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Fourth Quarter 2022

Inflation has been the most important theme in markets this year, and that continued in the fourth quarter albeit in a different direction. US data released in November and December point to inflation having peaked, with the rate of change of consumer prices falling to 7.7% and then to 7.1% having peaked at 9.1% in the summer. This was welcome news, and while it has not translated into much of a slowdown of rate hikes by central banks, this possibility looks more likely now than a few months ago. Most financial assets performed strongly in November after the first of these inflation prints, though this fizzled out in December as equities and bonds reversed most of their gains. Nonetheless, for the quarter as a whole the MSCI World index returned +9.4% in local currency terms, but just +0.7% in GBP terms as the pound rallied against the dollar. US stock market returns were mixed, with the S&P 500 up 7.1% in dollar terms, but the technology-focused NASDAQ 100 falling slightly. European bourses were stronger with the Eurostoxx 50 index gaining 14.3%. The rally in equities was mirrored in bond markets, where yields fell and prices rose. UK government bond yields declined as stability returned after a tumultuous period in August and September – the 10 year yield fell from 4.08% to 3.66% during Q4, but touched as low as 3% in early December. The global aggregate bond index, which includes investment-grade corporate bonds and is weighted towards US issuers, returned +4.7% during the quarter. Despite this it ended the year down a little over 16%, a sign of the magnitude of movements during 2022.

The Russia-Ukraine conflict continues but commands less attention from investors than earlier in the year. Its impact on inflation has been significant but otherwise it has drifted from headlines. Putin's next move is almost impossible to predict so focus has returned to macroeconomic and monetary policy which are slightly easier to form a view on, though also beset by complexity.

Central banks worldwide continued to raise interest rates, with each of the US Federal Reserve, the Bank of England and the European Central Bank concluding their final meetings of the year with hikes of 0.50%. The rapidity of rate rises this year has been unprecedented, and it has taken until the fourth quarter for financial markets to begin to digest them. Policymakers look set to continue this path into 2023, prioritising inflation control over the negative impact on economic activity which is likely to be felt during the year.

The US dollar weakened sharply during Q4, reversing some of its gain that occurred during the rest of the year. This is particularly welcome for emerging markets, which tend to be relatively sensitive to changes in the value of the dollar against local currencies. Having been the subject of rather hysterical headlines during the Truss government's dark days, the pound rebounded impressively during the quarter as it gained 7.6% against the US currency. It remained fairly stable against the euro, indicating that this was primarily a dollar move rather than a Sterling-specific development.

Another noteworthy development during the quarter was China's abrupt U-turn in its 'Zero Covid' policy. As protests against localised lockdowns grew, and the transmissibility of current Covid strains made such restrictions widespread, the government adjusted and then quickly abandoned many of its limits on movement and activity such as tracing apps, screening and rules on international travel. While it remains to be seen how large an impact this will have on the health of the population – vaccination rates are relatively low amongst the elderly, but current virus strains seem mild – it is expected that economic growth will rebound in 2023 having been suppressed for nearly three years.

Outlook

It looks most likely that inflation will continue to fall as we head into 2023, but the degree and speed with which this will happen is open to considerable debate. Supply-side factors such as freight costs and, to some extent, energy prices have improved considerably but we have not yet seen demand pressures weakening as employment remains strong. Central bank tightening, especially via the impact on housing and discretionary spending from higher mortgage rates, does not seem to have bitten yet; monetary policy acts with long and variable lags, which is not helpful for forecasting but at least tells us that some economic weakness can be expected this year. The consensus seems to be that a mild global recession will ensue this year, predicated on inflation being fairly well-controlled and drifting lower as the months pass.

Bonds, particularly those issued by high quality corporates, appear good value with attractive yields and the potential for capital gains unless inflation remains stubbornly high. Equities are arguably more difficult to predict, but have certainly factored in some form of corporate earnings slowdown. The UK and some emerging markets, including China, look well-placed to perform strongly when looking out over a one year or longer investment time horizon, given the degree to which they have de-rated. China's reversal of its Covid controls should also buoy economic activity and this could be helpful for sentiment more broadly, though it does have the potential to add to inflationary pressures. If the country's huge internal market is now open for business again, this could be a powerful tailwind for Asian companies and those further afield that count Chinese consumers and industry as important customers. Asian stock markets performed far worse than their Latin American counterparts in 2022, as the latter are orientated towards commodity exporters which have done well, so there may be room for catch up this year.

We have not changed our asset allocation as we seek to balance the opportunities in areas that have suffered over the past twelve months – such as certain fixed income segments and emerging market equities – with the risk that economic weakness could damage sentiment further.

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