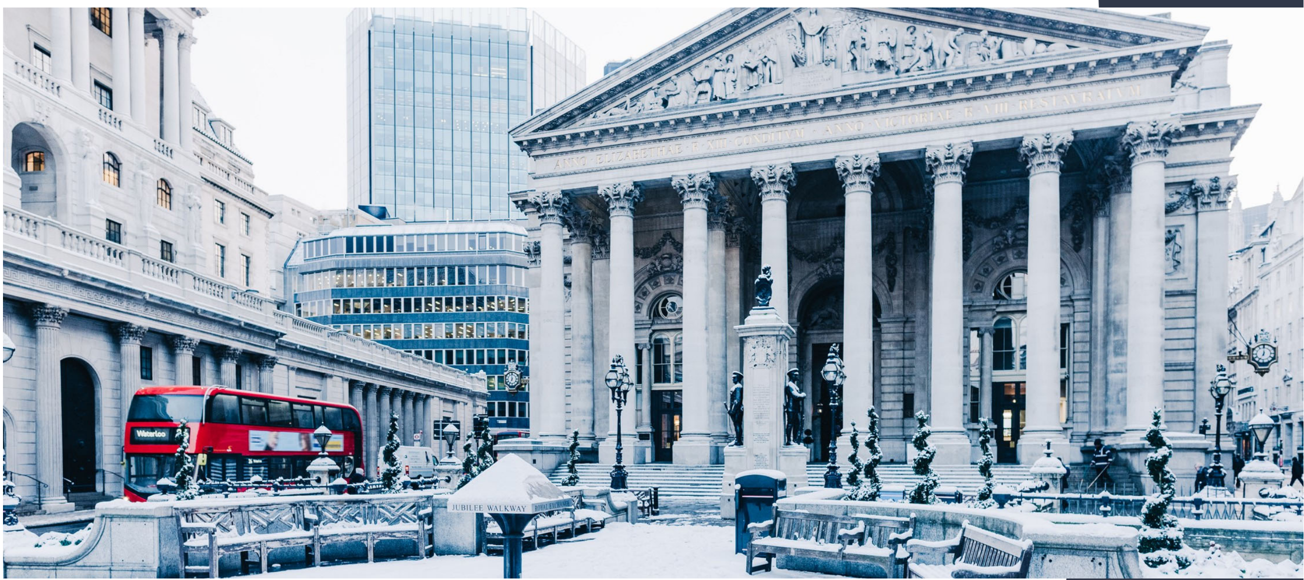
OUT OF THE ORDINARY

Investec

WEEKLY DIGEST | 12 December 2022

A Final Flurry



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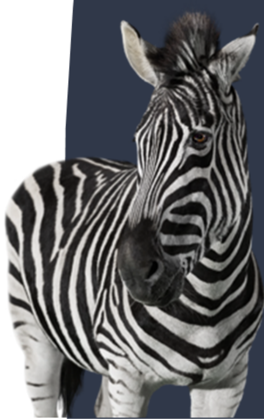
I am writing this week's commentary while able to look out onto snow-covered trees in my garden. One result of the snowfall is that I can see all the footprints of the local foxes on the lawn and paths, and it looks as though they had a very busy night. No doubt this goes on every night, only there is usually much less evidence. I think I'd rather not know.



Another thing that happens while I am sleeping is that investors in Asia are busy going about their work. Trading in Asian markets tends to set the tone for the opening in Europe, but it also tends to reflect the previous close in the United States. We can't get away from the fact that the US market dominates global markets and that the US Federal Reserve is very much at the top of the central bank tree in terms of its influence.

What can we expect for the Asian markets?

Having said that, Asia, especially China and Hong Kong, has been dancing to its own tune a bit more recently, mainly thanks to the influence of China's zero-Covid policy. That policy is being relaxed in response to recent protests, which is encouraging hopes for a re-opening of China's economy and a potential surge in demand. This might be something of a mixed blessing if it forces up commodity prices at a time when western central banks are trying to dampen local demand to squash inflation, but it would at least have the benefit of unblocking bunged up elements of manufacturing supply chains.

Hong Kong's equity market has been a primary beneficiary, being the best-performing major global equity market for three of the past four weeks (and the worst for the other one, so there has been some volatility). A Bloomberg poll of 134 fund managers released over the weekend had Chinese equities as their top pick for 2023, and the market does feel a bit like a coiled spring. It also looks as though the re-opening could be a bit of a stop/start affair if certain projections we have seen for the number of new Covid infections are met, but the trend should be persistent in its eventual return to more normal activity.

The same survey saw 71% of respondents expecting global equities to rise in 2023, versus 19% forecasting declines. For those seeing gains, the average response was a 10% return.

What do surveys tell us is the outlook for 2023?

This result contrasted with another Bloomberg survey of Wall Street strategists conducted last week, which found that, on average, they are expecting the S&P 500 Index to end 2023 lower than it will start (if only by a couple of percent), the first time they have made such a prediction this century. And, for the record, the S&P 500 had eight down years during that period, including three in row at the beginning. However, there is also massive dispersion at the tails, with a range of around 32% between the lowest and highest forecasts, the greatest since we entered 2009 in the throes of the financial crisis. That turned out to be a 23% up year. This outcome echoes the latest Bank of America (BoA) client survey, which was generally gloomy, especially regarding the economic outlook. The BoA survey also reflected defensive positioning.

Fund manager surveys are worth following, because they give us a reasonable feel for what is priced into markets, meaning that any positive (or negative) divergence from expectations could result in a big market move. Sentiment and expectations are currently low. Thus, despite our continued caution, we don't want to be too defensive either. There are two more surveys to unpack, and they paint a similar picture.

In Goldman Sachs's latest QuickPoll of its clients, the first question was "Which theme do you expect to deploy the most capital to in early 2023?" By its nature, that sounds like a question more directed at shorter-term traders and hedge funds, perhaps, but the overwhelming winner was "Recession", with 39% of the vote. One assumes that intention could cover anything from being short of equities and credit to tilting in favour of defensives or being long of duration in government bond markets. One observation I have seen made (more by the trading community) is that positions are unlikely to be cranked up between now and the year end as books are flattened and gains protected where they have been made, but it will be instructive to see if there is any immediate impact once we return to business in the new year.

The second question elicited a similar response. The question was "Which US trade offers the best risk/reward for 1H23?" The top two answers were "Short S&P 500" and "Long Treasuries", which are effectively two sides of the same coin. Importantly, though, it does signal an expected reversal of the trend of positive correlation between equities and bonds that was prevalent for most of this year, a view with which we have some sympathy. Government bonds look like much better potential risk diversifiers than they did a year ago, although would be less effective in the event of inflation being much higher than expected.

Next up was "Where do you expect the terminal Fed Funds rate to be?", with 43% of respondents saying 5% and 36% saying 5.5%. So higher US rates are very much anticipated, although we remain unsure that their effect on the economy and earnings has been fully accounted for, especially in analysts' earnings forecasts.

The single highest response in the poll was to the question "Do you think the Fed will cut rates in 2023? 57% said "Unlikely", which is at odds with futures market expectations. And that sets us up nicely for the Fed's new dot plot this week, more on which in a moment.

The final survey came hot off the press from Deutsche Bank at the start of this week. I am only going to comment on three of its market-related questions, although it also asked for everyone's favourite Christmas song ("All I want for Christmas is you" was the global winner, if you must know. My vote went to Slade, again).

Back to the S&P 500 (and for many that is a proxy for global markets), the first question was whether we have already seen the lows (3,500 vs 3,934 at last week's close). Only 21% thought the bottom was in, with 79% expecting the trough to come in 2023 (or later). And so at least 11% downside.

The answer to the next focus question suggests a feeling of "worse first, better later", with the average expectation for a 2.2% decline during 2023. But a third of respondents expect the index to be down 10% or more by next December. Last year the average expectation for 2022 was for a gain of 4.2%, and it's currently down 17.5%. Where's that positive surprise when you need it to bail you out?

Finally, 44% see the Fed Funds rate peaking in the range of 5-5.5%, with another 42% expecting a peak even higher than 5.5%. Current futures pricing is for a peak just below 5%.

What may move the markets this week?

That leads us nicely into this week's potential market-moving events. They might set the tone not just for the rest of this year, but also the start of 2023. Everyone's attention will be on just one economic data release, and that will be quickly overtaken by policy decisions from three major central banks. The data point is the US Consumer Price Index for November, which is due on Tuesday. After last week's higher-than-expected Producer Price Index numbers, there will be a bit more nervousness ahead of this one, although consensus expectations are still for a reduction in the headline CPI from 7.7% to 7.3%, with the core rate dropping from 6.3% to 6.1%. Month-on-month growth in both cases is forecast to be +0.3%. It was October's lower-than-expected print that sparked a massive 5.6% one-day rally in US equities (further comment on which below).

However, the main event will be the Federal Open Market Committee's last meeting of 2022, with the policy decision being made public on Wednesday at 7pm our time. That will be followed by the usual press conference with the Chairman Jerome Powell. Market expectations have drifted down since the last meeting to an increase of "only" 0.5% following four consecutive 0.75% rises. That might bring relief in the eyes of some, but hardly constitutes the much-anticipated "pivot". There will also be a new "dot plot", the graphic representation of members' rate forecasts. Remember that the latest one, published in September 2022, heralded the new era of "higher-for-longer" interest rates, with Fed members saying there would be no cuts before 2024, although investors continue to test that assertion in the futures markets. Will they stick to their guns and reinforce that message? Where will they pitch their peak rate forecast? It is also a possible that they will edge up their estimate of the neutral interest rate that keeps supply and demand in balance in the long run. The threat of persistently higher rates in the longer term could exert downward pressure on financial assets.

Then on Thursday we have meetings of the Bank of England (BoE) and the European Central Bank (ECB). Both are also expected to raise the base rate equivalent by 0.5%; in the BoE's case from 3% to 3.5% and in the ECB's case from 1.5% to 2%. The ECB's statement about its intentions for running down its balance sheet might be of more interest than the rate decision. Given the already more parlous state of the UK economy, the BoE's statement could be the most dovish of the lot, although the proliferation of strikes could also encourage further efforts to dampen future inflation expectations, and thus, it might hope, current wage demands.

We should brace ourselves for the possibility of a big move this week. In the latest Monthly Commentary, I made some observations about the trend for buying very short-dated call options in the US. I think they are worth expanding upon. This is apparently not a new retail fad, but something being embraced by institutions. Choose your scheduled piece of potentially market-moving economic data or central bank event and place bets accordingly. With so little time value to be priced in, there is huge asymmetry in the payoff, especially if you venture a bit further out-of-the-money, with investment banks furiously having to hedge any short positions owing to the effectively open-ended losses that they face.

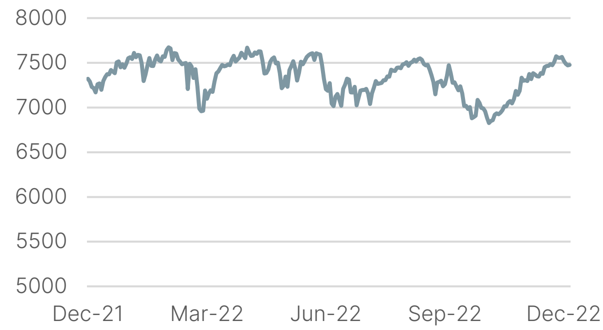
In November, this phenomenon was visible twice. On the day of the CPI release, the S&P 500 rose 5.6%, and then, following a much-anticipated speech by Fed chair Jerome Powell in which he effectively confirmed that rates would rise by "only" 0.5% in December, equities rose by 3.5%. Both days saw much-higher-than-average trading volumes. In the end, though, the net monthly gain for the S&P500 was 5.4%, meaning that, in aggregate, the other twenty trading days provided a negative return of around 4%. Seat belts on!

Economic Commentary

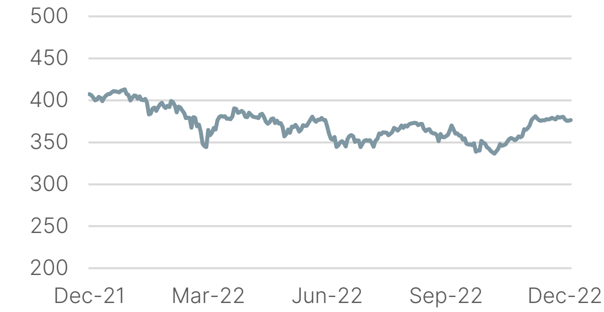
FTSE 100 weekly winners	
DS Smith Plc	6.5%
Prudential plc	5.8%
Rio Tinto plc	4.5%
InterContinental Hotels Group PLC	4.3%
Rolls-Royce Holdings plc	4.2%
BHP Group Ltd	2.5%
GSK plc	2.4%

FTSE 100 weekly losers	
London Stock Exchange Group plc	-10.5%
International Distributions Services plc	-9.3%
Abrdn plc	-8.2%
Just Eat Takeaway.com N.V.	-6.3%
BT Group plc	-5.9%
Intermediate Capital Group plc	-5.2%
Halma plc	-5.2%

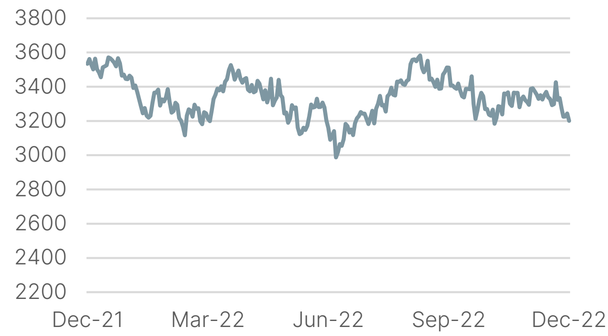
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

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