Investec

06 January 2023

Market commentary

OUT OF THE ORDINARY

John Wyn-Evans
Head of investment strategy

Overview

The financial media company Bloomberg recently re-interviewed respondents to a survey of market predictions that was taken a year earlier, at the end of 2021. A consistent pattern emerged. When not allowed to refer to any crib sheets with their actual answers, respondents' memories let them down. Their recollections of forecasts made were much closer to how things turned out than to what they had in fact predicted. Indeed, they had generally been far too optimistic. The generous explanation was that this was partially a function of having gradually recalibrated expectations in the face of emerging news as the year progressed. The more negative conclusion was that they displayed recency bias in anchoring their thoughts to the most recent experience (having made the same error a year earlier). This suggests that a lot of people claiming "I told you so" about their past prognostications will have done nothing of the sort.

What did our previous predictions say?

The publication of Monthly Commentaries (and Weekly Digests) means that our views on markets are recorded for posterity. A re-reading of the commentary from the beginning of 2022 shows that we were on the right track on many counts but failed to foresee the force of the impact or the magnitude of market declines. We clearly saw the threat to financial assets from tightening monetary policy; we made the case for greater insurance against rising inflation; we thought that more speculative assets would come under greater pressure as liquidity tightened; we even noted that Russia's dominance in terms of the supply of natural gas to Europe would present threats of economic disruption and political upheaval if there was any interruption.

All of this led us to be cautious, and underweight both equities and bonds in balanced portfolios, but we generally expected returns to be flat to down a bit rather than sharply negative (although we did become much more cautious in the aftermath of Russia's invasion of Ukraine – a stance that we maintained until early October).

A year ago, we commented on a conundrum. We noted how well equity markets had performed in 2021 in the face of rapidly rising inflation expectations and an upswing in bond yields and suggested that such a performance would not have been predicted on an ex-ante basis had those inflation expectations and bond yields been known in advance. As it turned out, the negative reaction was delayed rather than cancelled.

This year's conundrum is different in that it questions why global equity markets performed so badly despite aggregate earnings expectations holding up as well as they did. Remarkably, Wall Street analysts came within less than 1% of correctly predicting the earnings level for the S&P 500, which is a very rare event, and yet the index fell almost 20% during the year. No doubt there was some speculative froth that had to come off the top of the market, but there were other factors at play. We shall go into more detail in the regional section below, but suffice to say for now that there was a big difference between the best and worst performing sectors and that rising bond yields had a meaningfully negative impact on longer duration stocks (that is those whose current valuation is predicated more upon earnings that will be generated in the future rather than today). The big platform technology leaders which comprised around a quarter of the market's capitalisation were amongst the hardest hit.

What happened in equity markets?

If one were to try to sum up the reason for the global equity market decline of 2022 in a single word, that word might be "de-rating". Price/Earnings ratios (PE) compressed dramatically, with the UK and some European and Emerging Markets now sporting single-digit prospective PEs. And although the US equity market has hardly reached bargain basement territory, neither is it egregiously expensive on a forward PE of around 17x having entered 2022 around 22x.

But herein lies the next potential problem for investors. Is the E in the PE correct? One reason for us to retain a cautious stance heading into 2023 is the risk that earnings estimates are too high. The head of the International Monetary Fund rang in the New Year with a warning that "a third of the global economy will be in recession this year". Recessions tend to bring earnings downgrades. We have noted several investment banks

projecting “base case” earnings estimates being flat this year, but with “recession-scenario” earnings as much as 20% lower. There is also a wide range between the highest and lowest forecasts for potential equity market performance this year, another measure of uncertainty.

How might central banks behave this year?

Much will depend, yet again, on the behaviour of central banks. And their behaviour will, in turn, be largely predicated once more upon inflation, both in terms of outcomes and expectations. It is the US Federal Reserve that remains the key player, and its regular meetings and subsequent publication of the more detailed minutes provided some of the key catalysts for risk assets last year. It laid the groundwork as early as 5 January with the release of minutes from its December 2021 meeting by setting a much more “hawkish” tone than had been apparent earlier. Subsequent meetings continued this line until June, when Chair Jerome Powell made some surprisingly “dovish” comments. This sparked a considerable rally through the summer, which was only brought to a halt when Mr Powell re-emphasised the inflation threat during his speech at the annual Jackson Hole central bankers’ symposium at the end of August – a point that was made even more forcefully at the next FOMC meeting in September and again in December.

And this is pretty much the tone that prevails into 2023, with the latest projections from the FOMC’s members suggesting a peak in the Fed Funds rate over 5% (vs a current effective rate of 4.33%) and no cuts until 2024. Even so, there is a game of Call My Bluff going on, with futures markets discounting a peak of 4.95% in June with rates then falling through the second half of 2023. There are two main possible reasons for this divergence of opinion, but they have very different implications for financial markets. The more optimistic view is that the Fed pulls off an immaculate “soft landing”, bringing inflation under control with limited damage to employment and the overall economy. This is certainly not impossible, and it will be helped by recent falls in wholesale energy (and some other commodity) prices as well as by gradual improvements to global supply chains. But, as we also pointed out a year ago, there remains an alarming lack of consensus within the economics community about the causes of the current bout of inflation and what might cure it. There are also impassioned debates about cyclical versus structural shifts in inflation. Our central view is that longer-term inflation might well settle higher than the levels that prevailed pre-pandemic, but that does not preclude a sharper drop first.

As for the more pessimistic reason that rates could be falling sooner than the central banks maintain, that encompasses the possibility that higher interest rates end up having a much more negative effect on consumption and investment in a highly indebted world and that a nasty accident occurs somewhere in the economy or financial system, forcing the Fed’s hand. Our view tends towards the more pessimistic outcome, although balanced with the more soothing belief that there is less risk of a wider financial crisis developing as in 2008.

Could we be positively surprised this year? Certainly. A swift resolution to the war in Ukraine would be hugely beneficial, although recent activity suggests little current hope. A successful re-opening of China’s economy following the end of its zero-Covid policy would bolster demand as well as relieve supply chains, although it might also

contribute to higher inflationary pressures via commodities. And we should never rule out the progress of new technologies, with recent advances in nuclear fusion and Artificial Intelligence providing tantalising glimpses of the future (although the latter comes with its own threats).

Markets – US

As discussed earlier, the US equity market was subjected to a severe derating as interest rates and bond yields rose. However, the near-20% fall in the flagship S&P 500 Index fails to tell the whole story. The best-performing sector was Energy (+59%), which benefitted from rising oil and gas prices thanks to Russia's invasion of Ukraine, as well from something of a rebound from being the bête noire of ESG-driven strategies. Nine of the top-10 performing stocks in the index were from the energy sector (with, interestingly, First Solar, being the exception). Energy was the only sector in positive territory for the year, although more defensive sectors such as Utilities (-1%), Consumer Staples (-3%) and Healthcare (-4%) managed to hold their ground well on a relative basis. Information Technology (-29%), Consumer Discretionary (-38%) and Communications (-40%) were the big losers, with their membership dominated by long duration companies. The latter two sectors' fate was sealed by the poor performance of two heavyweight constituents in each case: Amazon (-50%) and Tesla (-65%) in Consumer Discretionary; and Meta (Facebook as it used to be/-64%) and Alphabet (parent of Google/-39%) in Communications.

UK

The lowlight of the year for the UK came in late September with the ill-fated "mini"-Budget presented by the then Chancellor Kwasi Kwarteng. Although the effects on financial markets were relatively short-lived, the fallout resulted in the swift departure from office of both Mr Kwarteng and Prime Minister Liz Truss. It might be tempting for other countries to look upon the episode with a degree of schadenfreude, but it would be wiser to extract at least the following lessons from it. First, politicians have to remain mindful that markets are, in the end, more powerful. Second, fiscal policy must have some degree of sustainability about it, and that "magic money trees" do not exist. Third, the weakest links in the financial chain can emerge in the most surprising of areas (and years of stable low rates might well have weakened more links than are currently observable). And, finally, that a swift reaction to such turmoil (and, if needed, intervention by monetary authorities) is vital to prevent a more systemic crisis unfolding. As for the UK equity market, it stood out as a rare developed market gainer in local currency terms, buoyed by its heavy exposure to energy and more defensive sectors as well as high dollar-denominated profits, but this was no reflection on the state of the domestic economy or of those in charge of it. The FTSE 100 Index ended with a gain of 49 points (+0.66%). The biggest positive contributions came from Astra Zeneca (+159 points/+32%), Shell (+145/+27%), and BP (+114/+50%). The biggest loss contributor was a former darling, the Scottish Mortgage Investment Trust, which was highly exposed to US growth stocks (-33/-46%).

Europe

The year on the Continent was dominated by developments to the North, with Russia's invasion of Ukraine setting off an unwelcome chain of events leading to inflation rising above 10%. This was especially shocking in a region that had struggled desperately to

reach its 2% inflation target in recent years. The euro briefly fell below parity against the US dollar. The disruption to supplies of natural gas from Russia highlighted the fragile nature of dependency upon a dominant external source of energy, but even France's much-vaunted ability to rely on its nuclear power plants was tested by a series of technical mishaps. Even so, worst expectations were not met, which led to a recovery later in the year for equities, bonds and the single currency. Matters were certainly helped by an unseasonably warm autumn (now extending into the New Year), which meant that expensively procured gas supplies were maintained at high levels before the winter chill descended. However, it remains to be seen how costly replenishing them for next winter will be. More laudably, necessity became the mother of invention for many industrial and residential consumers, with energy use reportedly reduced by as much as 25% in some industries through the adoption of more efficient practices. But, with the European Central Bank still intent on further interest rate increases, at least a shallow recession remains a probable outcome.

Emerging Markets

Although China continues to dominate any discussion of Emerging Markets owing to its dominant size in indices as well as its huge influence on global demand, it is worth noting that several smaller EMs acquitted themselves well in 2022 when returns are measured in sterling terms. Turkey was up 130%, Argentina +54%, Chile +34%, Brazil +21% and Singapore +15%. There were idiosyncratic reasons for these performances, ranging from domestic politics to the tailwind from higher commodity prices, and this is an area where we believe it is prudent to continue to outsource the exposure to specialist managers. But from a Tactical Asset Allocation perspective, the stars could well be aligning in favour of EMs again. One key factor in their favour would be a clear peak for the US dollar. Owing to high dollar-based liabilities and funding costs, a strong dollar tends to be a drag on EM performance. As alluded to earlier, a successful exit by China from its zero-Covid policy could also provide a helping hand. Emerging Market equities have consistently risen to the top of the rankings in many investors' long-term capital market return assumptions in recent years but have failed to deliver on the promise since China's huge investment surge in the first decade of this century. However, sensible monetary and fiscal policy has seen many EM countries fend off the worst effects of global inflation in the last year and there is plenty of ammunition to provide renewed stimulus to growth. Valuations are relatively attractive, too.

Fixed Income

Despite rallying towards the end of the year, global investment grade bonds suffered their first bear market (a fall of 20% or more) in seven decades. Another rare event was that they failed to provide any balance within supposedly balanced portfolios, with the falls being similar to those suffered by global equities. The main culprit in all of this was inflation. At the start of 2022 the consensus view of economists polled by Bloomberg was that global inflation would be around 4%, but the outcome will have been close to 7.5%. With yields now considerably higher than they were a year ago (3.87% vs 1.63% for the US 10-year Treasury, and 3.67% vs 1.08% for a 10-year Gilt), there is a much greater probability that sovereign bonds can reassume their role as portfolio insurance in the event of lower growth or a recession. But much will depend on the path of inflation. And if we were to move into a world of permanently higher inflation which is also more volatile than we have been used to, then the relationship between bonds and

equities could prove to be equally volatile.
UK Gilts have delivered a total return of +1.7% over the last three months and -23.8% over the last year. Index-Linked Gilts returned -6.2% and -33.9% over the same respective periods. Emerging Market sovereign bonds produced a total return of +0.5% in sterling over the three months to end December (-7.4% over 12m). Global High Yield bonds delivered +0.2% (-1.7% over 12m) in sterling.

Conclusion and Outlook

Perhaps unsurprisingly, following a very rare year during which both global bonds and equities performed so poorly, the tone of this commentary is a touch gloomy. But therein lies the hope of eventual redemption. There have been only four previous occasions in the last century when both asset classes posted negative returns, and never in consecutive years. The human flaw of “anchoring” to recent experience was mentioned earlier, and it is important that we do not anchor our future expectations to what has just happened. The inflation cycle does appear to have peaked, and we believe that the interest rate cycle will also peak in 2023. Valuations are more attractive than they were a year ago and our favoured “growth compounders” are still compounding growth, even if it is not as highly valued as it was. And while we enter the New Year with a still-cautious bias, we are looking forward to finding opportunities to increase portfolio risk during the year ahead and expect to be able to project a much rosier scenario in twelve months’ time. And, of course, we will be able to look back on these words with the benefit of hindsight!

Investec

The information in this document is for private circulation and is believed to be correct but cannot be guaranteed. Opinions, interpretations and conclusions represent our judgement as of this date and are subject to change. The Company and its related Companies, directors, employees and clients may have position or engage in transactions in any of the securities mentioned. Past performance is not necessarily a guide to future performance. The value of shares, and the income derived from them, may fall as well as rise. The information contained in this publication does not constitute a personal recommendation and the investment or investment services referred to may not be suitable for all investors; therefore we strongly recommend you consult your Professional Adviser before taking any action. All references to taxation are based on current levels and practices which may be subject to change. The value of any tax benefits will be dependent on individual circumstances.

investecwin.co.uk

Member firm of the London Stock Exchange.
Authorised and regulated by the Financial Conduct Authority.
Investec Wealth & Investment Limited is registered in England.
Registered No. 2122340. Registered Office: 30 Gresham Street, London, EC2V 7QN.