Monthly market blueprint

Investment management service

March 2023

mazars

Contents

Foreword

Volatility and hope

Volatility around the numbers makes forecast and policymaking difficult. Errors will be made. While this environment is set to persist, we see a glimmer of hope.

Volatility. The end of the macroeconomic "Great Moderation". This was our theme entering 2023. We are already seeing data that is volatile, and contradictive. US Housing and manufacturing are at 2008 levels. Yet consumption data for January was one of the strongest on record. China is reopening fast. Yet, there are no traces of inflation. Japan is experiencing inflation for the first time in decades. However, for the time being the Bank of Japan is insisting on yield curve control (i.e. money printing). This volatile and unpredictable macroeconomic backdrop is also non-directional.

Now consider a key policymaking organization like the US Federal Reserve. Every month, it waits for 2-3 key pieces for inflation data, but also other numbers, indicating the general strength of the economy, such as retail sales, employment etc. What happens when the figures are so unpredictable? Or when they are not telling a coherent story? Interest rates are a longer term consideration and can't go up and down at every meeting. The Fed needs a direction, even if the data can't provide it. Thus, data-dependency may provide a good "objective" narrative as to why interest rates go towards a particular direction, but when the story isn't clear, it is ultimately it's people who decide, and people have biases. Economists, in particular, are a profession notorious for biases, usually created in academia.

This creates confusion for markets, who may see the same data and reach different conclusions. The Fed has indicated that it will proceed with single rate hike instalments. After the latest data, double rate hikes are back on the table.

George Lagarias
Chief Economist, UK

So, **the inescapable conclusion is that there's a growing probability that policymakers will miss the mark**. They will either over-tighten (more likely) or under-tighten, each one with a different set of repercussions. The same goes for every major policymaker, not just central banks.

Our world that is gravely imbalanced, and inefficient not necessarily because the economy can't find an equilibrium. It's shifting supply chains that is the problem. A better explanation is that the great nations of the world persist that antagonising each other and undoing the decade-long benefits of globalisation is somehow good for their internal electorates. We are quickly moving towards a bi-polar world, not too dissimilar from the one we grew up in.

Inescapable conclusion number two: if indeed its geopolitical imbalances that hinder sanguine policymaking, expect this to last for some time.

Yet, those looking for a glimmer of hope should look no further than Europe, and, more recently, Great Britain. The Government, despite its commanding majority in the Commons, has changed its strategy. It no longer tries to thumb its nose at its neighbour, even if it is egged on to do so by some MPs and part of its core electorate. As a first result, last week it achieved a breakthrough, the "Windsor Framework", a workable deal for Northern Ireland. The deal itself is of limited impact, an incremental first step towards averting a trade war. More market access for the financial sector will be a difficult task to achieve, but when people negotiate in good faith anything can happen.

Inescapable conclusion number 3: At an age when the West has forgotten war, electorates will eventually see that confrontation results in worse economic outcomes and it was international cooperation that increased their wealth.

Market performance
The month in review

February saw the optimism in risk assets fizzle. Robust economic data has increasingly called into question the end of rate hikes. That has adversely impacted bonds and equities

The US non-farm payroll data for January that came out in the first week of February was almost triple the consensus estimate. It was such a large number that it led people to question how the Federal Reserve has quashed inflation with such a robust economy. Equity markets and bond prices then responded to this over the course of the month as the narrative gained traction.

Global equities were down -2.4% in January as risk off sentiment saw a partial unwinding of the rally that risk markets have enjoyed since October.

In the US, equity markets fell in line with global equities, -2.4%. While the Federal reserve began the month with dovish rhetoric, this was contradicted later by Jay Powell proclaiming that more hikes were needed to reign in inflation.

In the UK equities were up +1.8% as investors continued to favour the prospects of certain sectors, notably energy.

In Europe equities overcame the ECB's hawkish sentiment and rose +1.5%, led by cyclical sectors automobiles and financials.

In Japan the equity market was up +0.9%.

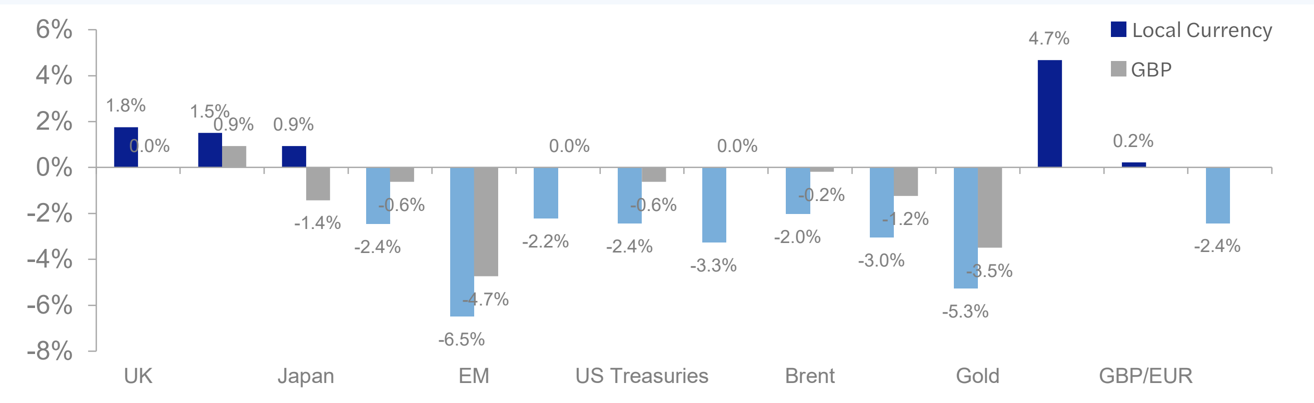
Emerging Market equities endured a strong sell off in January. To some degree this is profit taking after the robust recovery that Chinese equities had staged since October, as Geopolitical tensions gave rise to consternation.

Inflation concerns in the developed world pushed government bond yields higher in the UK, US, & Germany. The US 10 year government bond yield ended the month at 3.9%, the UK at 3.8% and Germany at 2.7%. The US and German yield curves inverted further during February. The UK yield curve actually normalised, leaving a slight would upward slope. Traditionally the UK yield curve has not been as reliable an indicator of recession as it has in the US.

The gold price contracted -5.3% in February as concerns over recession fell away with stronger US economic data. The oil price also came down -2.3%.

GBP was weaker against the US Dollar, during February, which flattered returns. GBP fell -2.4% against the dollar and rose modestly, +0.2%.

Basic asset classes



Charts Source: Mazars Calculations

Key risks
Risk downgrade

Risks are now broadly balanced, as inflation subsides, China reopens and pressures on markets are reduced.

2023 is expected to be another year of great uncertainty and a wide variety of outcomes, the fourth in a row. High inflation and central bank hawkishness squeeze real disposable incomes and increase the possibility of another global recession. The stresses in the credit market are retreating, but are still 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 all the below risks could have a bigger impact on markets than in previous years. Other central banks, bar China, are following with a lag, which means they can stay hawkish well after the Fed has paused rates. We expect macroeconomic and market volatility to last well into 2023.

Overall, we currently see risks as broadly balanced. China's reopening appears to be more helpful to growth than hurting prices.

Heightened volatility: The most important risk presently, comes from volatility. As the world becomes more unbalanced, macroeconomic volatility is heightened. This is reflected on interest rate unpredictability and then translates into financial market volatility, for equity, credit, bonds etc. The effects of heightened macroeconomic volatility, a phenomenon that we haven't experienced since the 1980s could be far and far reaching. From financial accidents due to mark-to-market practices or counterparty failures, to fiscal and monetary policy mistakes, to difficulty in making accurate business predictions and sound decisions. In this environment, companies and nations could be more vulnerable than they would seem.

Global and UK 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. The European R/E sector is getting ready for significant write downs, as new rules are implemented. We are observing a similar, yet more benign trend in the UK.

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.

Credit Event/Financial Accident: In the past few months, we have witnessed a significant build-up of pressures in the credit market. We still observe 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 retract liquidity, organisations and even nations who learned to depend on them will find themselves faced with steep funding cost rises and concomitant rising risks.

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

A US default: In summer, a divided US Congress will debate on extending the debt ceiling. Failure to do so could lead the US to default, with potentially significant consequences for the global financial system.

Asset allocation

Changes in our Strategic Asset Allocation

Asset Class	Stance	Comment
Equities	Neutral	We see that markets are looking past the potential for a slowdown in the global economy and the impact that that will have on corporate earnings and equity prices. At the same time inflation is coming down but may not return to the target levels of central banks for some time yet, which may delay an end to rising rates. 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. We added to our UK equity income exposure and reduced the allocation to US growth.
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. The risk of a slowdown in corporate earnings may hurt high yield credit so we reduced our allocations here and increased the weightings of more secure bonds
Alternatives	Neutral	We maintain a neutral positions in alternative asset classes for their diversifying characteristics.

Outlook and portfolios

The Investment Committee convened on 6 January and reached the conclusion that although some of the challenges that have emerged over the last 12 months appear to be easing, risks remain and the current environment continues to warrant a cautious approach to portfolio construction. For now, inflation has peaked in major developed economies but it isn't clear that it has fallen enough to allow central banks to pause interest rate hikes. Equity market valuations have broadly fallen closer to long term average levels but some significant sectors remain overvalued. The forecast recession is not expected to be as deep as previous recessions but corporates with weak balance sheets still pose a risk to investors. In this context, we have left our broad asset allocation unchanged but have increased the quality within the portfolio.

We continue to think that a neutral equity allocation is the right place to be considering the uncertainty in markets. Given that companies in the tech sector and growth companies still trade at stretched valuations we have opted to reduce our exposure to US growth companies and add UK quality income stocks.

To limit exposure to riskier parts of the bond market we are reducing high yield bond exposure and adding quality fixed income securities which will be more resilient if the economic environment deteriorates. If corporate earnings come under pressure then it will be the lower quality issuers which will come under pressure and money will likely move into the higher quality areas of the market. Were that to happen the money will most likely flow into the bonds of higher quality issuers.

Our themes

Japanese risks?
Uncertainty over the Bank of Japan

Investors have flagged the Bank of Japan's potential change in monetary stance, as a key financial risk for markets. Although we think that the BoJ abandoning Yield Curve Control could increase volatility and possibly push bond rates a bit higher, we don't see any systemic risks from it.

One of the issues that has caught the attention of investors is the possible change of regime in the Bank of Japan. The issue, and the economy, might seem removed, but it could have significant implications for investors globally.

Central banks in Europe and the US have been in "inflation fighting" mode since the summer of 2022, hiking interest rates aggressively in order to reduce aggregate demand and drive prices down. In Japan, a country that has barely grown in the past two decades, inflation has never really been a problem. Even now, when the West is fighting with double-digit inflation, Japanese inflation is at 4.3%. While it appears low, it is the highest read since 1981.

Low inflation had allowed the BoJ and departing central banker Haruhiko Kuroda to maintain an aggressively liquid policy. Throughout the pandemic, to this day, the central bank has exerted "Yield Curve Control". In other words, it has bought long term Japanese bonds in order to maintain the yield near 0.2%. At the end of last year, Mr Kuroda shocked the markets by lifting the cap to 0.5%, which was seen as a fist step in abandoning the policy altogether. His heir, Kazuo Ueda, has vaguely suggested that he would maintain the policy but has refused to commit.

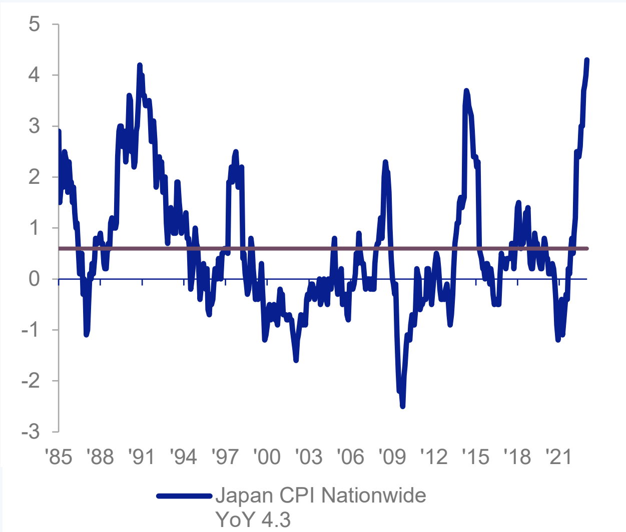
Markets are now thinking of the repercussions if Japan adopts a hawkish stance, similar to the US, the UK and Europe.

The first problem would be to the balance sheets of Japanese companies. While they are not very leveraged, these companies have been set up and run in the assumption of perpetually low rates. This goes for their pension schemes too. Higher rates after two generations could uncover problems yet unknown.

The biggest threat however, comes from $3tn of savings from Japanese consumers. Banks turn these savings into investments, usually outside Japan. The Japanese own 7.3% of US Treasuries, 7.5% of French and over 9% of Dutch bonds. Higher yields for the

Japan inflation at the highest level in over 40 years

Japan CPI Year over Year



Yen would mean massive repatriation. This would put further pressure on US and European bonds, which are already trending very high, and risk upsetting the balances in bond markets.

The final risk is carry trades. Traders borrow in cheap currencies, like the Yen, and lend in more expensive ones, like the Dollar, reaping the difference. While in the past the USD/Yen had significant leveraged positions, after 2007 this has been less of a risk.

Outlook: While we feel that a potential shift in Japanese policy could be a significant market event, we don't yet have evidence to say that the new leadership of the BoJ will preform a U-turn. Even if it did, however, yields in the EU and the US remain much higher than the BoJ could offer. Simply put, it's too late in the game for Japan to catch up to western central banks. Therefore, we would expect the unwinding of positions to remain paced and orderly.

The global housing market slump

During 2020 and 2021 global house prices were growing at record pace – bolstered by record low interest rates and buyers with savings to deploy. A year later, the picture is not so rosy anymore.

As the financial pressures on households have increased, the savings accumulated during the pandemic that helped support the housing boom are rapidly depleting. Not only can households buy less with their money, they are more likely to struggle to save for a deposit. As a result, the pandemic-induced housing boom across the globe is likely to be followed by the broadest housing market slowdown since the financial crash.

The biggest factor in the slowdown is undeniably mortgage rates. In the UK, the mortgage market has been sent into turmoil by the political crisis triggered by Liz Truss's short-lived government. Consequently, interest rates are expected to rise to 4.5% this year and UK mortgage approvals have fallen to their lowest level in more than two years.

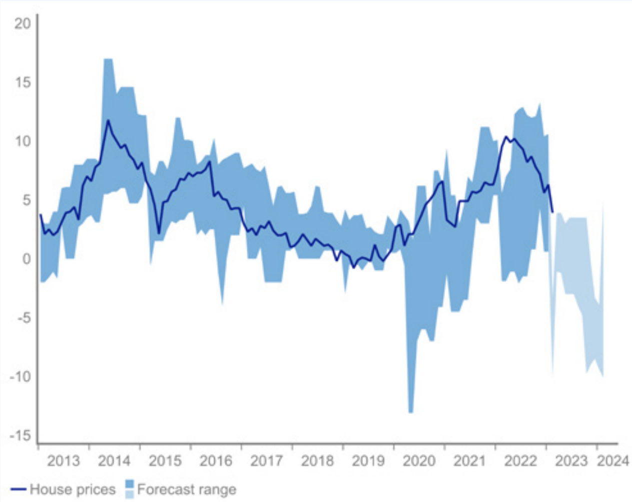
However, not all countries share the same risks. In Canada, New Zealand and Australia, for example, an acceleration in house prices over the last few years, coupled with the large proportion of households with a mortgage and high levels of debt make the housing market particularly risky. Similarly, Sweden and the UK are raising alarm bells because of their reliance on floating or short-term mortgage rates. Yet other countries like Japan, Italy and France, are better positioned, thanks to more modest price rises, less elevated valuations, and lower levels of household debt. France and Italy also have quite low shares of floating-rate debt.

Globally, analysts are optimistic that in most large economies, the conditions of the property market do not suggest as deep a downturn as that experienced during the GFC. There's also another major difference this time around: in many markets, households have lower mortgage debt relative to income than they had before the GFC.

One thing is clear - all signs suggest that the surge in housing demand underpinned by low interest is now a thing of the past.

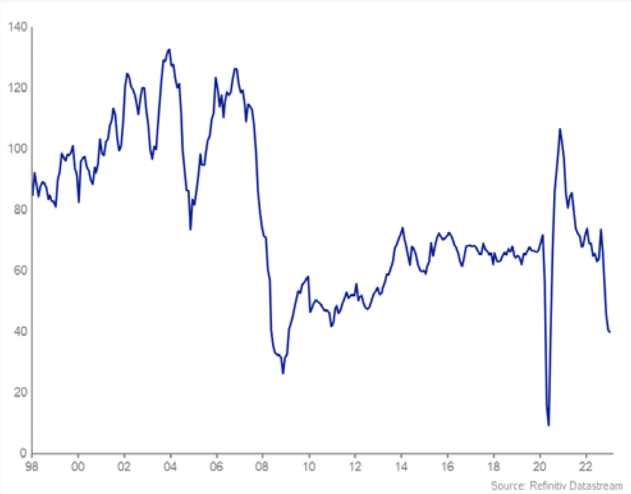
The UK housing markets is showing signs of a prolonged slowdown

UK House Price Index (Residential), Change Y/Y. Range of Forecasts, House Price Inflation (Q4 2022), HM Treasury.



UK mortgage approvals slump fifth consecutive month

UK mortgage approvals, thousands



The Inflation Reduction Act will be a boon to the US economy, prompting manufacturers to locate more activity in the US to take advantage of government funding. There will be implications for economies that do not develop green technology domestically.

You don't have to study the Inflation Reduction Act for long to realise that it has very little to do with reducing inflation. $400bn of federal funding will be directed towards different sectors with the aim of reducing the country's carbon emissions by the end of the decade. $216bn of this will be delivered to corporations through tax credits aimed to encourage investment in clean energy, transport and manufacturing. A requirement to claim the tax credits available is that production must be based in North America.

By heavily incentivising US-based production, companies that may have previously considered basing manufacturing in other jurisdictions will be likely to move that production to the US, bringing benefits to the wider economy. Since August of last year 22 electric vehicle companies, including Ford and Audi, have committed to increase production in the US, creating approximately 100,000 jobs.

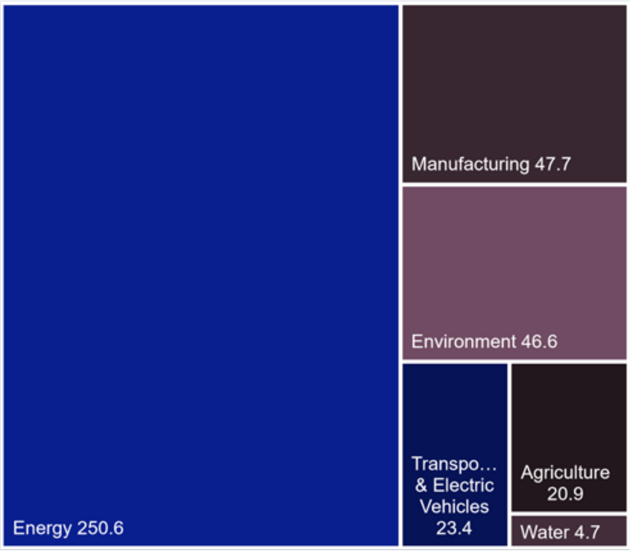
This has elicited strongly-worded responses from foreign governments, condemning beggar thy neighbour policies which adversely affect the economies of other countries. Beyond the jobs that will go to the US, there is also the domestic specialisation in the strategic sectors of clean energy and carbon reduction which will be lost, prompting calls for reactionary policies in other countries.

In China, state and corporations already work closely together to ensure that strategic industries are given adequate support and are able to grow. The European Union is considering relaxing the rules to allow individual member States to provide state aid. It is also considering an EU wide approach to enable smaller countries to make investments.

There are concerns for countries like the UK, which do not have a clearly defined their industrial policy and have not allocated resources to the nurturing of these industries, which are strategically important and could bring benefits to the economy in the future. The risk is that countries do not take this seriously enough and find themselves forever purchasing the services of other countries rather than relying on home grown industries. As yet, the UK Government has not made any moves launch a package similar to that of the Europe or the US. Given the current fiscal position of the UK government it is unlikely that the funding is available to do so.

The Inflation Reduction Act has nothing to do with Inflation

Subsidies available to different industries as part of Inflation Reduction Act, $bn



Inflation. Higher for longer?

Early in the year, consensus view was that the US economy was headed for an immediate recession, with inflation falling sharply and central banks slowing the pace of rate hikes. However, data releases in January and February suggested the opposite.

Since peaking at 9.1% in June last year, US headline inflation has been steadily declining to its current level of 6.4% in January. The main driver of the disinflation process has been the reduction in goods inflation, which has fallen from a peak of 14.1% in March last year to 4.4%. Conversely, services inflation has continued to rise, reaching 7.6% in January, the highest level in 40 years.

Goods inflation should continue to fall in the coming months. Oil prices remain below USD 80/bbl., which is 20% below the 2022 average price, food prices stand 10% below 2022, and freight costs have returned to pre-Covid levels and continue to fall.

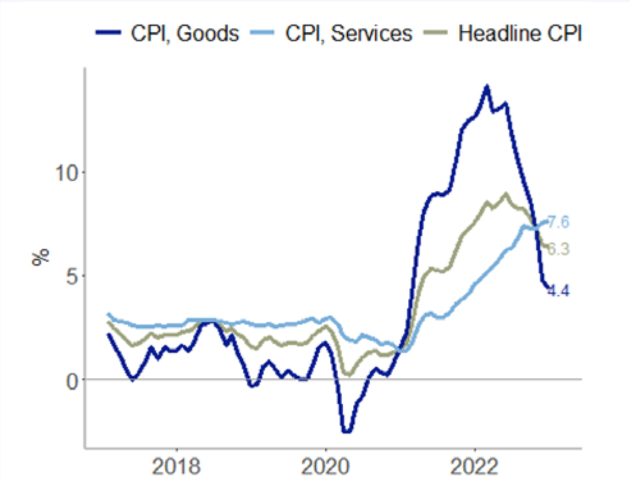
Services inflation dynamics are less clear. The services CPI basket has two main components with different price-setting mechanisms: housing services and non-housing services. On the one hand, non-housing services are labour-intensive and therefore their inflation tends to follow wage increases. On the other hand, housing inflation is mainly driven by house prices and rents, and it's more sensitive to interest rates.

Both wages and residential prices have shown signs of moderation in recent months. According to the Atlanta Fed, wage growth peaked at 6.7% year-on-year in August and is currently at 6.1%. Meanwhile, home prices declined 4.4% from its peak in June, according to the Case-Shiller national home price index. Historically, housing inflation has been highly correlated with home prices and rents. Housing accounts for about a third of the CPI basket, so if this relationship continues to hold, the housing CPI should slow sharply in H2 2023.

We currently expect inflation to end the year at around 4%, but the risks are tilted to the upside. The labour market remains too strong, unemployment is at a 57-year low and the economy continued to expand in 1Q23. In addition, the reopening of the Chinese economy may push oil prices higher: a 30% increase in oil prices (WTI at USD 100/bbl.) adds 1% to inflation according to our estimates.

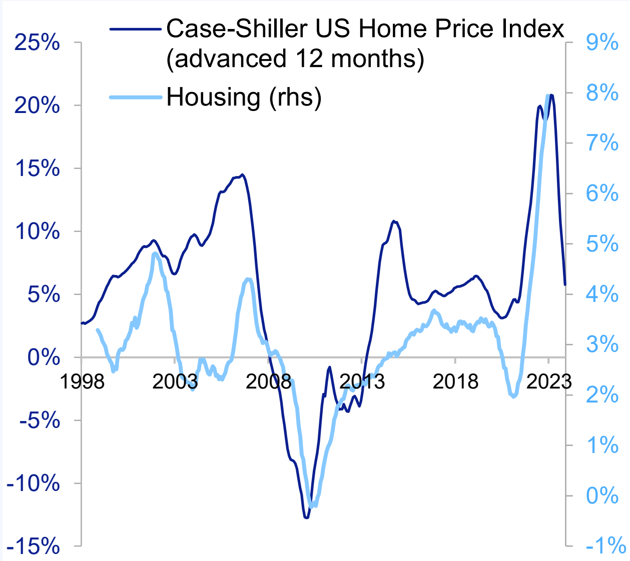
Stubborn services inflation

Goods and services inflation (YoY, %)



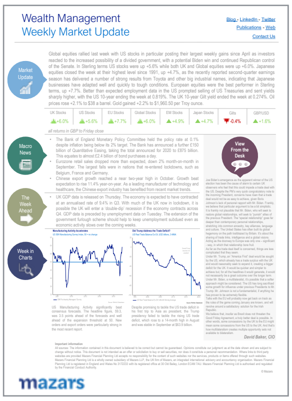
Housing inflation should slow down in 2H23

Housing CPI and home prices (adv. 12 months)



Source: Mazars EIU, Macrobond.

More reading...



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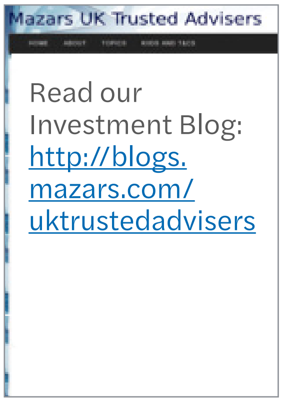

[Investment blog]

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