O-IM 2023
Market Outlook

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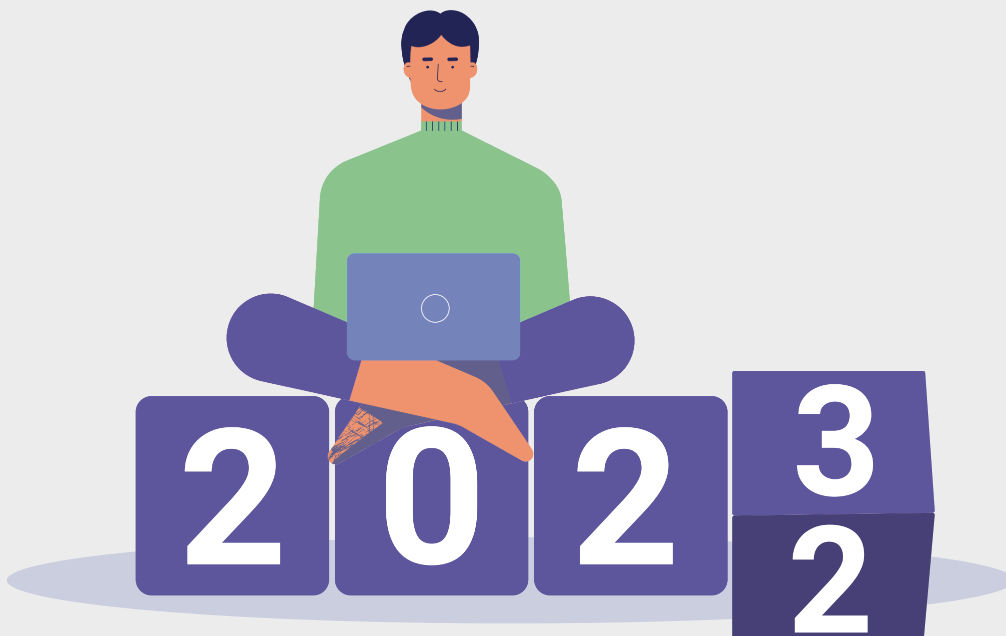
The not so roaring **20's continues...**

2022 is a year most investors would like to forget. Following the pandemic boom, consistent government support and uninterrupted central bank monetary policy, inflation became a very sticky problem made worse by Russia's invasion of Ukraine. Most major indices will end 2022 in the red, with a rare bright spot for the FTSE 100 thanks to its energy, commodity, and consumer staples weighting. With recession looming and the doom rhetoric growing louder you would be forgiven for expecting another red year in 2023 but there are reasons to be optimistic, just not unrealistic.



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To summarise what we think 2023 will bring

Inflation will lose its headline grabbing position and we think a combination of central bank action, recession and improved supply chains will see inflation fall quickly and potentially quicker than expectations.

Central Bank interest rates will peak and the narrative will transition from taming inflation to supporting the economy and avoiding a hard recession. Although we think it's unlikely, there could even be a rate cut late into 2023 should both a recession and slowing inflation provide Central Banks with an easing opportunity.

The UK, US and Europe will fall into recession. The US will avoid the large declines and will likely return to growth sooner. The UK and Europe will suffer longer recessions albeit with low levels of retraction.

The global political landscape creates the biggest unknown and we, like many, struggle to form an opinion. So instead, we will go with hope. Our hope is that Putin takes diplomacy seriously and looks to end his invasion of Ukraine. We feel some positive movement in China-US relations have occurred but the tension with both Taiwan and Hong Kong has far from been resolved. Closer to home, after having 3 prime ministers in 2022 we would like to see a stable house next year but with popularity of the Labour party growing and an election in 2024, Number 10 could turn their sights to retaining support to maintain their control over the red wall and their much-prized majority. Each of these could introduce additional volatility in risk assets

Bonds will return to favour for the investor community and will have the opportunity to provide real yields. Government bonds and high-grade corporates will be more attractive over high-yield and EM debt as tightening credit conditions during a recession could see some areas of the market experience stress.

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Equities will recover from their 2022 lows, but we expect more idiosyncratic behaviours in sectors and companies. The wide market sell-off saw overvalued companies come back to earth (some remain in the atmosphere) but also brought others down to very attractive levels. Earnings may come under pressure in the short term, but we feel a significant amount of "bad news" has been factored in and any slight upside surprise in earnings could offer a catalyst for recovery. Our long-term view of socially responsible companies, particularly alternative energy, remains intact but we expect continued volatility as consumers focus on basic needs and government spending commitments are swayed by immediate political pressures.

Alternative asset classes (commodities, real estate, hedge funds and private equity) will find pressure for different reasons. We remain bullish on hard commodities with precious metals remaining attractive. Gold hasn't behaved as it may have done given inflation in 2022 but we consider it to be a critical asset for 2023. The Real Estate market, both commercial and residential, will face a tough year as commercial property is unlikely to return to pre-covid levels during a recession and mortgage rates will impact consumer housing demand and mortgage affordability. Hedge Fund returns will continue to not compensate investors for the inherent risk and Private Equity will be subject to lower valuation points as institutional fundraising eases.

Active management will demonstrate its worth in 2023. We are exiting a prolonged period of low rates, expansionary policies and the full-scale commercialisation of big tech that has served passive allocations well. Effective asset allocation and equity selection will become paramount given our view of a selective recovery in 2023.

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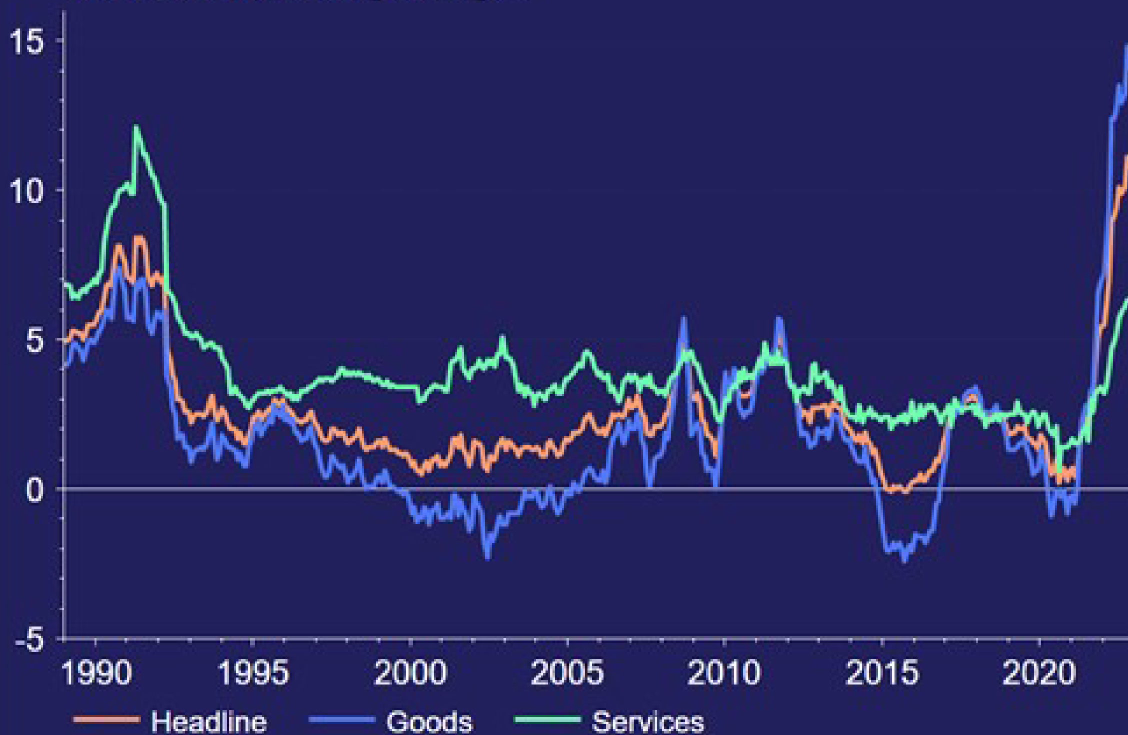
1 - What goes up, must come down

Inflation has proven a lot more stubborn than many expected. Transitory inflation has largely been expelled from the vernacular and the Fed Chair commits to “getting the job done”. We think central banks have taken the right action and haven’t blinked in the proverbial staring contest with a potential recession. This tightening of policy alone may have struggled to be enough to have the desired impact but thanks to China’s abandonment of the ill-fated zero covid policy, supply chain pressures should ease and allow the supply and demand dynamic to come back to a more normalised level alongside the benefit of seeing wholesale energy prices stabilise.



Although still at historically high levels, the UK registering a 10.7% inflation rate in November was a welcome reprieve from the 11.1% recorded in October and the 10.9% expectation. The drop in core inflation (excluding energy, food, alcohol and tobacco) from 6.5% to 6.3% was a further positive sign that underlying price pressures are moderating. Inflation swap pricing shows expectations falling sharply from earlier in the year.

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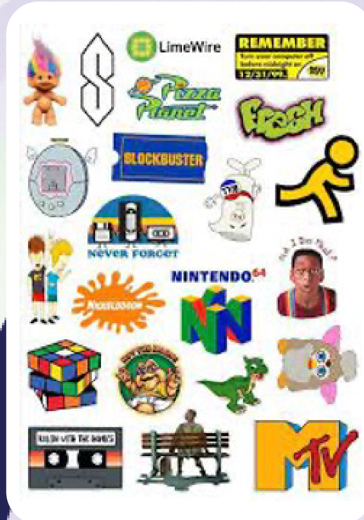
2 - More like the 90's



Recession is coming in 2023 and may have already started in various economies around the world including the UK but we do not anticipate a deep recession albeit potentially a relatively long one. The early 90s saw GDP fall for 5 consecutive quarters with the economy losing a total of 2.3%. Whilst that sounds like a lot, it is the same loss, which was seen in a single quarter of 2008, where the 2008-2009 recession saw GDP fall by a whopping 6.2%. The major difference between now and the 90s (where inflation was high with interest rates rising) is that the labour market is remarkably strong. We expect the labour market will weaken as companies reduce their workforces, but we do not expect to see significant job losses. Although pay increases have not kept up with inflation it has provided an absolute increase for many in the active workforce. As inflation falls and supply chains improve we expect consumer confidence to return to healthier levels which will be the primary reason for a mild recession in our base case scenario.

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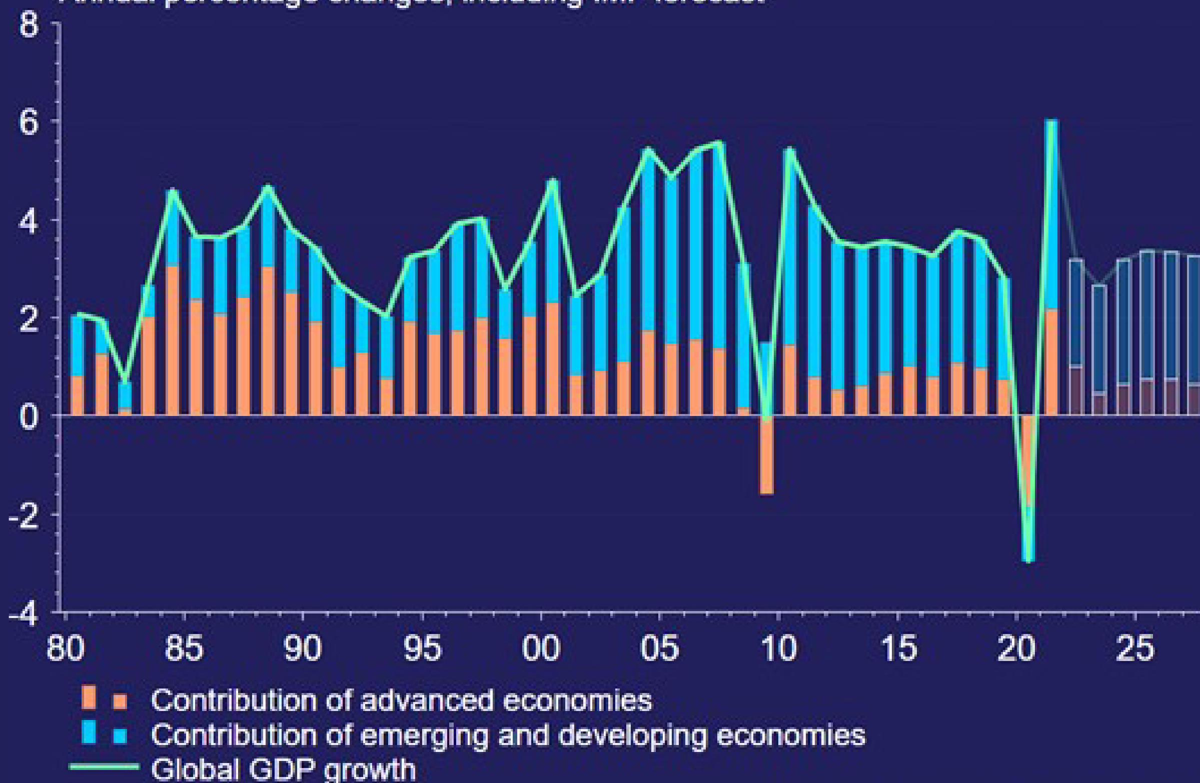
3 - Turning the screws too tight will cause damage

Four turns forward and one turn back is good advice (I am told) when working on machinery. The same advice could be offered to the central banks. After a volatile summer and a renewed hawkish narrative, central banks are now slowing and even flirting with the idea of pausing interest rate hikes. We expect the narrative to continue to be hawkish until inflation has not only passed the peak but is consistently falling closer to target. Given the other forces impacting the world economy we certainly expect a pause as recessionary data becomes more obvious and corporate behaviour regarding employment changes. The argument that inflation, cost-of-living and recession will do the job for the central bankers is one we support, and we wouldn't be surprised if by the end of 2023 we are even talking about rates being cut once again.



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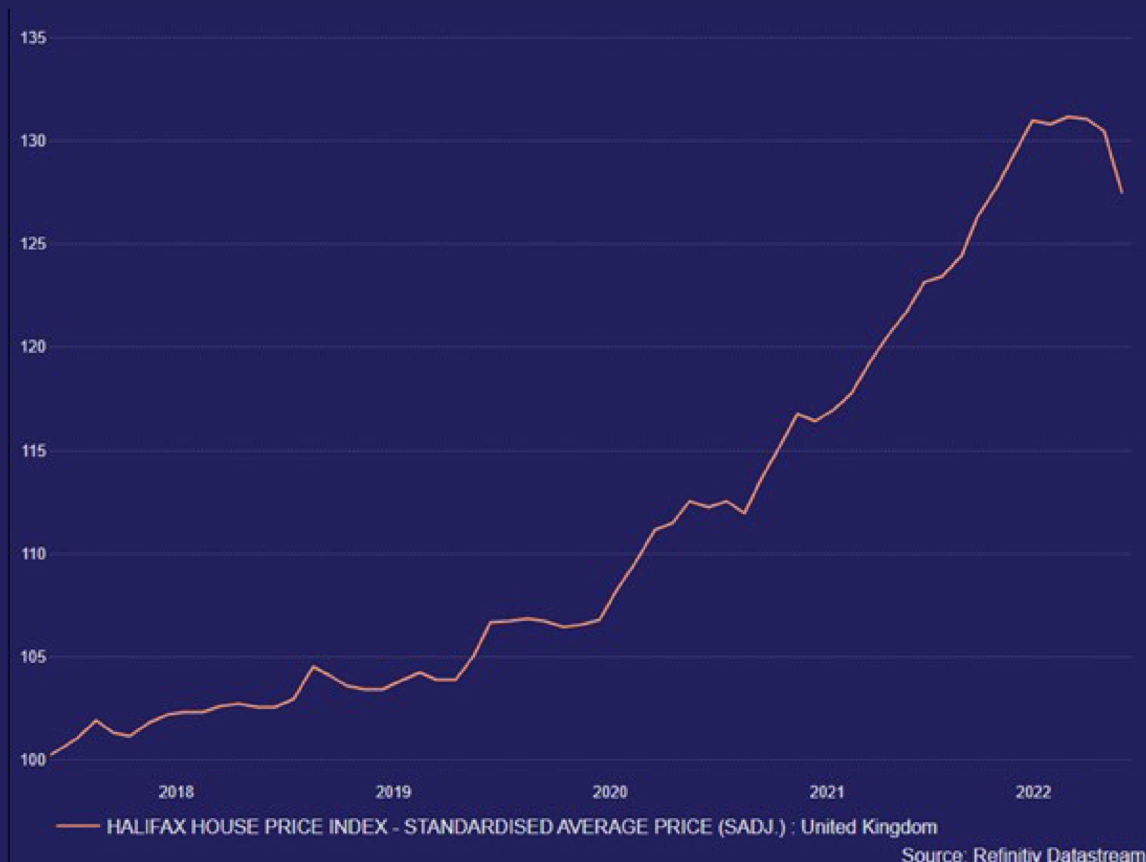
4 - House prices will squeeze homeowners (not the banks this time)

The fourth quarter saw UK house prices cool as 40-year high inflation levels and the resultant interest rates hikes by the Bank of England (and let's not mention the Truss mini-budget!) pushed mortgage rates to their highest level seen in more than 10 years, breaking through 6%. It is therefore no surprise that house buyer demand in the UK began to significantly decline in November. Although economists expect UK house prices to continue to decline in 2023 given the economic backdrop, this won't have the same lasting damage as 2008. Leading up to the 2007-2009 housing slump, Banks underwriting standards were lax (Google "NINJA mortgages"), homeowners were 'helped' with mortgages at 95% LTV and beyond, and most mortgages where above a 4% rate. So, when the market corrected, many homeowners fell into negative equity and unfortunately many others defaulted, and the banks were left with defaulted mortgages and properties to sell. Throughout the 2010's homeowners bought more of their house thanks to low interest rates and housing market returns created lots of wealth. It is therefore unlikely banks will need to write down assets on their balance sheets which would lead to terrible credit conditions and so it is more likely they will maintain consumer credit and corporate credit at healthy levels. Homeowners who can weather the storm and readjust to higher rates should see this as a painful blip but one that will pass and provide an opportunity in the future to realise the gains they have made.



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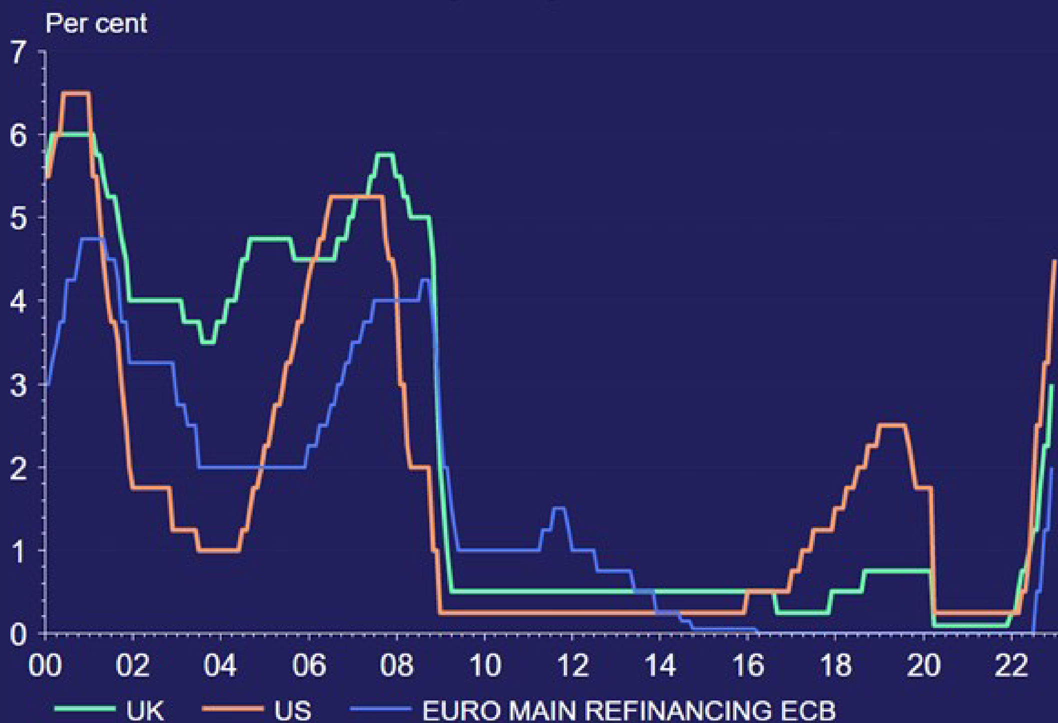
5 - The not so reserved Federal Reserve

Markets are widely expecting central banks to continue raising interest rates in 2023, however the size of rate increases is likely to slow as 40-year high levels of inflation begin to subside. US interest rates are currently estimated to peak at around 5% in 2023, with two 0.25% rate increases expected in the February and March meetings in 2023. US inflation peaked in June 2022 at 9.1% and has since shown a steady decline, with the December CPI figure showing 7.1%, a first sign that the Fed's monetary policy may be having the desired effect. This data caused the Fed to reduce the size of its December hike to 0.50% after four consecutive 0.75% increases, however any Fed changes in 2023 will naturally be data dependent. If the size of rate hikes is indeed going to reduce to 0.25%, the Fed will want to see a continuation of the downward trend in inflation. There is also the question of when the Fed may begin to cut rates, some investors are predicting that the Fed will begin cutting rates in 2023, as the US enters a recession and inflation comes back down to the target 2% level. Meanwhile, markets are currently pricing in at least two cuts in the final meetings of 2023, with rates predicted to end 2023 closer to 4.50%.



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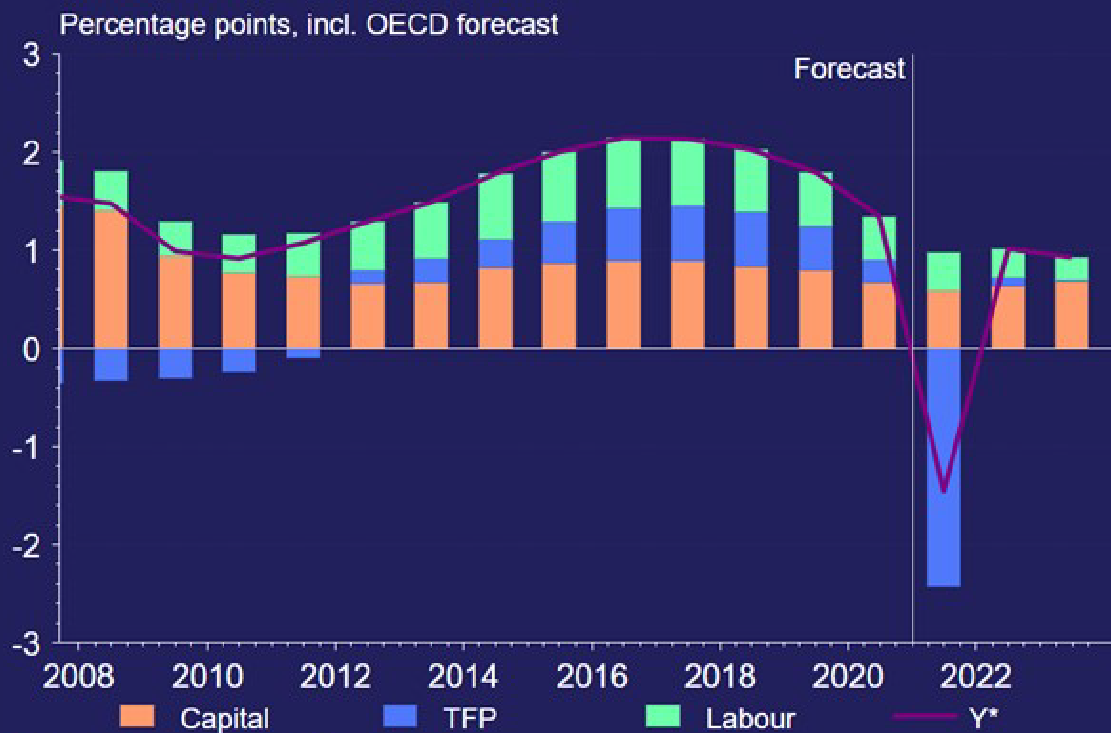
6 - Our great island has some greater challenges

UK interest rate policy led by the Bank of England appears to be mirroring the US, albeit with a delay. We expect that to largely continue, as although the economic backdrop for the UK looks a fair bit bleaker, the absolute levels of inflation, and likely policy responses follow the US. The Bank of England raised its base rate to 3.50% on the 15th of December, as inflation remains in the double digits despite falling back from the 11.1% peak. Markets are currently pricing in rates to continue rising a further 100bps to 4.50%, working under the assumption that inflation continues to decline back towards the Bank's target rate. If UK inflation doesn't show clear downward progress in 2023 or we see an upside surprise, rates could go higher than expected. It cannot be ignored that some of the pressure in the UK economy comes from Brexit. The UK was the last major economy to recover to a pre-pandemic level, labour shortages have been exacerbated, the Northern Ireland protocol has elevated tensions both with Europe and within Ireland and the cost-of-living crisis amplified.



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