Monthly market blueprint
Investment management service

December 2022

mazars

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Foreword

The world has changed

Acknowledging how the pandemic changed the world is a necessary step to predicting 2023

We are most vulnerable to mistakes at a time when, even if we recognise that the world has profoundly changed, we try to analyse it with the eyes of the past. Instead of trying to forecast with the past's eyes, we need to acknowledge how the present has changed, and develop the right tools to analyse the future properly.

It starts with recognising the impact of Covid-19 and the lockdowns. The pandemic broke supply chains, exacerbated simmering geopolitical tensions and aggravated relationships between buyers and suppliers, even between allies. It sowed mistrust between trade partners, forcing all to draw new fault lines. It shattered job norms and removed whole cohorts from employment, leaving the ageing developed world jobs market in extremely tight conditions. The pandemic also caused inflation, forcing central banks to depart from a 14-year ultra-accommodative paradigm. Meanwhile, the Great Moderation, a 40-year period of reduced macroeconomic volatility, can be officially pronounced dead.

The world has been changed profoundly and unequivocally.

In this world, British dreams of an easy transition away from the European Union proved fantasies as the global economic storm began to rage, drowning (or at least severely hampering) whatever post-Brexit plans its architects may have had. The UK economy is the only major economy remaining below its pre-pandemic size and inflationin the UK is projected to drag on. China is now facing a crumbling housing market, mountains of internal debt, dissent, and a dismal demographic picture.

George Lagarias
Chief Economist, UK

Meanwhile, US economic leadership of the West seems as aged as its leadership. 'America First' proved a promise too difficult to turn around. The Fed is too focused at home, completely failing to acknowledge it impact of tighter rates abroad.

The US government is faced with suspicion by its NATO allies, doing little to ease the tensions in Ukraine while at the same time welcoming the sale of Liquid Natural Gas to its European allies at exorbitant prices. The almighty Dollar is losing ground, as central banks load up on gold and investors are looking to build diverse reserves, for fear of America might become a less benign empire. Europe is increasingly pressured by the realities of an unfinished currency union, its addiction to Russian energy, and lack of true centralised leadership.

As for businesses? On the one hand, they are trying to navigate their needs for higher capital expenditure, and the re-designing of their supply chains. They know they need to grow sustainably, only they are not certain what this means, and they need to deliver higher returns to suspicious investors, in an era when the 'Fed Put' is hibernating. On the other hand, they need to make sure all important hands remain on deck, as inflation is driving up wages, significantly increasing key person risks.

A post-pandemic globalised economy has fallen in disarray. There's little room for central planning and a new Bretton Woods, as allies view each other with suspicion. It thus stands to reason that whatever world emerges will be the bottom-up result of individual, uncoordinated business and political decisions. Order born out of chaos.

This renders the present status quo out of date. There will be new winners and losers. Technology will play a determining role. The seismic shifts upended a world where the centre already didn't hold. They are the reason why old remedies may not work, as policymakers could well find out soon enough.

Market performance
The month in review

In November, markets continued to rally, embracing the Federal Reserve's narrative of 'lower for longer' as a tilt towards more accommodative monetary policy

November was another good month for risk assets, as expectations that the Federal Reserve would pivot towards more accommodative monetary policy steadily grew.

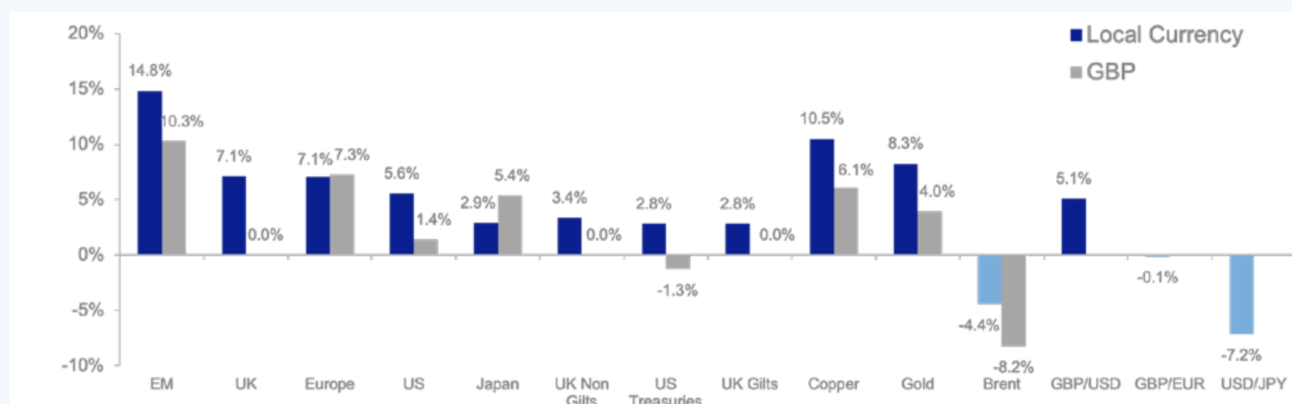
Emerging market equities posted the strongest returns over the month, gaining 14.8% over the month. The market anticipations of a pivot by the Federal Reserve have encouraged a relief rally. Due to market participants being less willing to pay a premium for 'safety assets', this has allowed the dollar to fall from its recent highs (GBP/USD has risen +5.1% over the course of November). As the majority of emerging market company debt being denominated in USD, the declining dollar has reduced fears that these businesses will unable to fulfil their debt obligations. This, coupled expectations that the 'Zero-Covid' policy will be abandoned in China, allowing their economy to fully reopen economy have buoyed emerging market risk assets.

Developed markets have also benefitted from the risk-on environment. US equities have risen 5.6% over the month as the Federal Reserve Chair Jerome Powell provided markets with further guidance surrounding the anticipated path for rate hikes. Whilst markets have generally interpreted the likelihood of smaller 50bps rate hikes moving forward as favourable, labour market resilience may permit the Fed to raise rates over a significantly longer time period than markets are currently anticipating. European and UK equity markets have also performed well, both up 7.1% over the month.

Turmoil in the bond market has also largely dissipated. Yields on UK Gilts and US Treasuries both fell last month, with the UK 10-year and US 10-year Government bond yields falling to 3.2% and 3.6% respectively.

Thanks primarily to the fall in the dollar, gold prices (which are denominated in USD) rose +4.0%. Oil prices fell -10.6% over the month as recession concerns grow and demand is expected to wane. Meanwhile, a price cap on Russian oil of $60/barrel was introduced by G7 as the war in Ukraine continues to rage on.

Basic asset classes



Charts Source: Mazars Calculations

Key risks

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

2022 is another year of great uncertainty and a wide variety of outcomes, the third in a row. High inflation and central bank hawkishness squeeze real disposable incomes and increase the possibility of a second global recession, a year after the recovery has started. The stresses in the credit market are pronounced, as the US Federal Reserve continues to emit hawkish signals, locking global liquidity away from money markets. Global supply chains, which were under pressure even before the war, are now facing more shocks, as China which lies at the heart of global supply chains is less stable than in the past.

The Fed's focus on inflation means that the below risks could have a bigger impact on markets than previous years. We expect macroeconomic and market volatility to last well into 2023. Having said that, the deciding element is the stance of the US Federal Reserve. If the Fed reverts to a more accommodative stance risks could be less impactful. Conversely, if it chooses to dial up the fight against inflation then the risks not only become more pronounced but also more interdependent.

Persisting inflation and a global recession: There is evidence that global inflation may be peaking, but we believe it will remain significantly above 2% for most of 2023. Hawkish central banks and lower disposable incomes are already having a significant impact on global demand. Markets are currently predicting that the EU and the UK will contract early in 2023, and the US may follow.

Credit event/financial accident: In the past few months, we are witnessing a significant build-up of pressures in the credit market. We already observing some (expected) dislocations in the high yield space, as well as rising dangers in the European periphery. Central banks have long dominated certain corners of the bond market and priced out private and bank trading desks. Now that they are retracting liquidity, organisations and even nations who learned to depend on them will find themselves faced with steep funding cost rises and concomitantly rising risks. Credit spreads are at stressed levels and the probability that we will see a major credit event or a financial accident is rising.

Central Bank policy error: A policy error is defined as tightening too much, or easing too early. Central banks are very data dependent. But the global economy is extremely volatile, trends are difficult to discern and wrong conclusions could be drawn. The same goes for the assumptions made about consumer behaviour by central banks. The decisions made in 2022 and 2023 will have a significant impact on businesses and credit markets.

Deteriorating geopolitics: The trend is easily observable, but it is difficult to quantify exactly what this means for the global economy. The obvious repercussions of the worsening geopolitical picture are higher oil prices and a de-globalised supply chain.

Chinese slowdown: China is still attempting to transition from the manufacturing to the services sector. At the same time it is trying to hyper-regulate businesses in a bid to stop their interests from directing long-term state policy. Meanwhile, the housing market, which impacts 1/3 of GDP, is very weak. There is evidence that the government is relenting on Zero-Covid policies, which could have a positive income on global supply chains and local / global growth.

European cohesion: The Euro is the one of market's weakest points. It was imperiled and almost ended right after the previous financial crisis. It could do so again if the ECB fails to explicitly back it at a time of stress.

Global real estate market crash: The stresses in the global real estate market are rising, as a result of higher interest rates and lower disposable incomes. We are already seeing a significant drop in sales in the US and a downward pressure on prices. We are observing a similar, yet more benign trend in the UK.

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 port 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

A global housing downturn

Few sectors of the economy have a greater ability to anticipate the business cycle than the housing market: declines in home sales have preceded nine of the last 12 recessions in the US, leading economists to claim that "the housing market is the business cycle" because of its properties as an early warning sign of an oncoming recession.

The housing market is relevant for the economy and financial markets not only for its contribution to employment, but also because Real Estate represents over 50% of global wealth and that impacts on consumption and investment decisions.

Unfortunately, the story of the housing market in the past year is not a positive one. In fact, the housing market has shown one of the sharpest downturns on record: building permits, which in December 2021 peaked at 1.9 million, plunged to 1.5 million in October. Traffic of prospective buyers (a leading indicator of housing demand) fell in November to its lowest level since 2011, while existing home sales for October also registered the lowest figure since 2011.

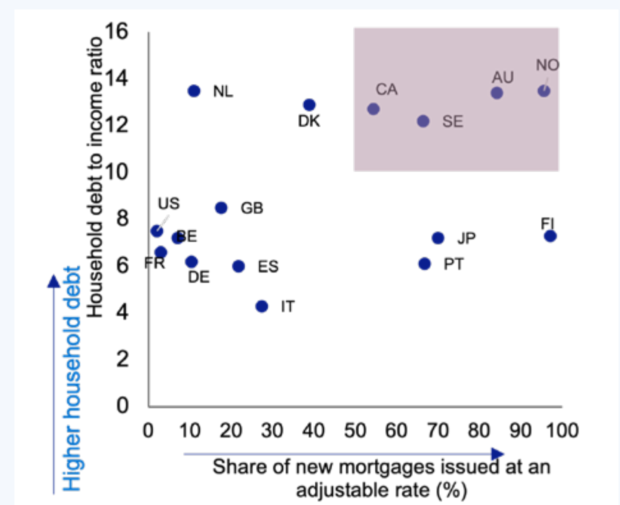
The reason for the downturn is rising mortgage rates. In the US, the rate for a 30-year deal is around 6.5%, more than double the rate last year and the highest since 2008. The same is true in the UK, where the 10-year fixed rate in Sterling stands at 5.27% also doubling last year's rates.

These rates are likely to remain high, at least for the next year, contributing to sharp declines in house building and home sales. House prices should also fall, although the magnitude remains to be seen. The markets with the sharpest downturns should be those in which households have higher levels of debt relative to income, a larger share of mortgages are issued at a variable rate and property prices have raised the most in the past years.

Although the UK is not among the most vulnerable markets, significant declines in property prices cannot be ruled out. As the chart on the right shows, the interest rate on 10-year fixed mortgages and real house prices are highly and negatively correlated. At current interest rate levels (5.3%), real house prices can be expected to fall in real terms. In its latest November forecast, the OBR expects real house prices to fall by 6.8% (13.7% in real terms) over the next two years.

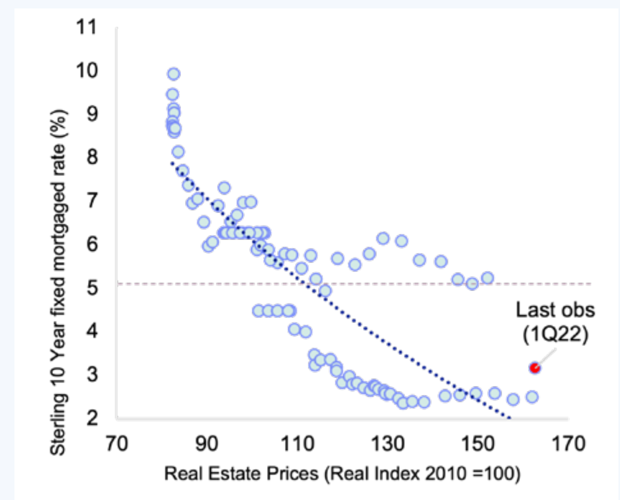
Housing markets with the largest expected declines

Household debt to income ratio and share of new mortgages issued at an adjustable rate



UK property prices will likely decline

Real property prices vs Sterling 10-year fixed rate



Source: Mazars, BIS, OECD and Macrobond.

Key outcomes and what's to come in the sustainability arena.

COP27 was a much anticipated event in the 2022 diary. While most onlookers felt this COP event lacked the enthusiasm and coverage compared to previous ones, there have been some positive developments too, from bold national and international pledges, to leadership at side events from youth and the most-affected regions. Below is a recap of what happened at COP27.

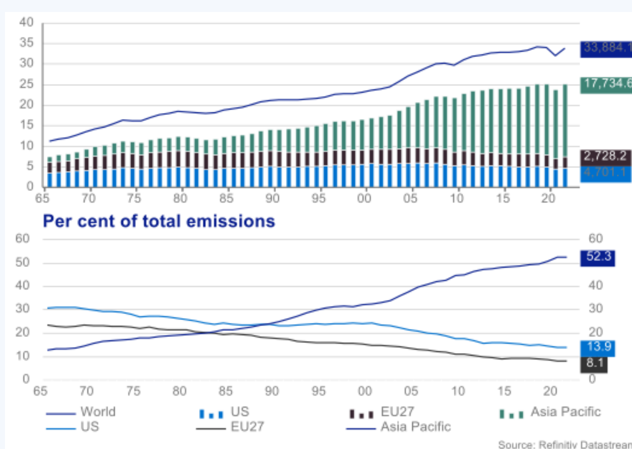
An agreement to create a loss and damage finance mechanism – The priority of many developing countries was the creation of a fund to address the damage that their societies and economies are suffering. However, developed countries were more focused on mitigation, on the basis that failure to do so now will create further damage and be even more expensive to address in the future. Thus, COP27 was always destined to lead to tensions surrounding the desired outcome. Eventually, in the final hours, a deal was reached. However, critical details of how the fund will work, including who pays, how much, and how it will operate, were left to be worked out at future talks.

COP27 failed in its objective of forcing countries to improve their Nationally Determined Contribution (NDCs) – The negotiations failed to secure an agreement to start a phase-out of all fossil fuels—language which at one point seemed to have made its way into the text, only to be withdrawn and replaced by "phasing down" coal and "phasing out inefficient fossil fuel subsidies" after objections from Saudi Arabia, Iran, and Russia.

The final outcome did not improve the commitments to cutting emissions – Although an attempt to remove the 1.5 degree Celsius goal from the Declaration in favour of the Paris Agreement's upper limit of 2 degrees failed, there was no mention of the requirement for global emissions to peak by 2025, which scientists see as critical if the world is to meet the 1.5 degree Celsius target. Also, the focus on reducing emissions appeared to be undermined by the last minute insertion by Egypt of a call to increase

Global emissions have been on the rise

CO2 emissions – tonnes, billions



"low-emission" energy.

Additionally, a reform of the World Bank (to focus its lending on tackling climate change) was placed firmly on the agenda. The U.S. and China also relaunched climate talks, which is critical to keeping a 1.5-degree Celsius goal alive, as they're the world's two largest emitters, together responsible for close to 50% of the globe's emissions. A deal committing 214 companies and governments to phase out diesel and petrol cars by 2040 was also signed.

In terms of what we expect to see at next year's COP28 – we envisage that there will be a focus on how to operationalize the loss and damage fund, as well as a continued focus on the global goal of adaptation, the new increased focus on climate finance, the first 'Global Stocktake' assessing progress on the NDCs of individual countries and the on-going role of private sector emissions reduction commitments. However, achieving these tangible outcomes will require a sustained effort to rebuild trust and confidence between all nations.

UK asset prices and the UK economy

UK assets have staged an impressive recovery over the last two months but the underlying economy still faces hurdles. This divergence leaves the door open for volatility in UK asset prices.

Since the brief spell of Liz Truss's leadership and the catastrophic mini-budget, UK assets have staged a remarkable recovery. To some degree this is a reflection of the confidence in the new government's ability to bring public finances under control. UK asset prices are also being lifted by a wider rally in global risk assets which has been caused by market optimism about inflation peaking in the US and US rate hikes coming to an end sooner than had been anticipated. Since the trough in UK asset prices on 12 October, UK mid cap companies have risen by almost +17%, and 10-year UK government bonds have risen over 10%.

Despite this jump in asset prices, one should not think that the economic outlook for the UK is vastly improved, compared to the time of the mini budget. Economic problems which haunted the UK throughout 2022 are still present, and have even been added to. Inflation in the UK continued to reach a 41-year high for the 12 months to October, which will not allow the Bank of England to pause its interest rate hiking cycle for now. Higher interest rates will continue to weigh on consumer confidence and push up borrowing costs in the UK economy. The UK consumer now has an additional headwind as higher mortgage rates are widely expected to depress house prices in 2023, which make up a large portion of personal wealth in the UK.

The negative outlook for the UK and the rally in UK asset prices contradict one another, and one is likely to come to an end to validate the other. Our take is that for now a relief rally in UK assets alongside global markets is understandable given a pick-up in risk appetite but a prolonged bull market is unlikely and therefore more volatility may lie in store.

Asset price returns from the lows following the UK's Mini Budget

Per cent

Index	Percentage change from 12/10/2022 to 30/11/2022
UK Large Cap Companies	+11.4
UK Mid Cap Companies	+16.81
UK 10 Year Gilt Price	+10.2
GBP vs USD	+7.03

Inflation

12m % Change

Charts Source: Refinitiv Datastream

The challenges facing the CCP are multi-faceted and complex. The waning narrative around the 'Zero-Covid' policy is bringing about new challenges to China's economic outlook. Decisions taken by the government in relaxing these restrictions will have unintended consequences and may impact economic growth for many months to come.

Chinese assets have experienced a sharp rebound in recent weeks. Whilst some of these gains can be attributed to rumours that central banks in developed economies will adopt less restrictive monetary policies moving forward, recent events on the Chinese mainland have also fuelled this rally.

The previously effective lockdown 'Zero-Covid' measures had already come under renewed pressure due to the emergence of new, more transmissible subvariants. This, in conjunction with a hectic decentralisation of Covid restrictions and broadcasts of the World Cup stadiums packed with fans socialising, helped ignite the political protests seen over the last few weeks, the unprecedented scale of which have fuelled change in the government's Covid policies.

After months of defaults, attempted restructurings, and mortgage boycotts, November also saw the People's Bank of China stepping up the support to the flailing property sector. The introduced directives aim to support heavily indebted property development businesses, and see projects through to completion, which has helped alleviate investor concerns.

Despite the relief rally, much about the short- to medium-term future of the Chinese economy remains uncertain. The approach to the reopening will likely be undertaken on a regional level, with some provinces loosening policy almost immediately, whilst others may even tighten restrictions temporarily. In addition, the impact of highly transmissible Covid variants could cause a variety of problems, ranging from strains on healthcare systems, to reduced productivity and further supply chain disruptions.

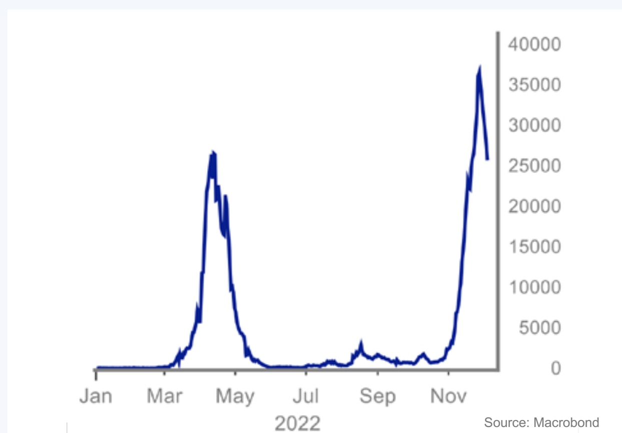
Markets may have priced in a full and speedy normalisation following the end of the government's 'Zero-Covid' policy, but the truth is that very little is known about how China's economic situation will develop over the coming weeks and months.

Chinese assets have rebounded in recent weeks

Hang Seng equity index, China-Datastream real estate index, USD, rebased, 100 = 01/01/2022

Covid cases have spiked across the country

China National Health Commission, asymptomatic Coronavirus cases under medical observation, new cases



What happens when everyone is a bearish?

It is no secret that bears are outnumbering bulls in this market. In fact, the ratio of bullish investors to bearish investors is at a historically low level. But how have markets performed when sentiment has been this negative?

Right now, the ratio of bulls to bears in the market is currently at a 3-month rolling average of around 1:2, a level which, in the past two decades, has only been seen during the Global Financial Crisis and the Covid-19 pandemic. Such a reading falls firmly in the 10th percentile of this indicator's historical levels.

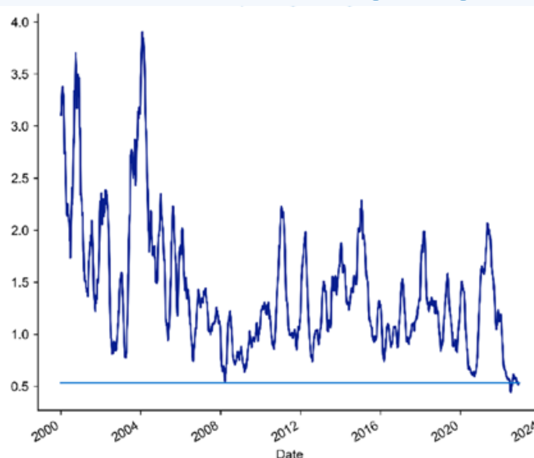
Such negative sentiment, on the surface, looks like a poor signal for markets going ahead. However, this has not necessarily been the case in the past. In fact, the bull-bear ratio has often been considered to be a contrarian indicator at its extremities, highlighting when investors have become overly confident in their calls.

In our analysis, we found that when the bull-bear ratio has fallen below its 10th percentile in the past, the returns on US equities were greater than their long-term average in the following quarter and the following year more than 70% of the time. The probability of outperformance is higher than when the bull-bear ratio suggests a more neutral or bullish sentiment. The effect is more pronounced at the one year time horizon than the one quarter time horizon.

Thus, we believe that the extreme pessimism of investors right now is not necessarily a cause for concern. In fact, for a longer term investor, it may represent an opportunity for future outperformance.

Market sentiment nears historic lows

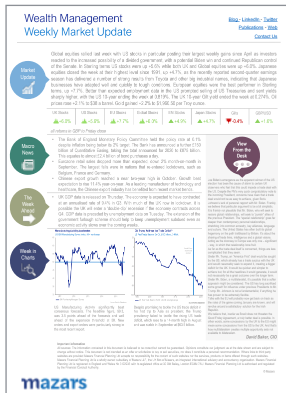
AAII bull-bear ratio, 90 day rolling average



Probability of index performance over one year	Positive	Negative
Bull-Bear ratio		
90th percentile (bullish)	47.8%	52.2%
Neutral	57.8%	42.2%
10th percentile (bearish)	73.0%	27.0%

Probability of index performance over one year	Positive	Negative
Bull-Bear ratio		
90th percentile (bullish)	35.8%	64.2%
Neutral	60.2%	39.8%
10th percentile (bearish)	74.1%	25.9%

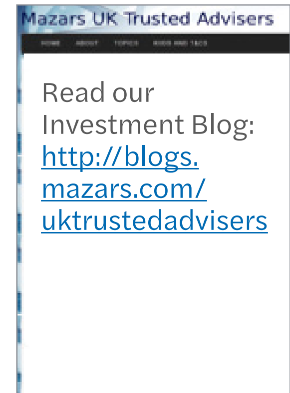
More reading...



Weekly Market Update

Investment newsletter

Quarterly outlook



Investment blog

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