January 9th, 2023

Shaping 2023

As we hit refresh with the onset of a new year, we wish to highlight the factors that will, in our view, determine the path that asset markets will take through 2023.

Inflation: Staying higher and for much longer; we see 4-5% headline US inflation
We believe that inflation will be more problematic in 2023 than the market currently anticipates. While we accept that inflation appears to have peaked, we remain concerned that the market is still attributing a lower probability to inflation persisting at a level that will unnerve the global central banks. We already sense an inflation mentality that is influencing the mindset of corporates. Therefore, we do not believe that the price increases we saw through 2022 were a one-off. In our view, companies are now more inclined to increasing prices annually or, at the very least, whenever they feel margins are under pressure.

Oil prices: Biased to the upside; we think $100, and not $50
Considering the supply-demand dynamics of the oil market, we believe oil prices are biased to the upside. Our view is driven by the following factors:

- Years of underinvestment in boosting productive capacity
- Little sign of the re-emergence of US onshore oil supply as a significant addition to overall supply growth
- The risk of Russia weaponising the oil supply – withholding oil from the market to force prices higher
- A sharp recovery in the Chinese economy offsetting any downside risk to demand resulting from the weakness in the Western economies

Our view of the upside risk to oil prices leads us to believe that an investment in the oil sector is an essential hedge against a critical risk for 2023 – that of higher-than-expected inflation.

Slowing growth proves a hard nut to crack – we see no substantial crack in growth in early 2023.
Despite the aggressive tightening by various central banks, global growth was generally quite robust in the latter stages of 2022. While that can't continue, growth in itself may not slow down that easily. The growing determination to spend on part of the people post the COVID lockdowns has prolonged the recovery and provided a solid boost to global growth prospects. In Europe, government subsidies offered to households on their energy bills have helped keep consumer spending strong. In the central banks' eyes, growth equals inflation risk.

Central Banks – determined but struggling to convince until they do.
Central bankers, particularly the Federal Reserve, are determined to convince people that in their attempt to rein in inflation they will increase interest rates to higher levels and keep the rates elevated for quarters and not just months. History is on their side, too. Inflation just doesn't disappear on its own. It must be squeezed out of an economy through sustained efforts over an extended period of time. For a monetary policy to be effective in bringing down inflation, necessitates higher unemployment and much slower wage growth than we see today.

Financial sector liquidity will be tested.

The recent problems facing the crypto markets are a testimony to what can happen when confidence is lost in the 'financial' institutions. The growth of the shadow banking industry, which has had much logic so far, has been phenomenal. In 2019, the size of the shadow banking industry was pegged at $52 trillion, a 75% increase since 2010. The lending sector has migrated partially to the collective investment sector, which comprises bond and hedge funds such as private credit funds. In 2019, the collective investment sector had grown by a phenomenal 130% over those nine years to $ 36.7 trillion. While these companies and funds are often regulated, they do not face the same regulatory framework as a bank. For instance, some institutions in the US could take deposits from companies without affording any regulatory cover or compensation in the event of a failure. These institutions take in cash from corporates or borrow from investors. Any loss of confidence in the sector could precipitate a snowball of fund redemptions and liquidations, forcing these institutions to rein in their lending.

The good news is that the traditional banks have been regulated into safer institutions today than they were during the financial crisis – hence the relatively robust performance of the banks through the past year.

Chart 1: U.S. banks sector relative to the US equity market

Rebased to Jan 2022=100

Source: Bloomberg

Reinvestment into the financial market – bonds first

For much of 2022, we advised investors to exercise caution and encouraged investors to hold outsize cash balances. The current sell-off in markets calls for a moderation of those cash positions. We would, however, be patient as far as buying back into the current markets is concerned. After all, the global recession has not even hit as yet.

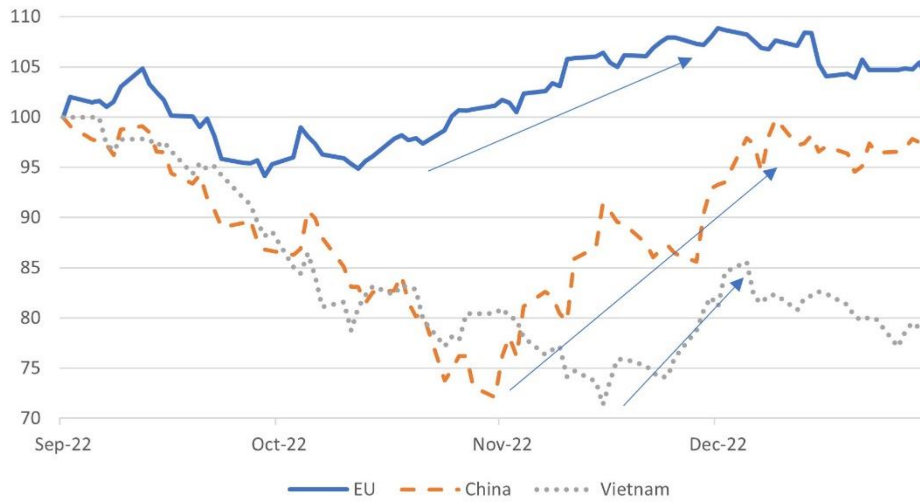
We are eyeing the bond markets for our first significant reinvestment. Central banks will keep pressing on the brake until inflation is well within their target. Hence, a level of bond yields that offers a reasonable premium over long-term inflation represents value. At couple of stages in the past six months, bonds yielded sufficiently to make them attractive. A US 10-year bond yield of 4.3% was a good marker for value and saw active buyers jump in. High-yield bonds that hit 9-10% represented good value, even assuming a pick up in the level of defaults.

Equities – wait for value to emerge

Investors will have to be patient with equities. It would be quite a surprise to us if the equity market went on a sustained bull run without a marked slowdown in the global economy. At this stage, it is difficult to gauge just how significant a slowdown in growth we will need to bring inflation under control. For equity market valuations, the macro picture has two consequences. First, a drop in global growth must bring down consensus corporate profit forecasts; secondly, higher interest rates lead to a higher discounting of future profit growth and a lower valuation (PE) for equities.

The fourth quarter of 2022 showed that opportunities would come in the equity markets even during challenging times, but often from a value level. Chinese equities rallied 35% between the beginning of November and the end of December. Vietnamese equities rebounded 20% between mid-November and the first week of December. EU equities rose 15% between the end of September and the first week of December. These sharp movements suggest an investor appetite for equities but only from value/oversold levels of the market.

Chart 2: Investors buy equities where they see value



Source: Bloomberg

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