Monthly market blueprint

Investment management service

November 2022

mazars

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Foreword

2023 will not be like 2022

The more pressure on bond markets, the quicker we will get to the pivot.

The British Autumn drama entered its third act, and the worst seems behind us. The UK has what may pass for an equivalent to the Euro-crisis technocratic governments in Italy and Greece. That particular playbook would, at this point, see market volatility ebb. Indeed the UK's 30y bond is now almost at the same place as the day before the disastrous mini-budget and the Pound is back where it was at the beginning of September versus the Euro. Bar any other surprises during the Autumn budget, we would not expect the UK to be singled out by bond vigilantes again in the next few weeks. Markets, and press headlines, seem to be finally moving on.

Having said that, the play usually hides an unsurprising fourth act. In Italy and Greece, the 'difficult decisions' caused the incumbent economic and political elite to collapse. It takes an enormous effort and political skill to maintain credibility with voters when one opts to satisfy 'bond vigilantes' and hedge funds to the detriment of one's electorate. Very few political leaders, if any, have managed to pass the 'market-voter test'. It could be that Mr Sunak's story is different. After all, he was an active politician, not an outsider, and he is backed by a strong one-party majority, unlike other technocrats backed by shaky multi-party coalitions. Most importantly, Britain is making 'difficult decisions' for itself, however much under duress, unlike other countries where those decisions were visibly imposed by external organisations, like the EU and the IMF. Nevertheless, this is a story for the near future, but not for right now. Markets, and press headlines, seem to be finally moving on.

George Lagarias
Chief Economist, UK

Which should turn our attention to global stocks. The Fed's decision to remain hawkish at a point where markets had started discounting a 'dovish pivot' took many by surprise and the beginning of November saw global equities losing their –big- October gains.

While we have been in the 'pivot camp' for some time, we haven't seen evidence to justify the narrative playing out right now. The month saw the most aggressive Quantitative Tightening since last May. Fed officials have been persistently hawkish and bond futures continue to price in more than five rate hikes by mid-December. There is simply no signal from the Fed that they are willing to even consider easing up on their inflation fight right now.

Looking at things sanguinely, we are somewhat disappointed at the lack of acknowledgement of the risk build-up in the economy and the bond market, due to the Fed's hawkishness. The US central bank continues to focus on inflation, persistently sidelining its role as the lender of the last resort and the world's de facto central bank. On the one hand it may preserve its reputation as a staunch inflation fighter. On the other hand, ignoring warning shots in the UK and Japanese fixed income markets and quickly rising global yields and spreads, is risking a financial accident. Broadly, we think the Fed could 'pivot' to an easier regime by February. Three things will happen by then. First, we will see more stress in fixed income markets (likely). Second, the economic downturn will play out (more likely). Finally, there will be fewer hawks voting for monetary policy after January (most likely).

We are more optimistic for 2023 than we were for 2022. Having said that, investors should tread carefully until they have actual confirmation that the Fed has changed its stance. We would not be surprised if we saw more retrenchments and volatility in the near future.

Market performance
The month in review

In October, markets embraced risk-on sentiment, as market participants began to look for early signs of a pivot on US monetary policy by the Federal Reserve.

October was a good month for risk assets in developed markets, as expectations that the Federal Reserve would pivot towards more accommodative monetary policy steadily grew.

The US equity market posted the strongest comeback, with equities gaining 8.1% over the month. The Federal Reserve continues to wrestle with mixed economic data. Whilst there are indications that demand is beginning to weaken, US consumer spending was reported to have increased more than anticipated. This, in combination with continued tightness in the labour market is likely to prevent the Federal Reserve from loosening financial conditions significantly; a situation that markets are beginning to price in.

Markets have also reacted positively to the rollback on the fiscal spending introduced by the new UK government. The newly proposed spending cuts and tax rises appear to have placated markets following the turmoil instigated by the 'mini-budget' proposals. UK equities were up 3.0% whilst Sterling also recovered from recent lows, with GBP/USD up 2.7%.

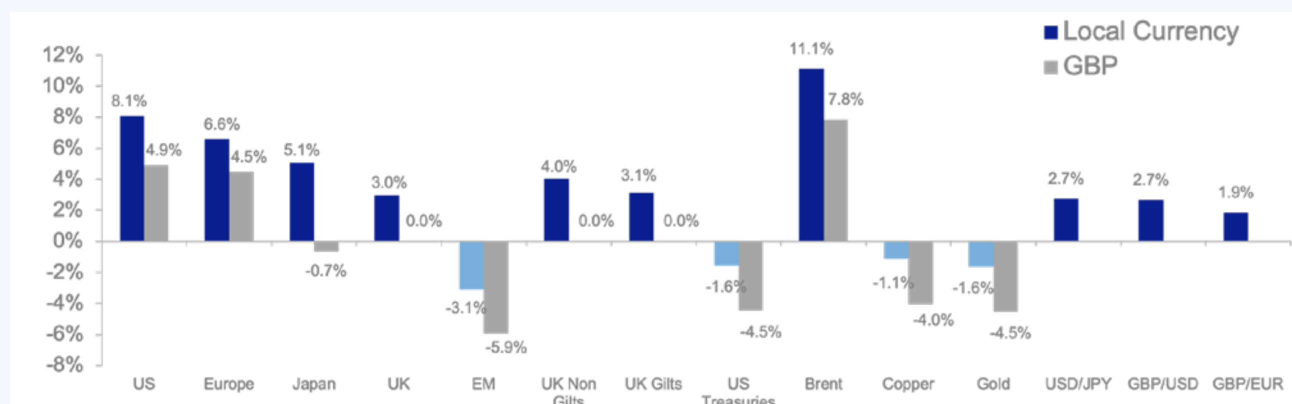
European equities, which have sold off significantly year to date, also benefitted from the risk-on environment, gaining 6.6%. However, little has changed on the underlying fundamentals of the European economy. Gas prices have declined over the month yet remain a significant headwind for European households and manufacturing businesses alike.

EM equities were once again the weakest of the regions, falling another -3.1%, as growth in China continues to slow down, and cases of Covid-19 once again spiked in several major municipalities across the country.

In the bond market, yields on UK gilts fell following the government's U-turn on fiscal spending, with the UK 10 –year gilt falling to 3.5%. US Treasury yields ticked higher however, rising from 3.8% to 4.0%.

As a traditional safety asset, gold fell by 1.6% as risk-on sentiment flooded markets, whilst oil rose significantly, up 11.1%. This was primarily due to the production cuts of 2 million barrels per day announced by OPEC+ at the start of October despite requests from the US to reconsider. These higher oil prices are likely to fuel inflation worries across developed economies, which have yet to see any material decline in inflation readings.

Basic asset classes



Charts Source: Mazars Calculations

Asset allocation

Changes in our Strategic Asset Allocation

Asset Class	Stance	Comment
Equities	Neutral	We expect that equity volatility can continue this year amid low liquidity. However, given the weak market conditions the likelihood of policy intervention is increased, which would send equity prices higher. Within our equity allocation we maintain positions in value equities and dividend paying stocks in order to offset the portfolio's exposure to sectors that are more sensitive to rising interest rates. As GBP has weakened we have reduced our unhedged equity exposure.
Fixed Income	Neutral	Given that bond yields now price in significant interest rate rises, we have brought our portfolio's bond exposure back to neutral. We maintain some low duration exposure where we see yields as being particularly attractive. Increased yields allow bonds to fulfil their traditional role as a safe haven asset in portfolios.
Alternatives	Neutral	As bonds and equities have fallen in 2022 we see less need to be overweight in exposure to alternative asset classes. While we maintain positions in gold and infrastructure, to some degree we see that these have played their role this year.

Outlook and portfolios

At the end of September our Investment Committee convened to decide the asset allocation for the fourth quarter. We added fixed income exposure through the addition of attractively valued, short-dated UK government bonds and reduced our exposure to alternatives, gold and infrastructure. We also took the recent sharp fall in sterling to add back GBP exposure, which we had previously reduced in June. We now hold a neutral position in equities, bonds and alternatives.

The changes that we made might be described as portfolio management. We previously held underweight positions to GBP and fixed income while we expected both face headwinds in the face of the UK's weak economic environment and rising interest rates. While the recent mini-budget was not forecast, it led to some sharp moves in UK asset prices, and we took advantage of this to add back UK gilts and GBP at attractive levels. Our alternatives, infrastructure and gold, have held up well in 2022 so we reduced those to fund the purchases that we made.

Our neutral asset allocation reflects both the opportunities and threats that are present in the market. While there is a lot of uncertainty as inflation remains elevated and economic growth weakens, we are increasingly optimistic as sentiment sours and asset prices fall. This tension can lead to big swings in asset prices and bear market rallies. In Q3 risk assets rallied and US equities rose +14% from the end of June to mid August, only to test lows again later. We are cautious not to chase such rallies at present.

However, there are reasons to maintain an open mind and even be optimistic. A lot of liquidity has already left the market in 2022. While this was anticipated as central banks sought to tighten policy to curb inflation, there comes a point at which low liquidity causes disfunction within markets and any restoration of liquidity can lead to a rally in assets. This played out in the UK gilt market in the wake of the chancellor's recent mini-budget in September and a sharp fall in prices had to be brought under control through Bank of England intervention. Given a market that has weakened significantly in 2022, we remain cautious of being caught up in the bad news to extent that we miss the formation of a rebounding market.

This leaves us balanced in our allocation, weary of risk but not closed to opportunities as they present themselves.

Our themes

Macro theme 1

Will we see a global recession?

As central banks and governments tighten, we could possibly see recessions and maybe even demand shocks.

Inflation is resilient (despite some easing in input prices) and has been exacerbated by the war in Ukraine, which will likely drag on. As a result of persistently high prices, wage pressures in developed markets remain intensive, prompting central banks to further tighten the supply of money. It remains debatable whether headline GDP in most developed markets will fall enough in 2022 and 2023 to technically qualify as a "recession".

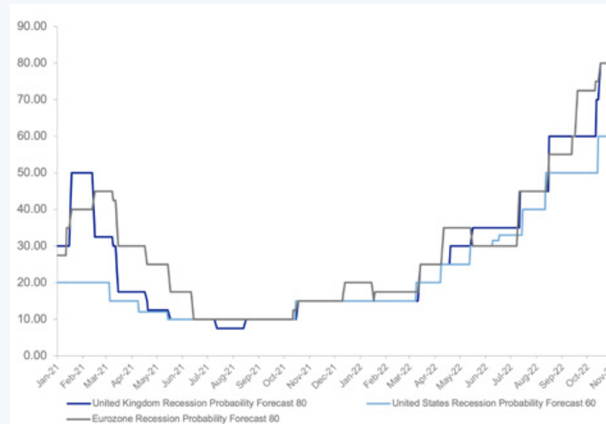
Nevertheless, the point is moot. Households are already seeing higher energy prices and overall inflation squeezing their real incomes. The UK government's backtracking its fiscal easing promises after a bond market shock sends a powerful signal to other governments that keeping a healthy balance sheet should be their number one objective.

Business and consumer surveys across the globe paint a picture of pessimism, particularly on the European continent. As a result, we are seeing significant reduction in expenditure, especially from marginal consumers. New orders for manufactured goods are declining and inventories of unsold goods are rising, whilst the global services industry is contracting concurrently. At the same time, China, the world's growth engine, is trying to reduce the economic impact of a crashing real estate market by reducing interest rates. The country's macroeconomic picture is still volatile as it endeavours to manage the transition away from the world's manufacturing hub and the fallout from the government crackdown on the real estate and technology sectors.

We are experiencing significant volatility as the economy remains in search of a new paradigm. Even if the old paradigm persists, we believe that once global economic growth slows down significantly, inflation will subside, giving central banks and governments more room to support the next economic rebound.

Economists fear recession in the UK and the EU

Bloomberg Survey: What do you think is the probability of a recession in the next 12 months?



Source: Mazars Calculations, Bloomberg

For the next 3-4 months, we expect to see intensifying economic pressures, as well as persisting supply side (cost-push) inflation.

Fiscal and monetary solutions will be less available than any time in the previous twenty years. Weaker economies and structures could come under significant pressure

In fact, we believe we could even see demand shocks, especially in Europe, as a result of the fast tightening of financial and monetary positions.

Having said that, all these could contribute to the central banks reaching their targets quicker and ease financial conditions thereafter.

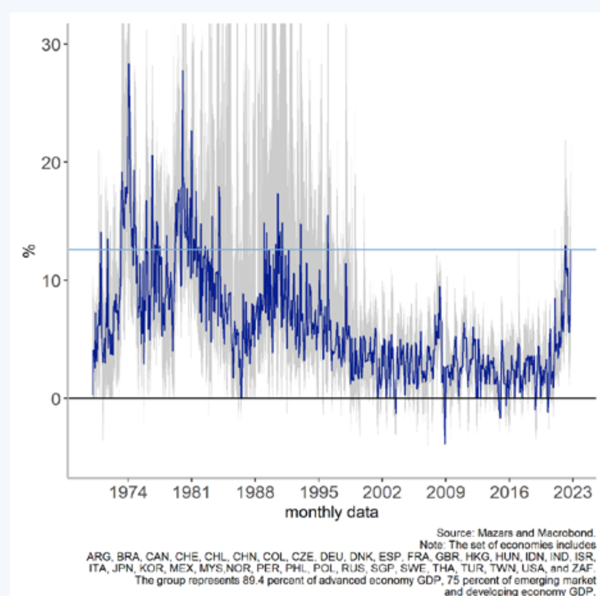
Macro theme 2

Inflation: is the worst behind us?

After decades of stability, inflation is back.

Inflation and its distribution across countries

Median and 25-75 percentile range; percent; annualized MoM



Source: Mazars Calculations, Bloomberg

Global inflation is estimated to have peaked at 9.5 per cent in the third quarter of this year, the highest mark in decades. Rising prices are affecting both advanced and emerging economies, oil exporters and importers, and fiscally sound and unsound national governments. Out of a database of 172 countries, 135 (78% of the sample) are experiencing inflation levels above 5%, while during the previous decade only one third of the sample suffered high inflation.

The current surge in inflation is the result of two overlapping shocks: COVID-19 and the war in Ukraine. The COVID shock triggered extraordinarily high demand for goods at a time when the world's capacity to supply these goods was facing unprecedented challenges. Food and energy prices began to rise sharply already in 2021. On top of that, the war in Ukraine caused additional disruptions in both markets, pushing prices even higher.

The good news is that the worst regarding inflation is likely behind us. We believe inflation rates are poised to come down both in the US and in Europe . However, there are elements to expect the disinflation will be slower in the latter.

US

US headline inflation will likely decline sharply in the coming months. This is due to the confluence of four factors - first, global oil and commodity prices have declined: U.S. petrol prices have fallen more than 20% since June. In the same vein, international food prices have subsided 12% since June. Second, supply bottlenecks appear to be easing. As production normalizes, the prices of goods like new and used cars, a prime driver of inflation last year, should decline. Third, the economic slowdown. As the Fed hikes interest rates, the US economy is expected to cool. Slower GDP growth will moderate labour demand and wage growth, thus decelerating services inflation. Fourth, the year-on-year effect will affect numbers. Last fall prices rose significantly so we would need very high CPI prints for annual inflation not to come down. We expect US headline inflation to be close to 3% by the end of next year.

Europe

Euro area annual inflation was 10.7% in October, and it is not at all clear that it's near its peak. The energy shock is an order of magnitude higher than in the US and the ECB's monetary policy tightening is a step behind the Fed, resulting in a weaker exchange rate and higher imported goods' inflation.

Despite the looming recession, unemployment is still at an all-time low, so services inflation is not expected to decline fast either.

Against this backdrop, our baseline scenario is for inflation to decelerate, but at a slower pace than in the US. We see EU headline inflation above 5% by the end of next year.

Macro theme 3

China's 20th National Congress Party meeting – a recap

The much-awaited National Party Congress meeting concluded with China's leader Xi Jinping securing a precedent breaking third leadership term. A new Central Committee – the party's 200-member central leadership – will be ushered over the coming weeks, which will in turn select a new slate of top leaders.

In a series of speeches made at the Party Congress, President Xi and his colleagues claimed credit for an array of policy successes over the past ten years and outlined a set of ambitious goals for the next five years. The initiatives launched over the past decade along with the rhetoric coming out of the congress underscore that President Xi's paramount priority has been and continues to be strengthening and centralizing the party's control over the government, the military, the economy and society. Interestingly, party leaders came across as being more fearful of domestic instability than they were about threats from outside their borders. Consequently, the CCP is focused on strengthening control over all sectors of society.

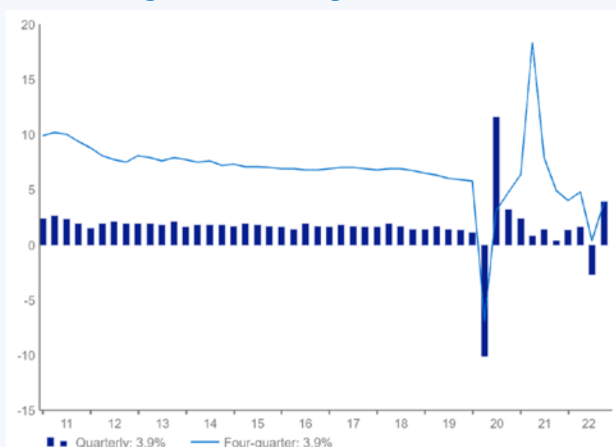
During his previous two terms, China's President targeted restructuring the economy through reasserting central control over most sectors and re-emphasized the importance of state-owned enterprises. This is expected to continue as it was announced to attending delegates that the party would "work to see state-owned capital and enterprises get stronger, do better, and grow bigger."

We expect this inward focus will inevitably cause a shift in policy away from matters such as GDP growth targets towards nation first goals such as national security, higher regulatory oversight and income equality. China has been becoming increasingly more assertive on 'self-reliance' in technology development and distribution services amid stiff competition with the US.

President Xi enters his third term as a leader who is faced with a range of knotty challenges. Among them are anticipated fierce economic headwinds which will strain the system and put pressure on China's policies over the coming years. Moreover, we also expect foreign policy complexities, notably with the United States, considered China's most potent and threatening competitor, and with Russia, ostensibly China's staunchest and weightiest strategic partner.

China's GDP growth is still falling short of 5.5% official target

China GDP growth, % change



Source: Refinitiv Datastream

The citizens of China can expect a continuation of current hardline policies and greater centralization of power; other countries should anticipate an assertive and combative PRC led by an activist, authoritative leader and an energetic party-military-state obsessed with seeking to control all activity and to dominate arenas both inside and outside its borders.

Post the NCP meeting and GDP data release of Q3 this year, the IMF marked down Chinese growth for 2022 to 3.2%, its second-lowest level since 1977. This revision not only reflected the negative impact of the nations zero-Covid lockdowns on mobility but also the crisis in the real estate sector. This slowdown in growth is estimated to have important spill overs to the rest of Asia through trade and financial links.

We believe China is set to experience a challenging economic future. While China still remains the powerhouse of manufacturing and innovation, a number of Asian countries are catching the sights of investors world over.

Comparing the Eurozone and the US

It is no secret that European economies are facing serious headwinds, such as the sustained pressure on household finances due to higher energy costs. But how does the economic outlook for the Eurozone compare to that for the US?

There are several factors to consider here. Let's observe some of the major differences in the backdrop of these two major economies:

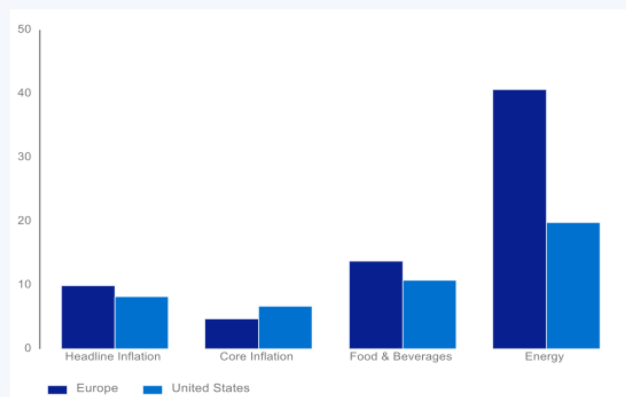
Energy: The European energy crisis is currently wreaking havoc on businesses and consumers alike, and the weaponization of energy supplies by Russia means that the issue of higher energy prices in Europe will likely persist for years to come. This impacts both business (particularly those in the industrial sector) and consumers, as households look to reduce their discretionary spending to offset the impact of higher fuel bills. As a net exporter of energy, the US economy is far less dependent on external sources of fuel and is likely to face fewer headwinds to growth from this avenue.

Inflation: Inflation has remained stubbornly high across both economies. However, the contributors to inflation in both economies vary. In Europe, the more traditionally volatile constituents of inflation, energy and food, have had a much more significant impact. Does this mean that inflation in the Eurozone will fall faster than it will in the US? Unlikely, as the main factor influencing food and energy prices across the region continues to be the Russia-Ukraine war, and a resolution to the conflict seems unlikely for the foreseeable future.

Monetary policy: The Federal Reserve has been far more successful at aggressively hiking interest rates than the ECB, which may help to bring down inflation in the US more quickly. The ECB simply cannot afford to aggressively hike rates if it wishes keep the European Union in tact. Worries over the ability of the heavily indebted periphery nations to fulfil their debt obligations have already stressed European bond markets. In addition, the current interest rate differential between the two is contributing to recent dollar strength, further exacerbating the above issues, as EU imports become more expensive due to the relative weakness of the Euro.

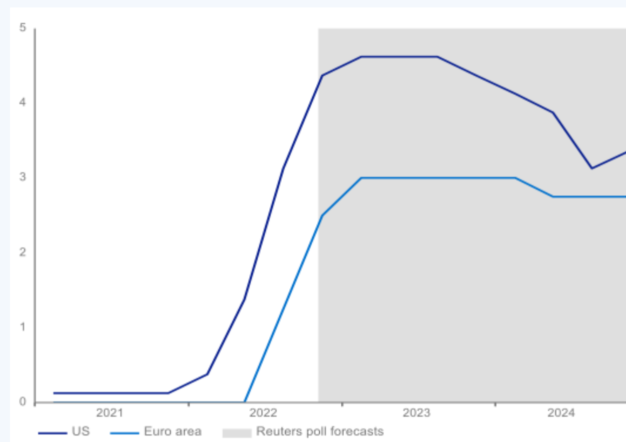
A comparison of inflation in Europe and the US

EU HICP and US CPI, select components, YoY change, %



The Fed has raised rates more aggressively than the ECB

Federal Reserve and ECB policy rates including Reuters poll forecasts, %



Charts Source: Refinitiv Datastream

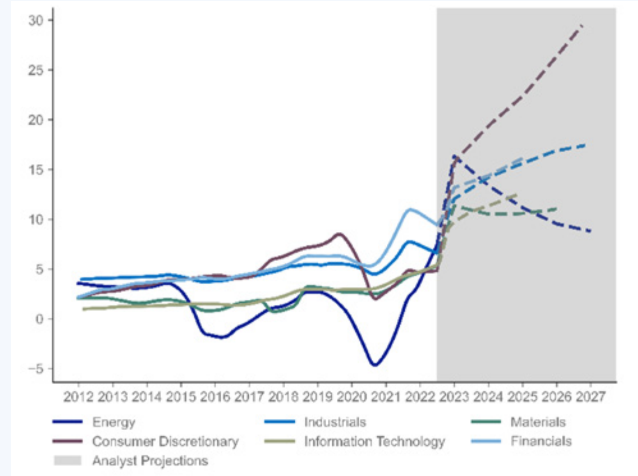
Despite the increasing probability of a global recession, analysts remain upbeat on earnings.

Thus far, 71% of US large cap companies beat earnings expectations in the US. Particular strength was seen in energy, where 92% of companies beat expectations. Industrials and technology also performed well, with 78% beating expectations in both cases. The largest misses were seen in the consumer discretionary and materials sectors, where 41% and 36% of companies missed forecasts respectively.

Higher costs are continuing to put pressure on companies. Producer prices in the US rose by 8.5% year on year in September, and the effect of this can be seen in company profit margins. Net profit margins for information technology, financials and industrials continued on a downward trend in the third quarter, although margins for energy and materials companies increased. US stocks have now reported a lower net profit margin for 5 straight quarters.

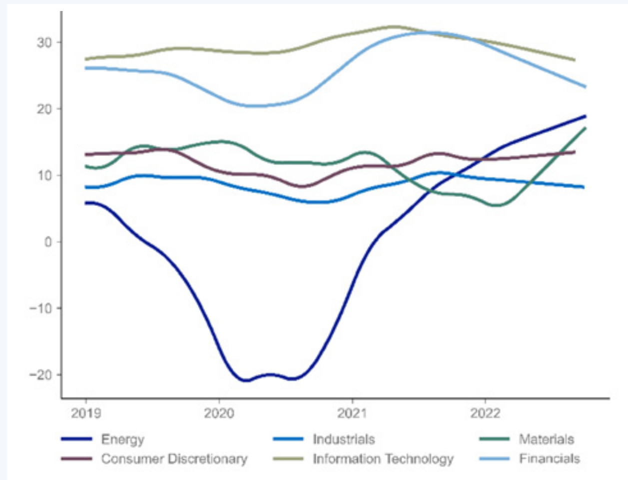
US earnings per share by sector

Aggregated EPS per sector, large cap, seasonally adjusted



US Net Margin % by sector

Aggregated Net Margin % per sector, large cap, seasonally adjusted



Charts Source: Refinitiv Datastream

Looking forward, analysts have remained optimistic about earnings, forecasting gains in most sectors. Sectors such as consumer discretionary, which generally fall during a recession, still retain high earnings estimates from analysts.

Earnings in the energy sector, despite showing remarkable strength this quarter, are projected to peak at the end of 2022 and fall in 2023, as energy companies find it more difficult to top their performance going forward. A similar story is seen in the UK, where earnings projections are also quite optimistic. Analysts also see energy earnings in the UK peaking at the end of 2022.

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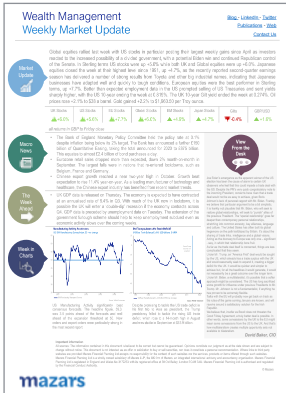
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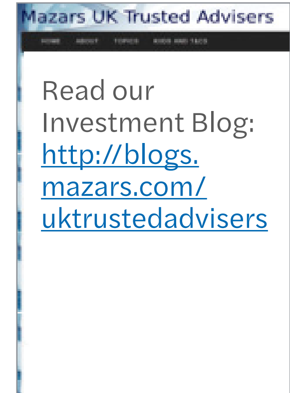
Investment newsletter

Quarterly outlook



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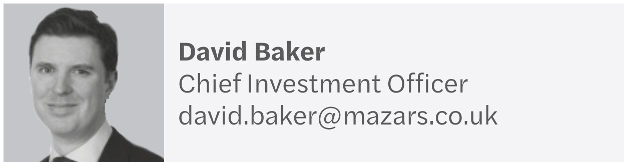
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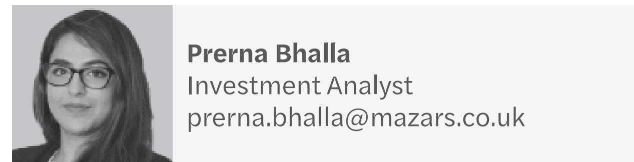
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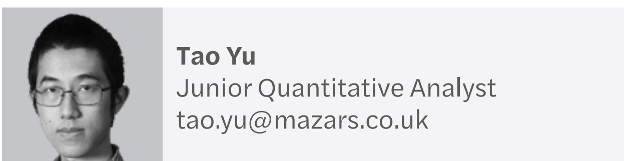
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