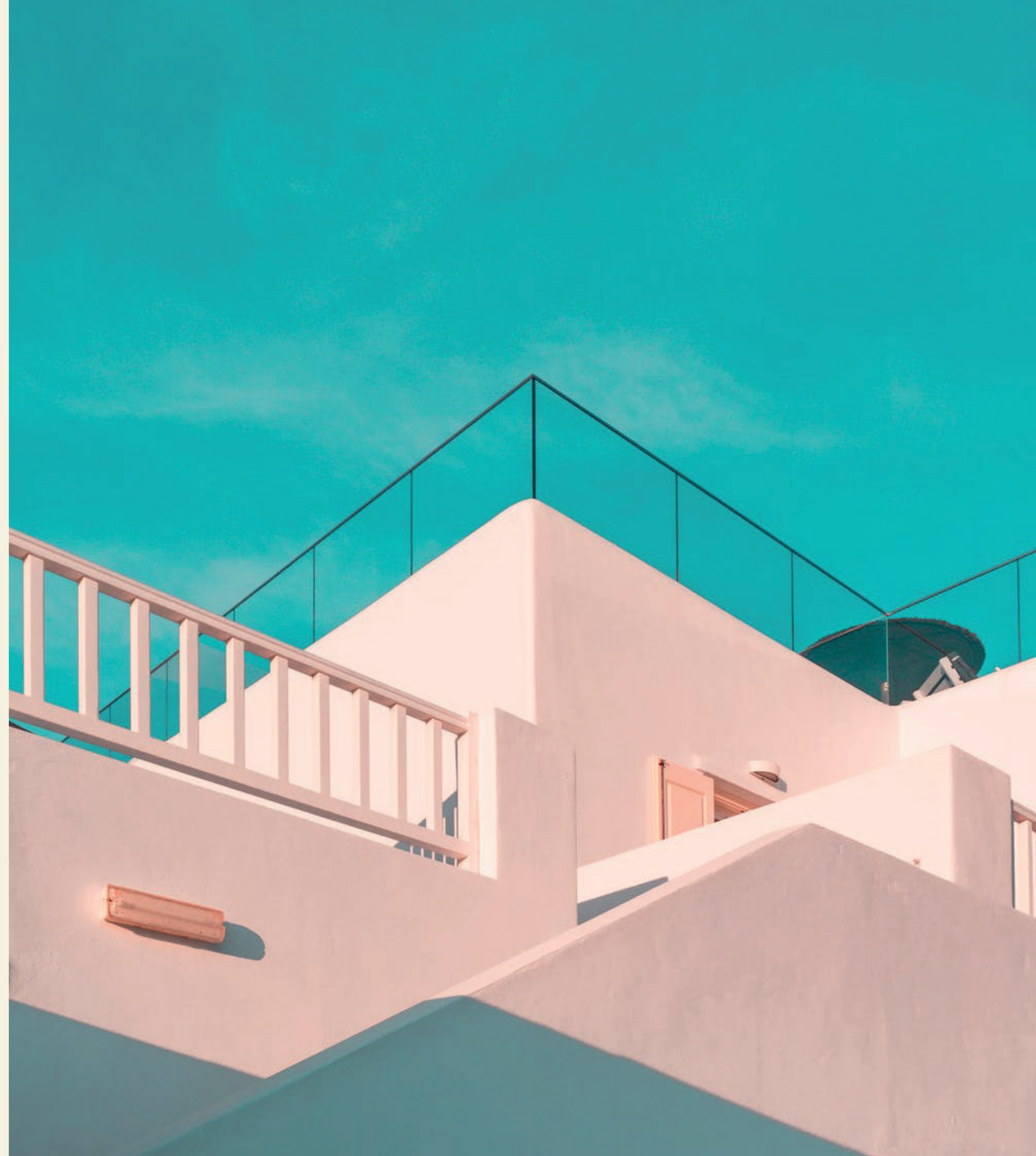
# A Better Quarter



# A Year to Forget and to Remember

The fourth quarter provided some welcome relief for bond and equity markets after a challenging nine months, wrapping up another eventful year. The return of inflation, following a thirty-year period of subdued price pressures, was the overriding theme of 2022.

Inflation impacts almost everything from interest rates, equity valuations, sector performance, currency values, purchasing decisions by consumers and businesses, politics and importantly, standards of living.





There have been three different elements to the inflation story: goods price inflation, services inflation and a commodity price shock. The pandemic and the vast monetary and fiscal policy responses were central to the first two with the Russia-Ukraine conflict driving the last. The challenge for markets and policymakers has been that all three of these combined in the first nine months of the year to create a perfect storm of inflationary pressure.

These price pressures have given central banks across the majority of the world a major inflation problem and they have responded with the most aggressive monetary tightening in more than 40 years. Interest rate hikes have been significant in terms of pace, scale and breadth, with GDP-weighted policy rates in developed economies rising by 300 basis points (bps) in less than 12 months.

High inflation has been particularly challenging for financial markets as it has been negative for both bonds and equities, which flipped the correlation between bonds and equities from negative to positive, meaning that they both move simultaneously. Investors had become accustomed to low interest rates, low inflation and bonds being a good diversifier from equity risk. All three of these assumptions were upended in 2022 and the adjustment process was a painful one. The year has seen the worst return for the US Treasury market going back to the 1920s and has been the first time that US bonds have lost money for two consecutive years since the 1950s.

The good news is that headline US inflation peaked in June, while in the eurozone and UK, it is highly likely that inflation peaked in October. Softer than expected inflation readings in the US for October and November helped financial markets recover during the fourth quarter, but the focus now turns to the year ahead and how quickly inflation falls is key to the outlook. The US economy has slowed materially compared to the very strong growth seen in 2021, but relative to expectations, growth has recently held up better than expected.

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# 300

The amount (basis points) GDP-weighted policy rates rose in developed economies in less than 12 months.

The year has seen the worst return for the US Treasury market going back to the 1920s and has been the first time that US bonds have lost money for two consecutive years since the 1950s.





## STRATEGY

This has also been the case in Europe as impressive efforts were made to fill energy storage ready for winter and industrial businesses have so far managed to reduce energy consumption without damaging cuts to production.

There is a lot of focus on what kind of “landing” the economy will experience. A “soft landing” would need inflation to fall significantly without a recession. This could happen because some prices fall sufficiently to bring overall inflation down without a broad-based decline encompassing services, prices and wages. There are promising signs with commodity prices and durable goods prices falling, but this would probably require the US labour market to cool without crashing and therefore allow wage growth to return to rates more consistent with the Fed’s target without a big rise in the unemployment rate. History suggests that this is typically difficult to achieve. However, this economic cycle has been anything but typical, so a degree of humility is required.

While bonds have not provided the diversification benefits that they have in the past, the good news is that yields are now substantially higher than they were this time last year. This regular income provides a much better cushion against volatility. Furthermore, good portfolio construction remains critically important, as an era of structurally higher inflation means previously unloved sectors such as Energy are good diversifiers.

Alternative investments also continue to have an important role to play in portfolios. Commodities again have low correlation with bonds and equities and there are plenty of opportunities for Hedge Funds in this more volatile environment. We have seen the benefits of that in 2022 with Macro funds in particular performing well after struggling in a world of low economic and inflation volatility.

In some sense, 2022 has been a year for investors to forget, but it has also provided an important reminder of the importance of active management, with a focus on portfolio construction and good risk management.



# China to the Rescue?

The final quarter was another volatile one in Fixed Income markets. US Treasuries have stabilised with the 10-year yield essentially range bound for the quarter and closing the year at 3.88%, just 4bps higher than the end of September. However, there was pronounced volatility in government bond markets in Europe. UK 10-year gilt yields fell by -42bps as the Bank of England and UK government moved quickly to address confidence, but yields still finished 350bps higher over the year. In mainland Europe, bond yields trended in the opposite direction. Even Swiss government bonds failed to provide a safe haven, with 10-year yields rising by 39bps.

This continued volatility in global bond markets kept the MOVE index (a measure of bond volatility) elevated at 122, almost double its 10-year average. This highlights the still elevated uncertainty over the near-term growth and inflation outlook for the global economy. Looking ahead, the lagged effects of tighter global monetary policy contrasts with a more open and stimulative China and a Europe less constrained by extremely elevated energy prices. These are major pillars of global growth and the impact of both remains uncertain at this stage, but will shape the potential for a global central bank pivot in 2023.





With US inflation data showing signs of having reached its peak and global energy prices falling rapidly, Citi's inflation data change index fell to -67 from +128 in mid-2021. Risk assets remained supported throughout the fourth quarter, even as signs of an economic slowdown build and geo-political risks remain elevated. US high yield spreads fell by an average of -83bps with similar relative spread compression in investment grade bonds.

With global financial conditions easing (weaker US dollar, lower credit spreads, higher equities) and raw industrial commodity prices stabilising, there is a risk that inflation pressures may re-accelerate if the US manages to avoid a severe recession. The rapid re-opening of the Chinese economy also looks set to boost global growth and inflationary pressures once the COVID-19 wave passes. This was the experience of other countries and could be achieved in the first quarter. As a result, inflation protected bonds look more attractive with valuations lower and the 10-year breakeven inflation rates back around 2%.

The US dollar weakened by approximately -8% in the fourth quarter with the Euro and Sterling rallying by a similar amount, reflecting improving economic data, a hawkish European Central Bank and a better inflation outlook. However, the major headline was the Bank of Japan's unexpected decision to widen the trading range for 10-year Japanese government bonds from a yield ceiling of 25bps to 50bps. This was driven by the highest core inflation since 2014, the end of governor Kuroda's term and more importantly, much firmer long-term consumer inflation expectations.



The figure Citi's inflation data change index fell to from +128 in mid-2021.



The Japanese Yen rose in the fourth quarter.

While this does not appear to be a major move, the signal that the central bank sent to the bond market was that they are now on the path to more policy normalisation, which could culminate in base rates being raised above zero for the first time in years. With the integration of global bond markets, this move could potentially fuel further upside in European bonds, a particular risk for Italy, and US government bond yields. This also led to a rally in the undervalued Japanese Yen (which rose by +9% in the fourth quarter).

Portfolio positioning within Fixed Income continues to remain defensive. There is some evidence that global macro risk troughed at the end of the third quarter, but the positive impulse is still significantly below the threshold which would prompt us to confidently deploy capital into riskier Fixed Income assets. Therefore, we remain very comfortable with our large allocation to government bonds (especially US Treasuries in dollar portfolios) with risk-free yields of close to 5% in short US dollar maturities. The bar to increase risk is high. However, the 200bps rise in high yield spreads combined with easier global financial conditions, stabilising global growth data and steadier US real yields could provide an attractive entry point to deploy capital in 2023.

Currently, we would need to see broader improvement in the factors that guide us, but an upturn in Chinese and European economic growth prospects could be enough of a catalyst to stabilise risk assets in the near term. In the meantime, we continue to reduce risk where valuations are expensive and/or the potential for volatility is elevated, hence we recently reduced exposure to long dated energy bonds in our US dollar bond funds in order to mitigate the tail risk of a more severe global recession in 2023.

## The rapid re-opening of the Chinese economy also looks set to boost global growth and inflationary pressures once the COVID-19 wave passes.

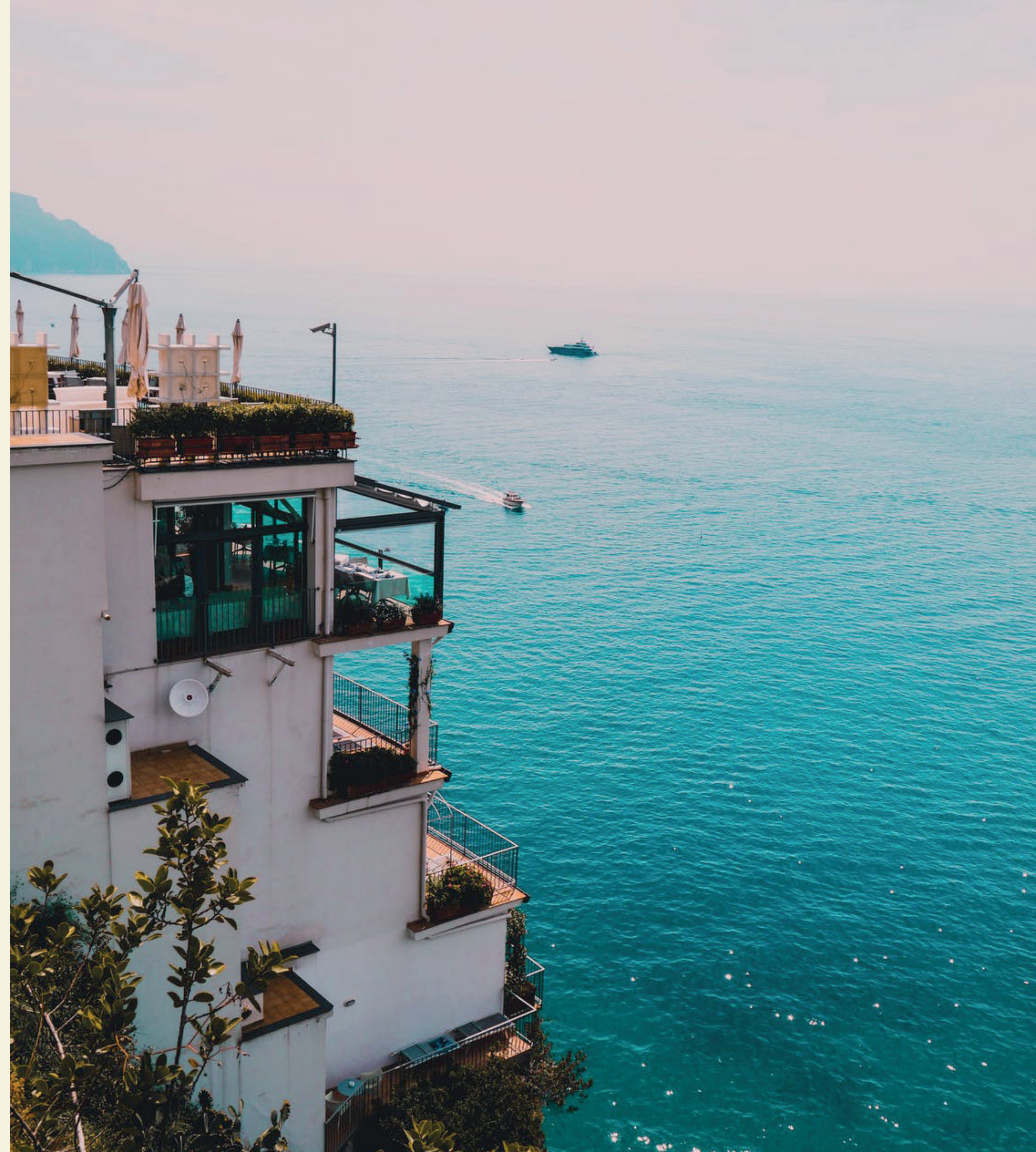


# A Better Quarter

Global equity markets rallied in the fourth quarter by +9.8% in US dollar terms, bringing full year returns to -18.1%. This followed three very strong years for markets with returns of +27.7%, +15.9% and +21.8% through 2019, 2020 and 2021 respectively. In all, 2022 was the weakest year for global equities since the Global Financial Crisis in 2008 and the fourth worst annual return since the 1970s.

The partial recovery in the fourth quarter was driven by slowing inflation and the view that central banks could moderate the path of aggressive interest rate hikes to focus more on reducing the probability, magnitude and duration of economic weakness caused by higher rates.

The quarter's positive return was a welcome respite from three prior consecutive quarterly declines of -5.2%, -16.2%, and -6.2%. The best performing major market was Europe, with a +20.1% rally in the fourth quarter (versus +7.0% in the US), reducing the region's full year decline to -18.0%; which is less severe than the -19.9% and -21.9% drops in the US and China.







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# 19.5%

Energy was again the best performing sector.

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# -30%

Consumer Discretionary, Communication Services and IT all dropped.

## EQUITIES

All sectors generated positive returns in the quarter except Consumer Discretionary, which was dragged down by Tesla's -53.6% free-fall and Amazon's -25.7% drop. Energy was again the best performing sector with a +19.5% return in the quarter, bringing its full year return to +46.0% (which stood out even more as it was the only sector with a positive return in the year). Sectors which contributed most to the overall market's positive return in the fourth quarter were Financials, Health Care and Industrials. Over the full year, the more defensive Health Care and Consumer Staples were the major sectors which held up best (each declining less than -10%), while Financials also outperformed the index. On the other end of the spectrum Consumer Discretionary, Communication Services and Information Technology each dropped more than -30%.

The US Fed did moderate the magnitude of its December interest rate hike from 0.75% to 0.50%, but remained consistent in its message that fighting inflation remains their priority. While future rate rises may not be of the same magnitude as last year, they have not yet finished hiking rates and may hold them higher for longer than markets anticipate. Hawkish central banks are not helpful for equity markets, although moderating near-term rate hikes and potentially leaving rates higher for longer is somewhat more positive for markets, as it gives the economy more time to adjust to higher interest rates.

Mega cap platform companies and those with valuations based on projected earnings growth in the distant future were weak in 2022 (including many in the Information Technology and Communication Services sectors), and this was particularly the case in the fourth quarter. Similarly, those companies which are more recession sensitive (such as the Consumer Discretionary sector) may remain under pressure as long as central banks maintain interest rates at levels which drag on growth. However, some of the more cyclical areas, such as Industrials, performed well helped by resilient earnings.



## EQUITIES

In each of the first three quarters of the year there were bear market rallies greater than 5%, which were subsequently given back in even larger market declines. In December, global equity markets again turned weaker, but performance of one major economic region stood out in contrast. China's equity market rallied +6% in December, with China's gaming hotspot Macau surging +23%. This followed the sudden abandonment of China's zero-COVID policy. This was an abrupt reversal after three years of lock downs for some of the most populated cities in the world. The zero-COVID policy contributed to ensnarling supply chains and has been a drag on global economic growth since the start of the pandemic.

This policy shift occurred after rare public protests and apparently broader societal dissatisfaction with such containment measures which appeared increasingly draconian and out of line with pandemic approaches throughout the rest of the world. Infections have spread rapidly since restrictions were eased. This is straining China's healthcare system, reducing the available labour force due to illness and/or desire to work, which is impairing productivity and global supply chains. While the region works through this difficult period, its equity market appears to be looking through the near-term pain to embrace China's re-opening without the economic drag of a zero-tolerance policy.

Corporate earnings actually held up well in 2022 and equity market weakness was driven purely by valuations as price/earnings multiples contracted. Earnings are likely to come under more pressure moving forwards as margins peak and slower global growth translates to weaker profits. However, valuations in the US are now close to long-run averages and in Europe and Japan valuations remain cheap relative to history, even after the recent rally. With significant weakness in more Growth orientated parts of the market there is opportunity within equities for active managers.

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# 23%

The amount Macau,  
China's gaming hotspot,  
surged by.








In December, global equity markets again turned weaker, but performance of one major economic region stood out in contrast... China.



# Global Asset Allocation

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

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	<div>CASH (MODEST UNDERWEIGHT) EQUITIES (MODEST UNDERWEIGHT) \$</div>	<div>FIXED INCOME (MODEST OVERWEIGHT) NON-TRADITIONAL ASSET CLASSES (MODEST OVERWEIGHT)</div>
Fixed Income		<div>EMERGING MARKET DEBT HIGH YIELD DEBT</div>
Equities Regional		<div>EMERGING MARKETS</div>
Equities Sector	<div>CONSUMER DISCRETIONARY + UTILITIES </div>	<div>CONSUMER STAPLES HEALTHCARE</div>



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