Investment*Update*

5 January 2023

Will 2023 be less volatile?

We can see a path to a new bull market in the second half of 2023, but we're not there yet

Twelve months ago, investors expected the Federal Reserve (Fed) to raise US interest rates by just 0.75% throughout 2022. Although we believed that inflation would fade meaningfully from the spring, we were concerned about the risks of more central bank rate hikes than markets were then pricing in.

In our view, interest rate futures and, in particular, bond yields reflected a complacency about the spread of likely outcomes. But we certainly didn't expect the Fed to raise rates by 4.25% – the sharpest increase in any 12-month period since the early 1980s. US interest rates are the dominant contributor to the global cost of capital underpinning the valuations of the multi-national securities we invest in. It's highly unusual for equity markets to fall over the first 12 months of a rate- tightening-cycle, when the real economy would typically still be growing as rate rises hadn't yet fed through. But the speed of central bank action, combined with persistent constraints in the supply of goods and services, caused an inflationary bear market to emerge from a 40-year slumber.

Nowhere to hide

The classic 60/40 portfolio – the textbook strategy for medium-risk investors comprised of a 60% allocation to US equities and a 40% allocation to the 10-year US Treasury bond (which would typically provide some ballast against equity volatility) – suffered its worst first nine months of the year since the 1930s, falling by over 20%. Our investment strategies have long been much more diversified across currencies, geographies, and asset classes (for more detail, see this video on what we call our "LED approach"). We also began 2022 with a negative stance on bonds and particularly longer-maturity ones, preferring to find diversification elsewhere. Nevertheless, there have been few places to hide from these losses.

Within equity markets, there were two key sector trends in 2022. First, the underperformance of cyclical sectors (those that are more sensitive to economic cycles) and the outperformance of steadier defensive ones, particularly those able to pass on higher input costs to their customers. Second, the de-rating of expensive 'growth' companies, particularly unprofitable technology stocks, and the resilience of cheaper sectors such as financials, energy and healthcare. A global benchmark of 'Value' (cheaper) companies was down 5% by in late December compared to the 24% loss in the equivalent 'Growth' composite. We had flagged this risk but, again, it would be disingenuous to say we foretold how large this gap in performance would be.

One key takeaway from the last year is that the huge increase in financial services regulation over the last decade has done a good job of maintaining financial stability (see below for our comments on the unregulated cryptocurrency markets) – and nothing destroys real wages, entrepreneurial profits or investor returns like a financial crisis. Over the last 200 years, such a huge increase in the cost of capital has often triggered one. To borrow Warren Buffet's phrasing, when the tide goes out you see who has been swimming naked, and the Fed caused one hell of a rip. Sure, the gilt market's reaction former PM Truss's policies caused a serious problem of liquidity in the UK pension industry, but its solvency stayed strong. Elsewhere, systemic cracks have not appeared. We monitor markers of financial susceptibility and are confident that a recession in 2023 won't be accompanied by a crisis in banking or traditional finance, although we can't rule out the possibility of disruption caused by more opaque non-bank intermediaries (e.g. hedge funds).

There is an aphorism in financial circles, attributable to various people, that investors love unregulated markets, until they want their money back. The world of crypto finance has proved this general truth. Our 2021 report *A 'bit' risky*, set out the argument for why bitcoin was unlikely to ever capture the monetary premium enjoyed by fiat money. We also said it was pure speculation to assume that it would behave as a portfolio diversifier, which some of our peers tried to claim. Our subsequent analysis found that cryptocurrency returns correlate with a 'high beta factor' – a strategy that buys the most market-sensitive stocks and sells the least market sensitive – and are therefore akin to a leveraged play on equity risk. Bitcoin has fallen by 65% over the last year and some of the industry's biggest players have been revealed to be fraudulent, underlining why analysis of corporate governance is a necessary component of our research framework (something we address in our next Investment*Insights* publication, to be published in early January). Despite the hype, the annualised return of bitcoin over the last five years has fallen to just 2.5%.

What happens next?

That was 2022. What happens in 2023 looks likely to be determined by the answer to two questions: will the world's major economies fall into recession?

Rathbones
Look forward

And how far will central banks continue to tighten policy? That second question is conditional on a third, how quickly will inflation recede?

Is recession coming?
Let's start with recession risk. As we flagged in our last Investment*Update*, the Eurozone and the UK are likely already in recession. We believe it will last longer in the UK than in any other major economy, due to a larger slump in inflation-adjusted wages, following the longest stagnation in real wages since the mid-1800s, and certain somewhat unique structural headwinds to productivity growth and labour markets.

The US economy is still holding up better than the UK and Eurozone. A much watched "nowcast" of Q4 GDP growth suggests the US economy is still expanding at a healthy rate. Even so, the risk of the US entering recession in 2023 still seems significant. Our quantitative models support the view that recession risk remains high in the next 18 months. The probability of recession assigned by these indicators has never been this high without a recession ensuing.

Monetary policy operates with a lag. Even the shortest estimates, among recent academic studies looking at how long it takes for rate hikes to hit the real economy, suggest that we are only just reaching the stage where the full impact of the Fed's first 0.25% hike back in March is being felt. And there's another 4% of rate hikes still to be felt after that.

The housing market, arguably the part of the economy most sensitive to interest rates, has already weakened considerably and the downturn there shows no sign of abating. Compared to their peaks of the past year, new building permits are down more than 20% and home sales have fallen by more than 30%. Durable goods sales and corporate capital spending are also falling sharply. Corporate investment and residential construction are two of the biggest drivers of corporate profits.

If this were a normal cycle, the recession call would be straightforward. But for the last three years, China, the world's second largest economy, has endured growth-crushing lockdowns, which today are ending just as the Chinese government leans more heavily on the stimulus pedal. Will its growth be enough to offset weakness elsewhere and avert a global recession?

It's possible, but it's not our central case, and the first six months could be rough. The sudden switch to an unplanned, largely unprepared reopening could delay recovery. Eastern China is the largest contiguous area of high population-density on earth. Millions of migrant workers live in cramped dormitories where the potential for contagion is sky-high. Once infection passes, much pent-up demand will be unleashed. Chinese family bank balances are up 42% from the beginning of 2020. But there are headwinds to the economy too: a weak export sector as demand turns down in developed markets; construction – a far bigger driver of growth than in the West – could remain depressed for a long time as developers repair their finances before starting new projects. In the previous two property downturns (2012 and 2015), it took nine months for housing starts to bottom out after sales began to recover. The inventory overhang, financial position and government attitudes mean it could take years this time.

How high will rates go?
The second of our two key questions for 2023 – on the outlook for interest rates – is harder to answer. Global inflation peaked a little later than we assumed it would at the start of 2022 (in the summer, not spring) and at a markedly higher rate, due largely to the impact of the Ukraine war on energy and food inflation. There is compelling evidence that global core-goods inflation is falling back down to zero and that food and energy will contribute much, much less to 2023's price rises. We expect inflation to fade rapidly, particularly in the US, from the spring of 2023. But to repeat a phrase we've been using a lot lately, an awful lot must go right in order for inflation to fade back down to central banks' targets as rapidly as current market levels seem to suggest.

The last two months' releases of US inflation data have been very encouraging. But Fed Chair Jerome Powell has said he wants to see more evidence that inflation in core services and wages will fall back persistently. Evidence here is mixed. Some services' inflation rates are registering new highs. Many indicators that lead wage growth, such as surveys of firms' intentions or the rate at which people are quitting, have been turning down for some months. But they remain at high levels and need to drop back a lot further before they signal the c.4% wage growth that is consistent with 2% inflation.

Trade unions are making their presence felt more forcefully again, but we don't see a repeat of the 1970s for two important reasons. First, union membership is down hugely. In the UK, union membership has almost halved since its 1980 peak; in the US, 10% of the workforce is unionised compared to 30% in the late 1960s. Second, labour disputes are being settled with below-inflation wage increases and without wage indexation clauses being put into contracts. Wage-price spirals (sustained accelerations of prices and wages) are rare. A recent study showed that in most of them wage growth ran hotter than price growth, in stark contrast to today.

The risk of inflation falling back slowly appears most significant in the UK. We believe the headline rate will drop sharply from its current highs, but is likely remain well above the Bank of England's (BoE) 2% target into 2024. The huge and continued rise in the number of people out of work due to long-term sickness (unlike every other advanced economy) is a particular problem. This appears to reflect ongoing strains on the NHS. The number of people waiting over a year for treatment has risen from c.1,000 before the pandemic to more than 400,000 now. UK inflation expectations are another concern, with some evidence that high inflation is starting to influence firms' and households' planning. One measure of households' long-term inflation expectations is above 4%, which we don't see in other markets.

We expect inflation pressures to recede enough to bring a halt to both US and UK rate hikes. A recent historical study of rate-tightening cycles in 11 advanced economies since 1970 found that front-loaded ones, like today's, tend to be successful at bringing inflation under control even in the presence of more persistent inflationary impulses, leading to rates reversing course sooner (i.e. doing more now means doing less later).

However, we stop short of forecasting rate cuts in 2023. We're also circumspect about the possibility that inflation will head back to target by the end of 2023. But financial markets appear to be pricing in rate cuts and, if they don't occur, equity valuations in particular could come under pressure.

Seeing a path ahead
With our macro colours nailed to the mast, let's delve further into our portfolio strategy view. We can see a path to a new bull market in the second half of 2023, but we're not there yet. The first half of the new year is likely to be volatile; it's possible equity benchmarks could reach new lows. This is not guaranteed, and a new bull market could start earlier. But, on balance, we believe the downside scenario is more likely than the upside one in the next six months.

Accordingly, we remain invested, but with a defensive bias. We aim to expose clients to less of the downside when equity benchmarks fall. Timing when to be entirely in or entirely out of markets is a fool's game, in our opinion, with the outcome dependent on too many variables. Tactical asset allocation, however, favouring defensive securities *within* financial markets when the risks are building and leaning into riskier or more cyclical investments when conditions for a turnaround are in place, is an important part of active investment management (we discuss the conditions for a turnaround below).

Of course, there's a risk that markets could rally before the point our fundamental analysis suggests they would – another reason why we discourage timing *wholesale* entry into and exit from markets. Historically, it's been better to stay defensively positioned for too long than it has been to take too much risk too early. We can see a simple example of this by looking at the returns from US equities around market troughs since the 1950s: the median return over two years from investing six months *before* the trough has been 13%; the median return over one year from investing six months *after* the trough has been 20%.

Preparing to change course
What would we need to see to increase our exposure to higher return, higher risk assets again? To go back to basics, equity prices can be driven by earnings growth or by the premium investors are willing to pay for those future earnings (what we refer to as valuation).These, in turn, are driven by investors' confidence – their 'animal spirits' – and/or the liquidity injected into the financial system by central banks. The 2003-2007 bull market was driven by widespread earnings expansion, while 2009-2021's was more about valuations – and central bank liquidity, in particular – with strong earnings growth in only a few market segments. As discussed above, we believe profit margins and earnings will be marked down in the first half of 2023, while we are likely more than 12 months away from central banks loosening monetary conditions. Accordingly, we do not expect to move away from a defensive mindset until the second half of the year. Of course, it's important always to remain flexible in our thinking. If the facts change, we will change our minds.

Our historical analysis finds that new bull markets have generally been preceded by a combination of the following five conditions: (i) valuations falling to historically cheap levels; (ii) a trough in leading indicators of the economy; (iii) earnings estimates downgraded to reflect the weak economic outlook; (iv) a capitulation in investor positioning; (v) the end of the Fed's rate-tightening efforts.

None of these conditions are met today (we will discuss them in more detail in another article in our upcoming Investment*Insights* publication). In short, valuations have fallen back considerably and are at levels that historically have been consistent with good medium-term returns. We certainly see value in some of our favoured names, and we believe investors with anything other than a short-term time horizon should consider putting money to work, albeit with defensive tilts. But valuations have not crossed the thresholds that have been tactical signals in the past for the end of a bear market (although the UK equity market is close).

Equity markets certainly recover when the economy is still weak, but pervasive gains tend to require signs of an improving outlook. We're not there yet either. It's also worth noting that since the 1960s, the US equity market has never troughed before the start of a recession, and we are fairly certain one hasn't begun yet. Our 'top down' models that attempt to predict corporate earnings using economic factors suggest earnings are likely to fall around 10% in 2023. Aggregating industry-wide 'bottom up' forecasts suggests equity analysts are expecting earnings growth in many sectors. The investors that 'make' the market are not the same as the research analysts that make earnings forecasts; our analysis suggests that the market prices some of a downturn in advance. But not all of it, and equity prices tend to track down with earnings downgrades through the first few months of a recession. Investor positioning is hard to pinpoint – we suspect many investors' answers to survey questions don't reflect what they're actually doing with their money. Looking at a range of indicators, it appears that investors – particularly retail investors – still have scope to sell out of certain sectors.

Data since the 1960s shows that the US equity market has never troughed ahead of the final rate hike, and this usually requires a peak in inflation. In novel analysis, strategists at BNP Paribas delved into the press archives and found that sustainable equity rallies have coincided with the Fed declaring "job done" on tamping down inflation. Again, we're not there yet. For sure, waiting for rate *cuts* usually meant missing out on the early – and largest – stages of the equity market recovery. But there is usually a long gap between the final hike and the first cut that enables investors to reposition.

The fog may start to lift
We finished 2021 by writing, "*This year was remarkable; so is the range of possible outcomes for the next one*". As we look ahead into 2023, the uncertainty around the outlook for wage, energy and overall price inflation is still high, as it is around the prospect of global profit growth. The corollary is that the range of possible returns from financial markets is still wider than usual. Yet we are likely nearer the end point. We will continue to update you on the progress.

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