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OUT OF THE ORDINARY

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Market reflection

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Overview

Few investors will look back fondly on 2022, a year in which they suffered the rare combination of losses in both equities and bonds. World equity indices closed at their highest level on the first trading day of the year and suffered a series of declines before finding some sort of floor in October.

Continued overleaf

Although corporate earnings expectations have held up well in aggregate, the valuation that investors have been willing to ascribe to those earnings has been progressively reduced owing to the rising level of both cash interest rates and government bond yields. These, in turn, were driven higher by increasingly aggressive moves by central banks to tighten monetary policy in the face of rising inflation.

The persistence of higher inflation was, perhaps, the defining factor of the past year, although its origins are still the subject of heated debate. Disruption from the Covid pandemic was a culprit, with supply chains thrown into disarray, but that should eventually normalise. The lagged effects of very loose fiscal and monetary policy are also being felt. Then there are the more direct results of Russia's invasion of Ukraine, especially in terms of energy prices in Western Europe, as well as other geopolitical shifts that have put obstacles in the way of the continued expansion of global trade.

All of which leaves the outlook for 2023 somewhat cloudy, with threats of recession hanging over the global economy. This could finally undermine corporate earnings. On a more positive note, the annual rate of inflation does seem to have peaked, and there is a growing expectation that the interest rate cycle will also top out within the next 12 months. Both of these factors will finally lay the foundations for a new bull market to emerge. And after a year during which the UK had four Chancellors of the Exchequer and three Prime Ministers, greater political stability would also be welcomed.

- The Bloomberg consensus World GDP growth forecast for 2022 started the year at 4.4% and hit a trough of 2.9% in August. There is some consolation in the fact that estimates have not deteriorated since then, with economists now expecting a growth rate of 3%. There is no expectation of a quick recovery in 2023, with the current forecast of 2.1% being perilously close to the sub-2% level that is widely regarded as being the definition of a "global recession".

- We end 2022 with expectations for global inflation still at their peak of 7.45%, as are forecasts for 2023, which currently sit at 5.2%. But the underlying trend should be lower as the effects of tighter monetary policy are felt through the economy.

- One of the biggest uncertainties for 2023 is the path of corporate earnings. Analysts' "bottom up" forecasts remain remarkably resilient, but strategists' "top down" forecasts are less sanguine. This mismatch of expectations could be resolved within the first few months of the year, and we suspect in favour of the strategists. Thus, we retain a somewhat cautious stance on equities for now.

- The relaxation of China's zero-Covid stance was initially greeted with enthusiasm, but the release of the virus into a population with limited immunity has created new threats of short-term disruption. Even so, the worst effects should have been felt within the next few weeks.

- It is important to be mindful of the fact that equity markets will start to recover long before the economy or earnings. We expect market sentiment to recover during 2023.

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