Table of Contents

Saved by the Ball?

Last quarter we spoke of a turbulent end to 2022, which very much ended as it began – with uncertainty, rising inflation and a consumer under strain. Now as we look back on that year and embrace the "new", it is apparent that GDP growth was actually flat in the UK over the 4th quarter – narrowly avoiding a recession. One reason for the surprising resilience of the economy? The increase in consumer spending during the World Cup, which saw food and beverage services increase by 2.2% in November alone. The recession bell still tolls however, and the economy is still expected (by no less than the Bank of England) to experience a mild recession in Q1 of 2023, and to be the weakest performer among the G7.

In the UK inflation remains stubbornly high (at around 10.1%) although it is showing signs of cracking elsewhere, and the Bank of England remained on a tightening path, increasing the base rate by 50bps to 4% in early February – its 10th consecutive rate rise. Now at its highest level in 14 years, the base rate will put continued pressure on mortgage holders and most consumers, as well as businesses seeking credit.

Key Developments since the last quarterly update:

- **Inflation seems to be beating a retreat around the world, with the exception of the UK and some pockets of surprise around the world**
- **Interest Rates continue to rise – but take a breather.** While both the Bank of England and the ECB delivered a robust 50 bps rate rise in early 2023, the US Fed eased its pace of tightening by decelerating to only 25 bps, indicating that there were a "couple" more interest rate rises in the pipeline

- **Employment continues to be resilient –** The US jobs report in January was described as a "blockbuster" showing the creation of over 500,000 new jobs, upwards revisions of prior months and the lowest unemployment rate since May 1969 – a 53 year low. In the UK, jobs remained strong too – at 3.4%. UK employment is similarly strong with unemployment at 3.7%, only slightly above its recent low of 3.5% last summer.
- **A warm winter delivered the "force majeure" that energy markets needed.** A warm winter in Europe as well as better than expected provisioning for energy supplies led to less energy price volatility and dampened the concerns of an energy crisis. This acted as a brake on inflation as well as a respite to beleaguered businesses and consumers, and turned around an otherwise bleak narrative at the beginning of the year.
- **Emerging Markets re-emerge.** China's swift reversal of its strict Covid policy was done without much fanfare and ushered in a renewal of interest and enthusiasm around emerging markets. Flows into the area were markedly up while funds flowed out of US equities, while a reversal in dollar strength also heightened the relative attractiveness of investing outside the US. The tragic earthquake in Turkey and Syria, which had a death toll of over 50,000 at the time of writing, was a timely reminder of the fragility of both the infrastructure in certain emerging regions as well as of the potential for political fortunes to turn on issues such as a response to the tragedy. As President Erdogan of Turkey prepares for an election in May, anger is mounting and his handling of the growing humanitarian crisis could well affect the outcome of the elections on May 14.

***

Current Macro Snapshot

In Outlooks for 2023 – Near Consensus About a Recession Spark a Counter-Narrative.

It is traditional for asset managers and investment banks to issue lengthy "outlooks" for the year ahead, which seems almost a quaint tradition in light of the fact that very few outlooks for 2022 predicted the speed of interest rate rises, the outbreak of war in Ukraine or the calamitous fall in stock and bond markets that occurred last year. Still, old traditions die hard, and the 2023 outlooks were remarkable in their consensus. Most, with the notable exception of Goldman Sachs, predicted a shallow recession globally in the 2023 – but less of one in the US. They expected inflation to moderate and interest rate rises to decelerate. This led to a curious twist – because the recession was all but "baked in" based on both the yield curve and the universally bearish commentator outlook, any positive news was quite well received. As can we seen below markets were relatively buoyant in the start to the year.

One commentator noted:

> *"This recession is one of the most anticipated and thus heavily discounted ever and markets are now looking across the valley to the other side."*

And even perma-bear Jeremy Grantham of GMO seemed to be putting his pessimism on ice – stating in his newsletter:

> *"I should confess that I am rather rattled as a contrarian by the enormous increase in pessimism and realism since my letters of a year ago and two years ago, with influential firms like Morgan Stanley and Goldman Sachs pointing to recession and lower earnings that do not yet seem to be in the price of stocks. Equally disturbing, it is said to be one of the most widely predicted recessions ever".*

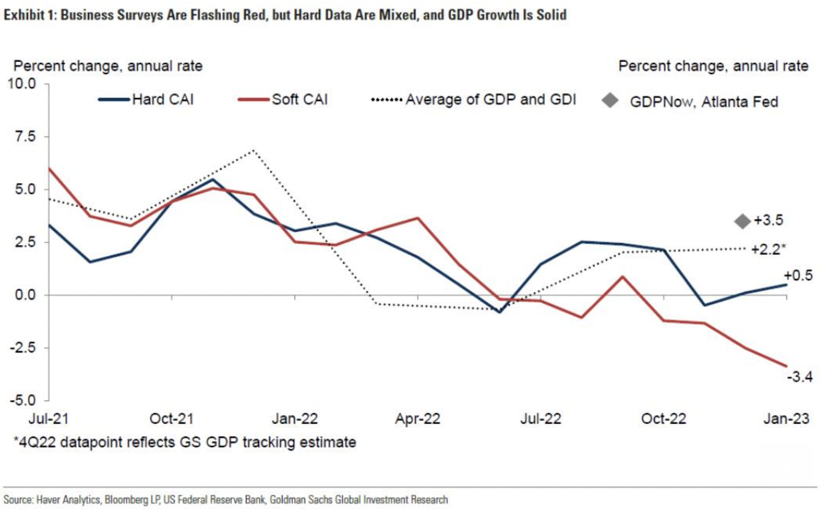
Inflation – A Twist in the Tale

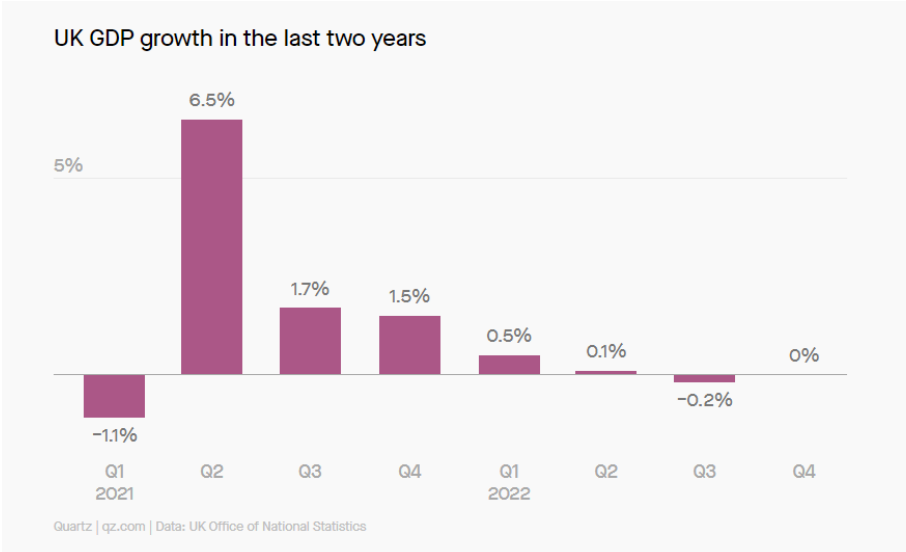
The latest inflation figures for the US showed headline CPI inflation falling from 6.5% in December to 6.4% in January, with core inflation (excluding food and energy prices, which are typically more volatile) falling to 5.6% from 5.7%. This overall downward trend was initially well received by markets but has more recently been seen as being naggingly persistent. While pockets of extreme inflation may occur based on isolated supply issues - e.g. the price of eggs in the US – the moderation of inflation seems to be a theme for 2023. There are exceptions, however.

We have noted before the divergence in Eurozone inflation – where the headline number (8.4%) reflects an average but conceals significant variation between different countries. Inflation in services continues to rise, although food and energy price inflation is slowing, but surprises like the 5.8% level in Spain in January (compared to 5.5% a month earlier), led to the President of the ECB, Christine Lagarde, suggesting that there was "more ground to cover" before they could bring inflation down to the ECB's 2% target.

Hard Indicators v. Soft Indicators

As noted above the so-called "hard" data-driven indicators continue to surprise to the upside. Inflation is less severe than expected, while growth is proving to be more buoyant than previously thought. Employment remains resilient (the UK unemployment rate remains unchanged at 3.7%) while the cost of labour is rising but at a lower rate than inflation. The current Strike resolutions in the UK may provide some "floor" under labour costs in the near term. These indicators conflict with "softer" indicators such as consumer confidence and purchasing manager index confidence, which is continuing to languish. The chart below shows some of the divergence at play between the hard "current activity indicators" (indicated by the blue line below) and the soft ones (indicated by the red line):





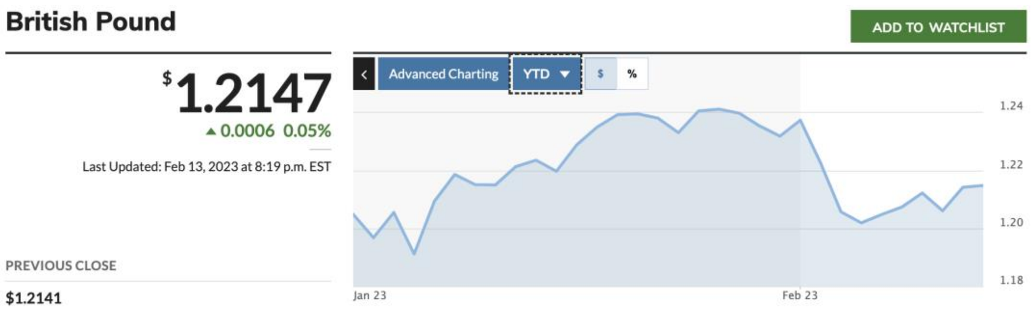
Tough talk by Central Banks – but is the market listening?

In announcing a mere 25 bps rate rise in January, the US Fed's Jerome Powell tried to sow seeds of caution, while the Governor of the Bank of England surprised markets with a higher than expected 50 bps rise in February, citing the uncertainty of inflationary pressures, and the need to "see (their policy) through". His messaging since has been decidedly neutral – neither suggesting a further continuation of hikes or that they have peaked. Christine Lagarde of the ECB also stressed the importance of "delivering on the goal" of bringing inflation down.

Markets didn't take much of this at face value – tending to price in a lower "terminal rate" when it comes to the end-point of the current rate rise trajectory and to jump to the punchline of markets flatlining and the central banks needing to stimulate again. Whether this is the market wistfully remembering "times past" or a realistic assessment of the likely game plan of the next few years remains to be seen, but it was an odd disconnect, which seemed to vex central bankers.

A breaking of the USD wave

The persistent strength of the US dollar has been a thorn in the sides of emerging markets and a boost to global portfolios for much of the past decade and the US currency has hovered near a 20 year high for much of 2022. This started to "crack" in the first few months of 2023, in a development that commentators hailed the "breaking of the USD wave". Sterling benefited from some appreciation against the dollar as the charts below show:



Emerging Markets Flows Buck The Trend; although Geopolitical Tensions Remain

Emerging markets and non-US markets followed the "reversion to the mean" norm in the first few months of this year – outperforming US markets for a period after nearly 15 years of underperformance. This was partly driven by a resurgence in economic activity in China, partly by the resilience of Europe and partly by the (sad) normalization of the conflict in Ukraine. The chart below shows the reversal of flows, and notes the outperformance of Chinese equities. This chart pre-dates the more recent pick up in US/China tensions characterized by a shooting down of "spy balloons" suggested to be floating over US airspace. This came at a time of a softening of the rhetoric around China by the Biden administration and a pending trip to the country by the US Secretary of State. We will watch the current developments with interest.

Individual Asset Class Performance.

- Equities
- Fixed income
- Other asset classes

The chart below shows recent performance in our measured equity and fixed income indices (at March 2, 2023)

Equity Index	Year to date (March 2, 2023)	1 year
FTSE 100	6.22%	6.53%
S&P 500	2.91%	-9.92%
Nasdaq	8.72%	-17.25%
Dax (Europe)	9.92%	9.32%
Hang Seng	4.24%	-7.72%
Shanghai Comp	7.22%	-4.93%

Equities: A Mixed Bag of Earnings; Punishment is Gentle

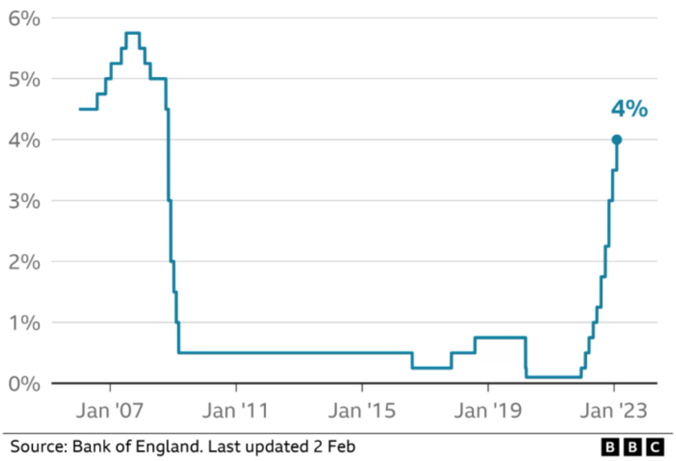
Earnings season was a bit of a mixed bag, with most companies playing down the impact of inflation but continuing to worry about the effects of a depressed consumer and a recessionary outlook. Layoff announcements mounted, some, no doubt, a "catch up" from a period of few lay-offs during Covid, but overall quite sobering across both new economy and old economy companies. The interesting part, however, was the market reaction. From Netflix to Alphabet to GE, the report of headcount cuts was rewarded by investors who celebrated realism, cost cutting and discipline on the part of company management and the promise of more robust earnings (and possibly dividends) in the future.

Most companies continued to beat expectations although overall earnings were down year on year – this reflected the accurate telegraphing of bad news that had occurred all throughout 2022, which had effectively guided expectations downwards. Even when earnings did disappoint in a surprising way – e.g. Meta, Amazon, Alphabet and Apple missed consensus earnings estimates in the aggregate by 8%, the "punishment" or effect on the stock price was far more muted than in other years. Investors seem to view the glass as "half full". It could be that as in the case of recessionary forecasting going into overdrive, investors had expected far worse outcomes from companies and were pleasantly surprised that things were not worse.

Markets have shown a sharp reversal in fortunes from the end of last year, with the tech-heavy Nasdaq leading the charge, although the upswing has been quite volatile. European stocks saw strong performance as market participants seemed surprised that Europe was still standing after all of the pessimism, and as the unusually warm winter improved the energy reliance picture. Asia too saw a remarkable come back although this has eased somewhat in recent days.

Fixed Income: The flipside of higher rates

As a 10th consecutive rate hike brought the UK base rate to 4%, an inevitable question arises as to the impact on mortgage holders and businesses dependent on borrowing. It is important to bear in mind that only one third of households in the UK have a mortgage, with around ¾ of those on fixed rate deals. While some of them will not adjust in the near term, there will be periods of crunch when deals are renewed. It is notable, however, that in expectation of lower rates in the future, rates for 2 and 5 year fixed deals are now lower than their peaks. This may ease some of the burden on homeowners.



The flipside of the higher base rate is the higher rates available on fixed income instruments today, although, as is the case in the US, there is generally less upside available in longer dated bonds, as the mortgage rates indicate and as the inverted yield curve in the US has shown for months. For investors this does, immediately, render cash a more viable place to leave dry powder, and also increases the relative attractiveness of bonds as an investment – particularly if inflation also moderates and the rate of return after inflation becomes more interesting.

Bonds did start to firm somewhat after the disastrous performance in 2022, and in high yield in particular yields were even tighter than higher quality credit suggesting that there was another "junk rally" or "dash for trash" in effect. This anomaly can sometimes occur when equity market sentiment outstrips the traditionally more cautious bond market, as higher yielding bond more often trades like equity, but it is an indication that some of the pain in bonds may now be behind us as we move into 2023.

Last quarter we discussed the emerging notion of "TARA (There are Reasonable Alternatives) to Equties" – but the year to date it is clear that old habits die hard. Even if bond yields can now be meaningful in their own right, the fear of missing out on a "turn" in equity markets, of missing the bottom or of not being invested in the only (liquid) means of capturing growth continues to drive flows as the enthusiasm greeting earnings season reveals.

Other asset classes – Commodities

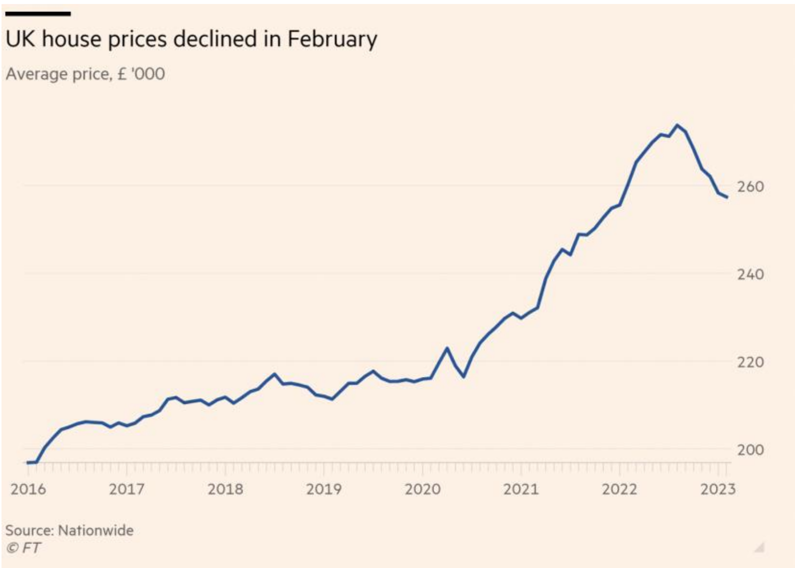
Commodities continued to be more subdued as the effects of the warm winter in Europe and recessionary fears took their toll on valuations. Oil is hovering more or less flat year to date, although at below $80 per barrel is well below its recent highs seen in mid 2022. Other commodities such as precious metals are weaker, which again will take ease some inflationary pressure for producers.

Spotlight*: Real Estate Gets Real*

As the hybrid work landscape shifts once again the outlook for real estate is once again muddied. The comparison to previous recessionary periods is inevitable, but a few recent market reviews have noted important differences between the current period and the financial crisis of 2007-2009. It is noted that oversupply of properties is not present – except, perhaps, when it comes to lower quality office buildings. In most parts of the world there is a housing crisis and inadequate supply of residential housing while in other areas, such as retail, a "flushing out" of the high street has been underway for some time. This leads some commentators, particularly in the US, to be bullish on the retail sector predicting a boon for grocery-anchored shopping centres and higher end shopping centres focused on "experiences".

There also have not been particularly rich valuations nor excess leverage or borrowing in the past few years in most sectors – and these two issues are most likely linked. A lower appetite to lend by banks scarred from the excessive lending and sub-prime borrowing that triggered the financial crisis has led to less leverage by both homeowners and businesses alike. Banks too are not over-extended at this time, even if a recessionary environment looks likely, which reduces the probability of collapse and instability up the chain. Even areas that have been popular such as industrial real estate and the "other" category such as student housing and self-storage is deemed to be richly valued, but still underpinned by strong demand. There remains such an abundance of dry powder in this area through funds that have raised assets earmarked for real estate that now that valuations are easing somewhat, and the crowding for deals is less severe, many buyers are expecting to start fishing for industrial assets again.

In the UK house prices showed the largest annual fall in 10 years in February (-1.1%) in February 2023 as higher mortgage rates started to take effect.



Finally we should discuss the well-publicized halting of redemptions that has occurred on funds with quarterly liquidity – so called "interval funds" – that have halted redemptions due to receiving more than the quarterly limit (usually 2% of NAV per quarter). Recently the Blackstone BREIT – a private real estate investment trust – halted redemptions and REITS run by Starwood and KKR followed suit, failing to meet all of the redemption requests they received. Usually firms in this situation will cite the need to maintain stability, orderly portfolio management and a desire not to disadvantage other shareholders as the rationale behind stemming redemptions, but it is a timely reminder of the potential mismatch in liquidity of assets such as real estate with investor expectations. It is also perhaps a sign of things to come – as large institutional investors adjust their portfolios to reflect the impact of 2022, there will be a hesitation around the use of private assets, as most portfolios are now overweight their targets in this area.

Outlook . . Calling Time

Last quarter we talked again about the concept of a "*New New Normal*" – in which investors seem to have quickly adjusted to a reality of inflation in high single digits and consecutive interest rate rises. Now investor sentiment has moved on again to "look around the corner" of the current post-Covid reckoning and is grappling to figure out what will stabilize when. Will inflation fall further and then stabilize at or close to the 2% level that persisted for the last decade pre-Covid? Or will the current excesses and supply chain blockages stick for longer – and will an expectation of higher inflation become self-fulfilling?

With Central banks poised to slow down their unprecedented tightening drive, will they start to revert to the old stimulating tactics employed after the last crisis – or will they hold their nerve while employment remains strong. And will it remain strong? Will employment continue to buck the trend to make the current slackening in economic activity unlike previous playbooks.

In coming months we will be watching in particular:

- **Landing the Inflation Plane.** We have noted many times the discussion of "hard landings" and "soft landings" (and lately "no landing") for the economy and the probabilities of each, which tend to move around monthly. One plane that has to "land" however is the level of inflation and it is perhaps better to watch this arc over a longer period than the nail-biting, month to month, frequency that we watch it with today. As the year reaches the mid-point we will start to see a pattern emerge, which will enable us to make more solid predictions about the long-lasting effects of inflation across the economy and what it means for growth and market performance.

- **Layoffs and Slowdowns – Course Correction or Something More Sinister?** Because Covid distorted the pace and pattern of hiring so dramatically for companies, it is very difficult to see what the new base level of hiring needs will be. This is accentuated by concern about the incursion of AI (e.g. Chat GPT) and automation as well as the dynamic of hybrid "work from anywhere" expectations. The current wave of layoffs and retreats by some of the champions of the last decade could be a course correction in their trajectory of growth or a sign of something deeply rotten or overstated about their growth expectations. This will need to be watched carefully as it will tie closely to consumer and investor sentiment

- **Energy Security Concerns Shift the Energy Transition Narrative.** The energy crisis and renewed talk of "energy security" that animated policy discourse over the past year, has changed to tone of the energy transition discussion somewhat. BP announced a decision to pare back its commitment to cut oil and gas production by 2030 as a response to the Russian invasion of Ukraine, but was accused of de-emphasizing its renewables project due to lower returns in that business compared to fossil fuels. Although the company's spending on the five transition businesses of biofuels, convenience, charging, renewables and hydrogen was 30% of its group capital expenditure in 2022 it plans to increase that to 50% by 2030.

***

March 2, 2023