



## Market review: December 2022

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- **Global markets end two-month run of positive performance**
- **Major central banks slow rate hikes to 50bps but deliver hawkish statements**
- **China relaxes Covid restrictions and BoJ stuns markets by relaxing bond yield cap**

**Global markets ended a two-month run of positive performance in December. Yet again, central bank guidance and actions proved decisive and drove much of the weakness.**

Global stocks took a tumble after central banks in the US, Europe, the UK and Switzerland hiked interest rates and warned more rises would follow to tackle inflation. The Federal Reserve, Bank of England and the European Central Bank slowed the rate of hikes to 50 basis points but delivered some hawkish statements, setting expectations that interest rates would stay higher for longer in 2023.

Global government and corporate bonds were also down slightly over the month as yields crept up but the Financial Times reported that large investors were now buying the asset class after the historic sell-off seen in 2022. As one macro strategist said: "Fixed income assets have become much more attractive than they have been historically from a valuation perspective. In particular, short duration looks like the natural asset class to veer towards. Regionally, we like emerging market and European credit markets due to the valuations and spreads on offer. Investment grade offers look attractive due to robust balance sheets. There has been a move in the investment environment from TINA (there is no alternative to equities) to CINDY – credit indices now deliver yield."

In our Q4 Tactical Asset Allocation Review, we raised our outlooks on global high yield and investment grade (IG) corporate bonds. This was in recognition of the attractive spreads now available from high yield versus government bonds and a belief that the peak in spreads for IG corporate bonds has passed. Furthermore, prevailing yields on government bonds are at levels we have become unaccustomed to in the post Global Financial Crisis era and offer, for the first time in over a decade, the prospect of a reasonable running yield.

### **US inflation continues to ease**

In the US, the S&P 500 index fell 1.3% in one day on news that Q3 GDP data were revised higher to 3.2% from 2.9%, sparking more fears about the extent of the Fed's rate hikes. However, figures for November showed that inflation continued to ease, with annual consumer price growth slowing to 7.1% from 7.7% in October. One US-based fund manager commented: "Market participants are eyeing two things – growth and inflation. Inflation is taming, while growth is slowing down." Another US manager told us: "The market is so illiquid, erratic and volatile, its trading on every impulse and we can't keep doing that." This is precisely why our investment process is designed to look through short-term "noise" to focus on longer term opportunities. Last year provided plenty of noise and plenty of headlines to tempt investors to act on shorter term impulses but this is increasing the risk of synchronising portfolio activity with "erratic and volatile" moves.

### **Lagarde accepts eurozone has bigger inflation issue than the US**

In Europe, Christine Lagarde, President of the European Central Bank, warned markets not to expect rate rises to end early in 2023, and promised at least two more 50bp hikes in February and March after raising the bloc's deposit rate from 1.5% to 2.0%. She formerly claimed that the Fed had a bigger inflation problem than the eurozone, but now admitted that the reverse is probably true. A European fund manager told us: "Owing to weakening economies and pricing power, companies' margins are expected to drop, leading to unfavourable corporate earnings. Consensus earnings are too optimistic and valuations are too demanding." We have a similar

view, retaining a tactical score of two out of five for Europe. Spain was the only eurozone country to announce monthly inflation figures in December. They were encouraging, however, slowing more than expected in December and raising hopes that price pressures were easing across the bloc.

### **UK economy shrinks more than expected**

The outlook was getting tougher in the UK. Latest data showed that the public sector borrowing requirement reached a record level in November, thanks to energy support payments and higher debt interest, while the Office for National Statistics said GDP fell -0.3% in Q3 versus Q2, modestly exceeding expectations of -0.2%.

The OECD had warned in November that the UK would be the worst performing economy in the G20 except for Russia over the next two years. New figures for inflation were more encouraging though: it dipped to 10.7% in November from a 41-year high of 11.1% in October, helped by easing petrol and goods prices. We continue to view the UK as being among the most attractive major markets presently and we are targeting an overweight position to UK equities in our solutions.

### **China relaxes restrictions and BoJ stuns markets**

In Asia, after three years of Covid restrictions, China re-opened its economy, raising hopes that it would be a boost for the global economy and trade. Meanwhile, the Bank of Japan stunned markets by announcing that it would relax the cap it imposes on long-term yields from  $\pm 0.25\%$  to  $\pm 0.50\%$ . The move sparked a sell-off in Japanese bonds. The BoJ refrained from hiking its base rate though: the aggressive rate hikes seen this year by central banks in other developed markets has left Japan as an outlier on monetary policy. We maintain our neutral view on Japanese equities and we are positive on the medium to long-term prospects for Asia ex-Japan and emerging markets.

### **Diversification and a long-term view are crucial**

Although markets weakened in December, a more positive underlying tone is developing. A lot of bad news has now been priced in and arguably we are through the worst of the peaking interest rate cycle – at least it seems likely we have moved through the most rapid phase of the hiking cycle. There are already some signs of inflation abating and the global economy remains on a fairly solid footing despite the recession fears.

Tail risks remain and more downside risks could lie ahead but trying to time the recovery or when asset classes will outperform is a hazardous pursuit. Over the past year, both equities and fixed income sold off and markets have returned to levels that have historically been attractive entry points for investors. The broad-based selloff means that fixed income asset classes such as investment grade and high yield can be considered alongside equities as attractive long-term investment propositions and with government bond yields off their rock bottom, they once more offer the prospect of providing their traditional role of a modest running yield and a foil for the riskier parts of the portfolio. Consequently, we believe it is crucial to adopt a long-term view and to spread risks via a broadly diversified investment portfolio to address market volatility and reap rewards from across the asset classes.

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