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OUT OF THE ORDINARY

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A Turn For The Better

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At the moment, every meeting I attend has an awkward beginning where the participants can't quite decide whether it's too late to wish each other a Happy New Year. From an investment perspective, though, the first two weeks of 2023 have generally put a happy smile on people's faces, with most equity indices moving higher, bond yields lower and credit spreads tightening.

In the last Weekly Digest of 2022, I posited three "reasons to be cheerful". To remind you, they were: 1) Bear markets are always followed by Bull markets; 2) Equity markets tend to bottom-out during recessions, and so the time of maximum pessimism around the economy tends to be the best time to increase investment risk; 3) Long-Term Capital Market Assumptions (expected returns for individual asset classes and overall portfolios) are more generous than they were a year ago.

While the first and third of those reasons are, admittedly, impossible to pin down from a short-term market timing perspective, one can make a reasonable case that investors are reacting positively to evidence that the worst estimates for economic growth and corporate earnings are not going to be met – at least not imminently. There are a couple of specific developments to take into account.

Why the markets are exceeding expectations

The first is that Europe (and the UK) appears less likely to suffer a severe recession over the winter. This is largely down to vagaries of the weather, which is not necessarily something that could have been predicted in advance. Media photographs around New Year showed people cavorting on beaches in swimsuits while proprietors of ski resorts cried into their glühwein for lack of snow. Yes, we have had an unseasonably warm winter (even accounting for the one big freeze before Christmas), which has meant that fears of running out of natural gas have not been met. Had they, we could have seen supply restrictions being imposed, which would, in turn, have led to large swathes of industry having to shut down.

At the same time, we should also applaud the reaction of companies and consumers. Reports suggest as much as a 20% reduction in gas consumption in the EU. And while at least some of this will have been weather-related or the result of switching to other sources (including coal, sadly), there was also a meaningful contribution from more efficient working practices as well as some degree of self-sacrifice. Could this be a small silver lining in the longer-term effort to reduce carbon-based energy consumption?

We can see a reason for the shift in investors' perspective in Citigroup's Economic Surprise Index (CESI). This logs how economic data comes in relative to economists' expectations. This is a mean-reverting series (because economists' forecasts always catch up with reality), and so will regularly pass through zero, but the pendulum-like swings away from and back to zero can be very instructive. The trough of negative surprises in Europe for this cycle (-105) was hit as long ago as last July, although data still tended to be worse than forecast until September when the index finally rose to zero. It hovered around there until late November but has since risen relentlessly to a current level of 78.

To employ market-speak, the positive economic surprises have encouraged investors to price out the "left tail risk" of a severe recession (with the accompanying risk of credit defaults, earnings downgrades and, it being Europe, threats to the sustainability of the single currency). If we take the bottom of the last market decline as being defined by the low the MSCI All-Countries World Index (ACWI) hit on 12 October, we can look at what has happened since. The EuroSTOXX 600 Index (SXXP) is up 17% vs the ACWI +16%. But it's much more impressive when we adjust for currency exposure. When priced in euros (and not dollars as it is quoted), ACWI is only

+3%. The better sentiment towards Europe has also propelled the euro higher, from $0.97 to $1.08. (There is a big element of dollar weakness in this, too). Indeed, the SXXP has shown all major developed market regions a clean pair of heels over the period. Again, adjusting into euro returns, the S&P500 is effectively unchanged, the FTSE 100 +13% and Japan's TOPIX +4%. Within Europe, the more cyclical German DAX Index is +24%. (Bloomberg market data to COB 13/1/23)

Although European and UK markets still offer reasonable value, it might be difficult to sustain this level of performance. Looking at the CESI series over the last twenty years, it has proved impossible for the index to remain in high double-digit territory (and certainly over 100) for long, with the only exception being the period immediately following the pandemic-related crash in economic data. It's one thing to price out a nasty recession, but quite another to start pricing in a more durable recovery or new growth cycle, especially when the European Central Bank is still intent on tightening policy.

What is developing in China?

Having said that, Europe could also benefit from the second positive development, and that is China's dramatic policy reversal regarding the management of Covid. We initially judged that China's approach to reopening its economy would be one of "crossing the river by feeling the stones". Instead, it has dived headlong into the current. Additionally, the government has announced further measures to support areas of the economy such as the real estate sector, and there was even what appeared to be a relatively constructive meeting between Presidents Xi and Biden.

I mentioned on several occasions last year that, in the eyes of many investors, China was becoming uninvestible, and the negative sentiment reached a crescendo following October's National Party Congress (NPC) and the confirmation of President Xi's third term in office. I also thought that this might end up offering an opportunity to go against the grain. However, the speed of the policy shift and the subsequent positive market reaction has been breathtaking. The MSCI China Index is up 50% since the post NPC market lows. Some highly leveraged Hong Kong-Listed property companies have tripled in value (although one has to take into account that these represent a tiny sliver of equity sitting on top of a volcano of debt). Companies in western markets with exposure to the region (and especially the re-opening) have also benefitted. Some might be surprised that shares of Prudential (yes, home of "the man from the Pru") are up 53% since the end of October, but the bulk of their business is now in Asia, notably Hong Kong and China. Luxury Goods companies have also been in the ascendant, with, for example, Burberry +22% and LVMH +21%. HSBC is +29%.

And there might be more legs in the China rally. There is little evidence of investment flows into the country from global mainstream funds so far. And the CESI for China is still right at the bottom of its latest cycle at -77, mainly thanks to the effects of the last leg of the zero-Covid policy. There is potentially quite a lot of more positive economic data in the offing.

You can probably sense that there is a "but" coming. And here it is. As for most of 2022, investors remain keenly focused on the US Federal Reserve and its interest rate policy. The Fed's actions are

the most likely determinant of whether the US enters a recession, and, as I wrote before Christmas, this will have huge influence on earnings and market performance. Although the potential US recession is often described as the "most anticipated in history", it is still not being reflected in bottom-up consensus earnings forecasts. While they have been downgraded gently over the last few months, the S&P 500 is still expected to generate $224 of operating earnings in 2023, up from what will end up having been around $221 in 2022. But recessions tend to see earnings fall around 20% on average. Even if this turns out to be a shallow one, as many believe, a 10% haircut does not seem improbable. But few analysts appear willing to pencil a recession into their numbers.

In the US, what action is expected from the Federal Reserve?

There is another interesting disconnect in markets now, and that is the gap between what the Federal Reserve says it is going to do with interest rates and what investors think it will do. The Fed mantra very much remains "higher for longer", with its most recent dot plot of rate expectations predicting a peak of 5.1% in the Spring and no cuts until 2024. Futures markets suggest a peak below 5% in June and then 0.5% of cuts in the second half of the year (and another 0.25% cut in January 2024).

Even if we take the lower rate scenario as being the outcome, the cause and effect are open to two very different interpretations, one very benign, the other less so. In the Panglossian world, inflation declines quickly thanks to commodity prices subsiding, supply chains relaxing and labour market shortages easing as workers are tempted to seek work again. At the same time, demand remains steady as consumer and corporate balance sheets are strong enough to withstand the rate increases already imposed. The Fed can declare that inflation was transitory after all, and we all live happily ever after. In this scenario, earnings could well increase, and the lower rate environment would encourage a higher valuation of those earnings. This is by no means impossible, although some have likened it to the economic equivalent of Captain Chesley Sullenberger (Sully) successfully landing his plane on the Hudson River in New York in 2009.

The less benign outcome is that the Fed is forced to cut rates because the credit cycle turns nasty as the lagged effect of past rate increases kicks in, unemployment rises quickly by a couple of percentage points and earnings come under pressure. Financial assets demand a higher risk premium. Credit spreads will have risen, and equities fallen, but sovereign bonds turned out to be a much better diversifier than they were in 2022. Even if this does create a good set-up for the beginning of a new bull market, it will probably be from an appreciably lower level than we are at now.

Which camp do we stand in? We continue to lean towards the second camp. Although we think that inflation will abate quite quickly, we are also of a mind to take the Fed at its word as long as the economy has not yet experienced too much pain. But in sticking to its guns, the Fed will eventually cause the economy to slow down sharply. And even if there is no official recession, the market will begin to discount one by moving lower again. But for now, at least, the market is backing the softest of landings.

Economic Commentary

FTSE 100 weekly winners

Polymetal International Plc	16.0%
JD Sports Fashion Plc	12.3%
International Consolidated Airlines Group SA	12.0%
Intermediate Capital Group plc	9.3%
Berkeley Group Holdings plc	8.8%
St. James's Place Plc	8.3%
Whitbread PLC	8.2%

FTSE 100 weekly losers

British American Tobacco p.l.c.	-6.6%
BAE Systems plc	-2.9%
Aviva plc	-2.6%
Coca-Cola HBC AG	-2.5%
B&M European Value Retail SA	-2.3%
Admiral Group plc	-1.8%
Fresnillo PLC	-1.7%

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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