

Turning away from the glass-half-empty mentality

by Gregoire Sharma, Senior Portfolio Manager & Research Analyst

As we turn the page on 2022 and look with cautious optimism at 2023 for some respite in markets, investors are appraising the investment landscape with an understandable degree of trepidation. Indeed, following the macroeconomic and geopolitical events of 2022, losses in fixed income markets were on par with those in equities making it one of the worst years on record for balanced portfolios. Conflating this with the prospects of a global recession, the amplitude of which is yet to be fully appreciated, pessimism in markets has led investors to position themselves incredibly bearishly at the end of 2022. This was demonstrated by recent spikes in the Chicago Board Options Exchange Put/Call Ratio which went haywire in November before spiking to its highest level on record in December. This normally contrarian indicator might therefore be pointing to a significant regime shift and things might in fact not all be doom and gloom.

Let's start with the good news. It seems, inflation has likely peaked and is expected to fall materially this year. Looking at the data in the US, the contribution to headline Consumer Price Index from prices of goods has come right off, as the supply and demand shocks from the global pandemic recovery have dissipated. In addition, commodity prices have fallen significantly from their peaks in 2022, some to pre-invasion levels. The one thorn in the side is core inflation, which strips out food and energy prices, and is expected to remain sticky, in part due to a resilient labour market (low unemployment and unwavering wage growth) coupled with a robust consumer.

Turning to monetary policy the US Federal Reserve (Fed) has already hiked rates to a range between 4.25% and 4.5% with expectations for terminal rates at around 5%, so arguably, the majority of hikes have already been priced in¹. Monetary policy operates with a lag, with services, jobs, and inflation being in general the last to respond to policy impulses. However, the early effects of last year's tightening on activity and inflation are clear. Growth in the US is cooling as illustrated by a raft of economic data. In fact, the latest flash Purchasing Managers Index's for January, while showing a slight improvement from December, still indicated a seventh consecutive month of contraction in the private sector. The one outlier is the strong US labour market, but even there we are seeing signs of weakness starting to materialise. High frequency indicators are flashing recessionary signals as evidenced by the growth over the last six months of weekly jobless claims. Additionally, looking at the rate of change of the (admittedly high) job openings over the last six months reveals a clear contractionary trend. Qualifying all

of this with the decline in hiring intentions, as suggested by the National Federation of Independent Businesses survey data, one can only expect an imminent cooling in the labour market. This would vindicate the market pricing of a Fed pivot as illustrated by the Fed Funds futures and the Fed dot plots. However, risks remain as the Fed will absolutely want to regain credibility after previously beating the 'transitory-inflation' drum for so long and in doing so, will tolerate an economic slowdown and higher unemployment to bring inflation down to its 2% target.

So, how have markets reacted? Focusing on valuations, these have rerated substantially last year with equity markets having returned closer to their long-term averages and bond markets now offering attractive yields without the need to take on significant interest rate or credit risk. Interestingly, strongly inverted yield curves are signalling an imminent recession, but credit spreads aren't pricing this in at all. What the higher yield levels do afford is a greater degree of reassurance as investor bearishness has been baked-in to prices, effectively discounting a substantial level of downside potential. Similarly, whilst equities aren't yet discounting a significant earnings recession, we can perhaps take comfort in the realisation that last year's equity market drawdown was exclusively driven by multiple contraction resulting from higher interest rates, whilst earnings growth remained positive. Given markets imply we are about 50bps from peak rates in the US, we can therefore reasonably expect a mild earnings recession to have a less dramatic effect on markets, especially if the outlook is more positive for 2024. Finally, if we consider a best-case scenario where fixed income markets are right and we do see a true Fed pivot this year, we could then reasonably expect a reversal of the multiple contraction seen last year.

Wishful thinking? Perhaps, but investors should turn away from the glass-half-empty approach and instead take solace in the fact we are entering a new regime where government bonds are offering positive 'risk-free' rates once again. Whilst a mild recession seems the widely expected outcome this year, markets have repriced closer to fair value (with some cheap valuations in areas) hence, we are starting the year from a more attractive base to generate long-term returns. Something positive to look forward to, then, amongst all the doom and gloom?

Source:

¹ <https://www.federalreserve.gov/newsevents/pressreleases/monetary20221214a.htm>

Unless stated, all data from Bloomberg Finance L.P.

Global Matters Weekly

30 January 2023

For more information, please contact your adviser or alternatively contact:

Belvest Investment Services Limited
研富投資服務有限公司
9th Floor, Centre Mark II
305-313 Queen's Road Central
Sheung Wan, Hong Kong

Tel +852 2827 1199
Fax +852 2827 0270
belvest@bis.hk
www.bis.hk

Important notes

This communication is issued by Belvest Investment Services Limited and/or Belvest related companies (collectively, and individually Belvest) solely to its clients, qualified prospective clients or institutional and professional investors. Unless stated otherwise, any opinions or views expressed in this communication do not represent those of Belvest. Opinions or views of any Belvest company expressed in this communication may differ from those of other departments or companies within Belvest, including any opinions or views expressed in any research issued by Belvest. Belvest may deal as Distributor or Agent, or have interests, in any financial product referred to in this email. Belvest has policies designed to negate conflicts of interest. Unless otherwise stated, this e-mail is solely for information purposes.

This message may contain confidential information. Any use, dissemination, distribution or reproduction of this information outside the original recipients of this message is strictly prohibited. If you receive this message by mistake, please notify the sender by reply email immediately.

Unless specifically stated, neither the information nor any opinion contained herein constitutes as an advertisement, an invitation, a solicitation, a recommendation or advise to buy or sell any products, services, securities, futures, options, other financial instruments or provide any investment advice or service by Belvest.

No representation or warranty is given as to the accuracy, likelihood of achievement or reasonableness of any figures, forecasts, prospects or return (if any) contained in the message. Such figures, forecasts, prospects or returns are by their nature subject to significant uncertainties and contingencies. The assumptions and parameters used by Belvest are not the only ones that might reasonably have been selected and therefore Belvest does not guarantee the sequence, accuracy, completeness or timeliness of the information provided herein. None of Belvest, its group members or any of their employees or directors shall be held liable, in any way, for any claims, mistakes, errors or otherwise arising out of or in connection with the content of this e-mail.

This e-mail and any accompanying attachments are not encrypted and cannot be guaranteed to be secure, complete or error-free as electronic communications may be intercepted, corrupted, lost, destroyed, delayed or incomplete, and/or may contain viruses. Belvest therefore does not accept any liability for any interception, corruption, loss, destruction, incompleteness, viruses, errors, omissions or delays in relation to this electronic communication. If verification is required please request a hard-copy version. Electronic communication carried within the Belvest system may be monitored.