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Charles Hepworth
Investment Director

Review *

Global equities, as measured by the MSCI AC World Index, fell nearly -16% in local currency terms in 2022, the worst full calendar year since the global financial crisis (GFC) of 2008. The immediate drivers of this decline were high inflation, higher interest rates, war in Ukraine and China's zero-Covid policy. The inflation component was especially important as the one factor that prevented the US Federal Reserve (Fed) and other central banks around the world from riding to the rescue of the global economy – and therefore investible assets – in the way that they have consistently done since the GFC. The Fed 'put' was reluctantly set aside in 2022 as the central bank belatedly attempted to control inflation by tightening monetary policy and, in so doing, slowing down economic activity.

However, to characterise the entirety of 2022 as an unremitting 'polycrisis' would be inaccurate. From 12 October to 31 December the MSCI AC World gained nearly 8% as relief came through on three key fronts: US headline inflation decelerated from its June peak of 9.1% to the 7.1% posted in November, with 10-year US Treasury yields – the market gauge of growth and inflation – falling from 4.3% in late October to 3.9% by the end of the year. In Ukraine, Russia's war strategy was dealt a severe blow by the re-taking of Kherson, giving the Ukrainians the strategic initiative. Finally, China abandoned its zero-Covid strategy under the weight of a widespread popular backlash. Caseloads inevitably spiked but the message was clear: the priority was once again the economy.

Taken together, this allows 2022 to be compartmentalised into a lengthy 'inflation and rates' phase book-ended by a period of meaningful reassessment. It is however worth noting that price action during the latter segment, while positive overall, was not one of consistent euphoria. The cryptocurrency meltdown, along with unrealistic expectations of a complete Fed U-turn on rates that did not materialise, meant that investors were relatively guarded in their response. Nonetheless, it was becoming apparent that the relentless onslaught of bad news that had gripped markets was starting to loosen.

Positioning

We remained tactically underweight equities during the last quarter of the review period. From a structural standpoint, the 6-7% real, net of dividends, multi-decade return articulated by the so-called Siegel Constant and confirmed by studies such as the Federal Reserve Bank of San Francisco's 'The Rate of Return on Everything, 1870-2015', suggests that an underweight to risk assets is probably never appropriate for a long term investor but short term tactical defensive positions can and should be tolerated from time to time.

The year 2022 did not look kindly on those themes that had worked up until the start of the year, namely rising interest rates and idiosyncratic risks which hurt technology companies with their long-range revenue streams; the associated stronger US dollar which hit emerging markets given their exposure to dollar-denominated debt and trade receipts; and finally the zero-Covid policy which suppressed Chinese stocks.

Within equities, we are overweight Japan, Asia and broader emerging markets, complemented by larger underweights to US, UK and European equities. The ensuing volatility was relatively well contained at the multi-asset portfolio level via our capital preservation fixed income sleeve. Here

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we held some exposure to long dated, higher yielding fixed income assets but over the course of the review period began to tilt in favour to short-dated or alternative return streams which demonstrated much-valued consistency. The latter consisted of money market instruments and ultra-short Treasury securities, complemented by mortgage-backed securities and financial related paper. In alternatives, our allocation to gold performed positively and outperformed falling main equity indices.

Outlook

Our ultra-long term outlook for the global economy and markets remains broadly unchanged. Low growth, and by inference low rates, look set to be driven by continued economic inequality, low productivity, deteriorating demographics, de-globalisation of trading, state expansion and climate change. While we believe our strategic positioning remains wholly appropriate for this scenario, the short to medium term offers less certainty and this explains our more cautious positioning. While the fundamentals of the good news that lifted the final quarter of 2022 look set to persist into 2023, investment trends rarely play out linearly and the economic backdrop remains challenging as consumers retrench. The OECD recently predicted GDP growth of 2.2% for 2023, down from the 3.1% that seems likely for 2022. Global inflation will suffer pauses and reversals as it decelerates, not least from a likely boost in Chinese energy demand.

Furthermore, market expectations of a Fed pivot are unlikely to be met given the central bank will be acutely conscious of its own credibility as it responds slowly to peaking inflation. This mismatch is likely to explain why indices will probably not spike euphorically on softer inflation data in the coming months, however welcome it may seem to market commentators. Ukraine meanwhile faces a long haul to restoring its territorial integrity, with slow progress and rising costs the main risk to vital continued Western commitment. In China, the lifting of Covid restrictions is seeing hospitals overwhelmed and, in the absence of a successful vaccination programme, localised but economically disruptive lockdowns could yet be re-deployed.

More broadly, the FTX scandal could have a temporarily dampening effect on investor enthusiasm. The collapse in bitcoin has been concurrent with outflows from US mutual funds and ETFs in the final quarter of the year, suggesting that investors have been turned off 'everything'. But, far from being a reason to be despondent, fundamentally better newsflow with limited (initial) investor participation is arguably a formula for improved returns in the medium term. Persistent equity engagement will remain key to capitalising on these better conditions of course, but effective diversification and tactical asset allocation will be important for the inevitable soft patches and unexpected occurrences that await. We approach 2023 therefore a little wiser, but quietly optimistic too.

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