Singer
Capital Markets

END OF YEAR MARKETS REPORT

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AN INTRODUCTION

The rises in bond yields in 2022 – and falls in prices – have been the largest for centuries!

In 2022 the West said goodbye to headlines about Covid-19, but China's travails continue, which are very much of their own making. What looks to be a confirmed trend is the continuance of a series of challenges for financial markets to contend with. The end to free money has reduced financial markets resistance to these challenges, with the backstop of government bond buying ended. We argue that it is for the good of the financial system looking forward. As this is the introduction to our Annual End of Year Report, we will outline some key elements at this stage and then go into more detail through the report. Some have been specific to the UK and others are influences on a global scale.

The overriding driver for financial markets has been, as we identified a year ago, the "End of Free Money". Some may argue on this point, but it is at the heart of most of the financial challenges that we are currently encountering in the Western world. No more will you read about how many $trillions there are of negative yielding bonds.

This time last year inflation was already coursing through the world economy and, in the half year report, we asked "are we approaching peak?" The Russian invasion of Ukraine clearly accentuated the supply chain challenges prevalent globally and has added to inflation. "Has inflation peaked?" remains a pivotal question.

Central banks moved late as one by one they retired their transitory inflation stances and they had thus got themselves behind the interest rate curve. The interest rate cycle is intrinsically linked with inflation and we will ask "Are the central banks coming to the end of their battle? Are they also targeting the correct metrics?"

Last year we said on Bonds "at least we are not investing in bonds!". How true that has been through 2022 and we will, in each country section, look at the huge moves – and losses – we have seen. The rises in bond yields in 2022 – and falls in prices – have been the largest for centuries! The positive correlation between bonds and equities has caused much pain (i.e. both asset classes have seen prices fall). Bond prices are expected to rise in line with interest rates rises to tackle inflation but, with central banks seen as behind the curve, then bond prices fell, too.

Labour markets are, we believe, a much more significant and important influence than people may think. Recession, we are afraid, is already present in some territories. Remember, though, that markets look forward – so don't despair.

The dollar and asset allocation have had a major influence on fund flows. Is the assent of the dollar coming to an end? Last but not least, Geopolitics remains at the forefront of investors thoughts.

We will now review the rest of the world through 2022 before centering in on the UK, with themes and expectations for 2023.

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ASIA-PACIFIC

ASIA-PACIFIC

The area has been dominated for decades by the outlook for China but that, we believe, is on the wane for a number of reasons. Firstly, demographics. The one child policy has come home to roost! The Chinese population is now moving fast towards decline. Economist Professor Charles Goodhart and Manoj Pradham identified in their book "The Great Demographic Reversal" (published in 2020) how the changes (in particular in China and globally) looked likely to have a major influence on financial markets.*

For China, their time as a low-cost producer of goods for the world has come to an end, with the speed of this accelerated by a number of factors.

Firstly, the afore mentioned demographics. With population growth peaking, that makes high single digit growth rates a feature of the past. The low wage economy has come to an end, as with wealth growing the populace as a whole has demanded higher living standards. Secondly, geopolitics post Covid-19 and Russia's invasion of Ukraine has driven countries to move away from their dependence on Chinese production inputs. Previously identified factors such as on-shoring, near-shoring and re-shoring have only accelerated and intensified, as themes of 2022 have progressed. For example, look at the global chip companies announcing multi-$billion capital investments in the US and Europe. Thirdly, Chinese government policy led by Xi, who confirmed his role for life at the National People's Congress, is penalising the largest and wealthiest companies and entrepreneurs. The policy is said to centre on wealth redistribution, but is surely a lot more than that. Youth unemployment in cities has hit the heady level of 20% – a counter to the shrinking population in the short term. Property bankruptcies and the health of the property sector continue to hamper the economy. Finally, the zero-Covid strategy has, pretty much, been a disaster. Civil unrest has started to build and this is forcing the government to ease the policy, but with a large part of the populace remaining unvaccinated (especially the elderly) combined with refusal to import more effective Western vaccines. The first half of 2023 could see rapidly rising death rates, but will the data be suppressed and, as for much of the Chinese data releases, can we trust them? A reason, again, to take care over companies dependent on Chinese inputs – at least in the short term.

We looked for China to be cutting interest rates whilst the rest of the world increased them, and they have, but growth has not recovered as expected for the reasons above. 2022 Chinese GDP growth is forecast to be 3.2% down from a 5.5% forecast at the half year and to recover to a possible 4.8% in 2023. Will that be high enough to keep the populace satisfied? Meanwhile, the leadership continue their posturing on Taiwan. Could internal strive drive them to a distraction attack? We hope not! Inflation is not an issue in China, with it forecast to end 2022 at 2.4% and 2023 at 2%.

Elsewhere, Japan is the last bastion of QE with bond yield targeting, but just prior to going to press, they have raised the 0.25% ceiling for the 10 year JGB to 0.5%. A potentially seminal move with all the implications around this for fund flows and positioning – particularly if this is the first move that it is followed by more. The Bank of Japan already owns over 50% of the Japanese government bond market. Inflation has finally appeared in Japan with end 2022 headline CPI at 3.6%. It is forecast to fall back to 1% at end 2023, but will it? GDP growth is forecast for 2022 to be 1.5% and 1.3% for 2023.

Equity markets in Asia have followed the global trends, with China and the countries more exposed to global trade performing the worst and those more driven by commodity prices the best. The Chinese CSI300 has fallen by 21.2% to 19th December 2022 with the Hang Seng -17.3% and Nikkei an odd man out at -5.4%. In Australia the ASX is -4.2%, South Korea -23.1% and Vietnam -30.7%.

**The Great Demographic Reversal – Ageing Societies, Waning Inequality and an Inflation Revival: Charles Goodhart & Manoj Pradhan 2020.*

EUROPE

EUROPE

Europe has been dominated by the Russian invasion of Ukraine. The closer geographically a country to Ukraine then, arguably, the larger the impact. The impact has been accentuated by how dependent a country had become on Russian supply of gas to power their generation infrastructure. In the summer, it looked like Europe would be suffering power outages this winter and that could still possibly be the case. The risk of these outages has reduced significantly though, as the counties moved to replenish their storage through alternative supply. A mild Autumn meant that as we entered December, and the weather turned more seasonal, storage was effectively full across Europe. Combined with a drive to reduce consumption, the outlook is significantly improved for this winter. Import infrastructure is being built and coming on stream, particularly in Germany, from about now with more to come. Alternative new pipelines are being considered centered on injecting supply through Spain.

At one time, the benchmark European one month forward gas price was up 1628% or 17x from the approximate average level pre-Ukraine of EUr18. As we move through the current cold spell it is 7x higher. Still very significant of course, but a long way from the highs. Germany is cutting their consumption by about 10% with various other schemes around Europe. The costs of government subsidies is having a serious impact on government finances, with the core countries of France and Germany being hit the hardest.

The new leadership in Germany have not made much of an impact, nationally or internationally, especially when compared to the Merkel era. Meanwhile, Germany's industrial powerhouse is under threat as its historic strong drivers wane. Firstly, if we are right on China, that destination for German goods diminishes. Secondly, sales to Russia have gone to zero. And thirdly, the move from internal combustion to EV requires a lot less manpower and components. New entrants are aggressively taking share from the incumbent OEM's. It's a similar picture for Italy. If anything, the outlook for the likes of Spain and Portugal are some of the more positive in the eurozone!

The European Central Bank ('ECB'), at last, moved onto the interest rate rising ladder. Interest rates have risen from zero to 2.5% as CPI rose to 'peak' at 10.6% year-on-year for the October reading some 300bps ahead of the forecast at the half year. Interest rate futures have European rates peaking in a range around 3.25%. Inflation is seen ending 2022 at 10.4% and the ECB most recently raised their 2023 forecast from 5.5% to 6.3%! Christine Lagarde, the ECB President, set the cat amongst the pigeons at the December ECB interest rate meeting press conference, saying that markets should expect the ECB to continue to raise interest rates in 50bps increments for the foreseeable future. Arguably, they are the most behind the curve.

GDP forecasts for the EU block are now 3.2% growth for 2022 down from 4.3% forecast at the beginning of the year and -0.1% for 2023 – yes in recession – with the ECB itself a bit more positive at +0.5%. We doubt the ECB number given that Europe has not seen interest rates at this level and rising since before the Great Financial Crisis. Within that forecast, German 2022 GDP is forecast to be 1.7% with a 0.6% contraction in 2023 and France 2.5% and +0.3% respectively.

One result of the Ukraine invasion is that the EU has been driven closer together, with Poland pretty much back in the fold, even though they are still following some policies that the EU is far from happy with, such as independence of the media. Hungary is still on the fringe though, as they are torn between Russia and the West. Europe has suffered a year of "capital flight" with funds being withdrawn and heading west across to the Atlantic (see "The Dollar" section on page 17).

Bond yields started the year with the German 10 year yield at minus 0.186%, it peaked at 2.41% and is closing at 2.2%. The closely watched German-Italy 10 year yield spread has remained below the 250bps level which is seen as critical and ends the year at 219bps. If it were a rise above 250bps then the fears are the EU monetary union could start to fragment

EUROPE

2 year yields have seen even more extreme moves, with the German 2 year yield bottoming in March at -0.76% and finishing the year at 2.42%. The Italian 2 year yield has moved from a low of -0.28% to close at 3.1%.

European equity markets have certainly travelled this year! At its lows, the German Dax had fallen by 24.6% and has rallied to be down by 12.2% in 2022. The Italian FTSE MIB was, at its low, -25.6% and has also rallied to be -13.2%.

In 2022 the capital losses in bonds countries have typically exceeded those in equities, as we foresaw at the end of 2021.

USA & THE AMERICAS

USA

At the mid-term elections, Biden and the Democrats retained control of the Senate which looked, at one stage, a faint prospect. The Republicans have wafer thin control of Congress. The Democrats probably have Trump to thank for the results for two reasons. Firstly, his loading of the Supreme Court angered the electorate. Secondly (as we surmised it might in our half year report) the decision to overturn the Roe v. Wade judgement on abortion does appear to have really influenced voting behaviour. Dare we say that it could be the end for Trump, particularly with the emergence of an adversary, with high momentum in Ron DeSantis from Florida.

Back to the economy and, again, interest rate rises are at the heart of the 2022 story. The Fed rate has moved from 0.25% to 4.5% as “free money” has ended with vengeance. Up until the end of 2021, the Fed believed inflation was transitional, now they are at full on war with it. At the December Fed meeting press conference, Fed Governor Jerome H. Powell did acknowledge that US inflation had already peaked. We concur with that, and correctly identified in our Half Year Report, that the October US CPI reading (released in November) would likely be the first month that we would see large falls in the inflation reading. It subsequently came in below expectations and we have seen the same direction with the November reading. Yes, it remains elevated at 7.1% but it is down from a peak of 9.1%. The Fed's preferred PCE measure peaked at 7% and is currently at 6% with the core rate at 5%.

We now see the major risk in the US being that the Fed is going to raise interest rates too high. They are focused on the jobs market with inflation now falling. Why are markets at risk? Firstly, jobs is very much a lagging economic indicator. And secondly, the jobs market has seen a huge distortion from the pandemic, arguably making it even more lagged (see the “Jobs & Wages” section on page 17 for further discussion on this subject).

On to the question of whether the Fed have done enough with their interest rate rises. The flash December Purchasing Manager Indices readings for the US read 46.2 for manufacturing, 44.4 for services and 44.6 for the Composite whole economy. A reading below 50 signals demand contracting over the next 6 months! Enough? We think so.

US and global financial markets are searching for the Fed “pivot”, and by that we mean interest rates peaking and then looking to start moving back down again. This has driven the volatility we have seen through Q4, as markets hang on every utterance from the interest rate setters. A market adage is “never fight the Fed” but Powell has to keep up his inflation fighting rhetoric until one second before he changes it to maintain his credibility. Expect the pivot in early 2023 – or has it already happened? Data will decide that, and US data releases illustrated above by the PMI’s is increasingly weak.

US GDP forecasts have the economy growing by 1.8% in 2022 but remember that, at the start of the year, this was 3.75% with growth falling to 0.4% in 2023. Inflation measured by CPI is seen falling from 7.1% in Q4 2022 to 3.1% in 2023 and for the Fed's preferred measure PCE falling from 6% to 2.7%. The latter is sufficiently within the potential margin for error for the Fed to, at least, pause its interest rate rises. The results of the Fed’s first FOMC meeting of 2023 will be announced on 1st February, so quite a lot of data between now and then. We believe that the top is, at the very least, in sight for the US rate rising cycle and Powell should at least pause the rate rises. Interest rate futures have Fed rate topping out at circa 5.1% from the current 4.5%. At the half year point, the peak was seen at 3.5%, so the direction has been clear. This cycle the US could enter a downturn after the rest of the west.

The US has seen the dollar index rise by over 20% to the end of September. It felt like the whole world was long to the dollar. It has since fallen by 8%. We will look at the outlook for the US dollar in more detail in the "In Summary" section.

Like those in Europe detailed above, US bonds have had a disaster of a 2022. The global

USA

benchmark, namely the 10 year Treasury, started the year yielding 1.51%, peaked at 4.2% in October and finishes the year at 3.58%. The two year Treasury Bill started the year at 0.73% peaked at 4.72% and ends at 4.23%.

US equities have been in a downtrend all year, with periodic rallies for the S&P 500 notable ones in March of 11%, June to mid-August of 17.4% and October to end November of 14.1%. A lot of travelling then, and these rally patterns have been repeated around world equity markets. The S&P bottomed -24.9% and closes -19.2%. For the Nasdaq Composite, the index bottomed at -34% and is closing the year -32.4% – so not much of a bounce there. As expected, the rises in bond yields hit the long duration stocks the hardest. The end to free money is also a major factor here, particularly for those loss-making companies in the indices. The rise in bond yields has increased the discount rate for the many technology companies, where valuations are high or profitability is not expected until some time in the future. The tide has turned for good!

UK

UK

Last but not least, the UK. At the half year stage we were looking forward to a (hopefully) less volatile period, but little did we know! We thus have to start with politics (sorry) and three Prime Ministers this year and four Chancellors illustrate the scale of the chaos. Truss and Kwarteng and their “Mini-Budget” left us literally sitting in our chairs in shock. They got one thing right, though, and that was to have a plan for the UK economy! The rest of their policy plans drove markets to some, quite unbelievable, levels as a £55 billion hole appeared in the UK government finances overnight.

Sterling approached parity against the dollar, bottoming out at $1.035.

Bond yields rose rapidly, with the UK 30 year gilt yield hitting 5.1% from 3.5% prior to the mini-Budget and the 10 year 4.6% from 3.3%. This caused chaos in pension markets due to an investment strategy called "LDI" or Liability Driven Investing. To cut a long story short, the Bank of England had to intervene and buy long gilts to support the market just as they were meant to be starting the reversal of QE through selling their bond holdings (i.e. QT). You couldn’t have made it up!

Over the period of Truss's rein, the FTSE 100 fell by 5.7% from 21st September to 12th October with the FTSE 250 falling by 11.24% over the same period, as the repercussions of the policy announcements ricocheted around markets.

The crisis had to be brought to an end, first with Kwarteng being sacked with a very short-lived replacement and then Truss resigning. A Conservative Party leadership election brought Sunak in as Prime Minister with Hunt as Chancellor.

Sunak and Hunt's Autumn Statement (i.e. Budget) has, at least, illustrated that the “adults” are back in charge and stabilised financial markets as they announced measures to close the £55 billion “black hole”. Half of the hole would be filled by tax rises, half by pending savings. The cost of this stabilisation was higher taxes for, pretty much, all – from the consumer to corporates with the 6% corporation tax rise reinstated. For households, the tax burden has risen to its highest level since WWII, whilst consumer disposable income is being squeezed by generational high levels of inflation. The overall UK tax burden will increase to 37.1% of GDP by tax year 2027-28.

The UK government needs to raise some £300 billion gross through gilt issues in 2022/23. 2023/24 is looking like being circa £170 billion of sales, so this is a huge increase with Quantitative Tightening gilt sales starting, too. The Bank of England hold circa £800 billion of gilts from QE. The final amount to be raised in 2022/23 will depend, to an extent, on the cost of energy support schemes which are dependent on the gas price. UK government debt, as a percentage of GDP, is at circa 100% and not forecast to fall much over coming years. Inflation is driving up the governments cost of servicing debt, too, with some 25% of all UK issued gilts being index-linked.

The twin UK deficits, one on the current account and the other on the fiscal budget, are a real challenge for the UK government and economy looking forward. Importantly, the UK is not alone in seeing this, particularly after the pandemic’s hit to government finances.

OBR GDP forecasts now have UK GDP rising by 4.3% in 2022, which is higher than the 3.75% at the half year! Why, you may ask? The government assistance on energy bills for corporates and households is the major factor. According to the government OBR forecast, they then have GDP shrinking by 1.4% in 2023. Independent forecasts are slightly more optimistic, with a fall of 0.9% for 2023. That's quite a delta and will be felt by all if that is the result. Inflation is seen falling back to 4.6% in Q4 2023 from 10.4% in 2022. This is still significantly above the Bank of England's 2% target.

Interest rate futures have UK interest rates peaking at over 4.75% from their current 3.5%

UK

level. Remember, they started 2022 at 0.25% and we have seen 8 rises. We would argue that the Bank of England have been way too timid with their interest rate policy. If anything, they have back-loaded it rather than front-loaded. The likely results is that interest rates will likely have to increase to a higher rate than they otherwise would have had to.

As we come to the end of 2022, the government is being challenged by public sector and regulated industry strikes. The squeeze on consumer balance sheets from rising inflation, higher taxes and rising interest rates are the root of the cause. Yes, at the heart of all of this is the ending of the free money policy that was in place for years too long. Whilst the private sector is raising wages by some 6% or 7% if you include bonuses, public sector pay is only rising by 2.7%, according to the latest data. In addition, private sector businesses are using their flexibility to make cost of living payments of say £1,000, which they hope will not be included in wage negotiations in 2023, thus not rising the base level. Like in the US, job vacancies remain at historically elevated levels, adding to the labour market tensions.

The strikes will be settled in due course, but will that damage government credibility again? Especially with the electorate. It is still 2 years or so away, but a General Election is fast approaching. We suspect that the incumbent government saw the Autumn Statement as their opportunity to get all the “bad news” on the economy into the public consciousness so they can hopefully, from their point of view, start to get into a virtuous circle of good news into 2024. No progress on that front so far.

UK bonds continue the trends we have already outlined in the Europe and US sections above, with the Trussonomics fun and games added for good measure. The UK 10 year gilt started the year yielding 0.96%. peaked (as said above) at 4.6% and is ending the year at 3.4%. The 2 year started the year at 0.64%, peaked at 4.55% and is closing at 3.55%.

UK equities have seen a huge divergence in performance between the FTSE 100 and the rest of the market.

At its worse, the FTSE 100 fell by 7.5%, and you will not be surprised to learn that was whilst Truss was in charge, and is ending the year -0.2%. It has traded up and down in a range between 6,800 and 7,670 all year with 4 up trends and 3 down trends. A lot of traveling again. This was driven by investment in financials as the yield curve steepened; the dollar strengthening benefiting the large number of dollar earners in the FTSE 100; and outperformance from oil and commodity stocks.

At its worse, the FTSE 250 was -29.3% and is closing the year -20.5%. It has effectively been in a downtrend all year, with periodic rallies.

At its worse, the Small Cap index was -23.9% and is closing the year -17.9%.

At its worse, the AIM All Share index was -36.25% and is closing the year -32.3%.

The trio of the 250, Small Cap and AIM have been on a rally following the adults taking over UK government again in October. The 250 have led this with AIM lagging. The start of the rally in the 250 coincided with the first large move downward for the US dollar index (more on this in the "In Summary" section which we will move on to now).

IN SUMMARY

IN SUMMARY

2022 was the year of “travelling” for markets. By that we mean that moves up and down were very large. Generally, for UK mid and small cap shares, we are afraid it was down, as detailed previously. Although, the FTSE 100 was the best performing developed market!

Let us look forward now into 2023 and what we see as the key themes...

Recession

Will we see a recession in 2023? The Purchasing Manager Indices ('PMI’s') are designed to measure activity some 6 months out. A reading above 50 is expansionary and below contractionary. Needless to say, for the major economies, pretty much all of these measures are signaling contraction. If that were to last 2 consecutive quarters then that would classify as recession. In Figure 1 to the right hand side, you can see the Composite for which read whole economy PMI for the global economy. As you can see, it has been hovering below 50 for a period now. A contraction, but only a shallow one. Looking at the UK, the most recent “flash” data for December had the manufacturing PMI at 44.7, services at 50 and the Composite at 49. Services is some 80% of the UK economy, and we can say that the growth outlook for the UK economy is not dissimilar to the world – if these indices are a good measure.

We see a shallow recession in the Western world as central banks increases in interest rates have their impact. Given that we have had, until this year, “free money” since 2008/9, then it is particularly difficult to judge. The economic impact of the large rate rises on economies acts with quite long lags. That argues for more caution than would be usual from the central banks as they assess that impact. We certainly argue for a pause in rate rises in the US, with them racing to raise interest rates by 425bps in 2022 Now is the time to pause to allow their lagged impact on the economy to wash through.

In the UK and Europe, who are further behind the curve, then more rises are most probably warranted. Do not despair, though! The falls we have seen in UK mid cap and small cap stocks in 2022 have been because of this outlook. We are now looking for the turning point upwards. Remember, equity markets are typically looking 12 to 18 months forward in time.

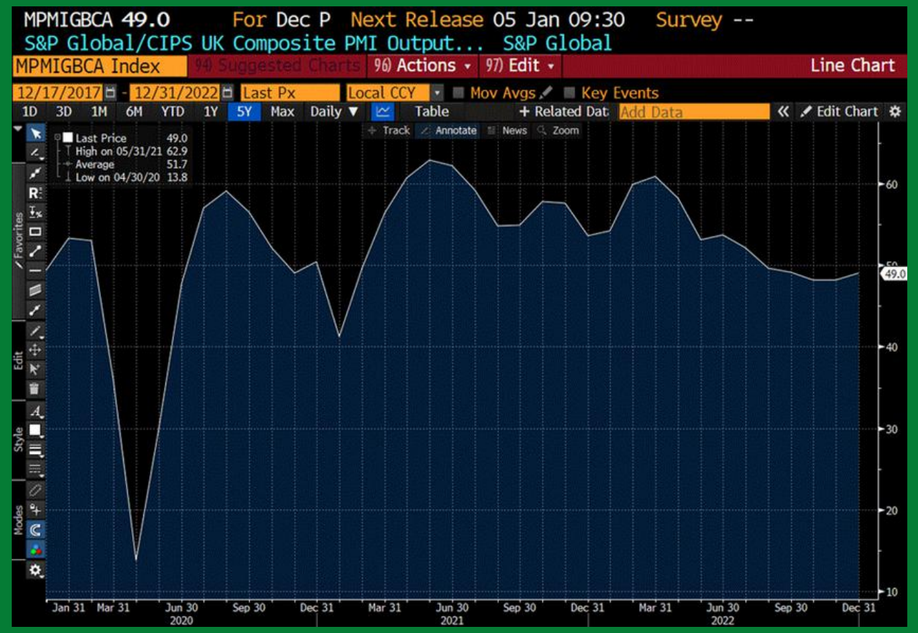

Figure 1. Source : Bloomberg Finance L.P.

IN SUMMARY

For example, we have already seen some strong bounces in the FTSE 250 on days that the dollar index has rolled over. We move on to the dollar next. Another driver will be already depressed valuations, which we discuss later.

The Dollar

Travelling is one of the themes through this report, and the US dollar has certainly done that this year. Up until recently, the direction has pretty much been one way, with the US dollar index rising by 19.3% to its high in September. Flows move markets and the UK and, for that matter, Europe, have suffered from continuing flows out of assets with those monies heading west across the Atlantic all year. Looking back into 2021, the dollar index rally started in mid-2021 and the rally from then to this year's peak was 27.3%. Markets mused whether the Euro and then sterling would hit parity with the dollar. The Euro did but sterling was “rescued” by the change of government leadership. From that September peak, the dollar index has fallen by 8.1%.

We argue a continued fall back in the dollar is likely, as with inflation peaking, the US interest rate raising cycle should be expected to come to an end, first amongst western markets. We would look for funds flows to reverse and to move back east across the Atlantic benefiting UK assets and, in particular, mid and small cap stocks. October 12th was a particular case in point when a very large 1.5% fall in the US dollar index drove the FTSE 250 up some 1.9% with that trend being repeated. Those funds are likely to find themselves into mid and small cap stocks over the large cap, given the latter's much higher exposure to that depreciating dollar.

We also shouldn’t forget that the UK government has some £300 billion plus of gilts to sell! That’s a lot of sterling to be bought if overseas investors are to buy them and, without overseas buyers, it is very hard to see issuance success.

Jobs & Wages

Our first point with respect to jobs, is that the Fed appears to be increasingly concentrating on the jobs market but have perhaps forgotten that jobs are a historically proven lagging indicator. To explore this further, there are a number of other key factors overlaying the current dynamics of the job's market – at least in the Western world and in China, too, for that matter.

Firstly, think back to the turn of the millennium and one of the key factors being discussed in respect of the longer-term drivers for financial markets was the forthcoming retirement of the so called "baby boomers" who were born in the mid 20th century post war baby boom. Generally, they have accumulated strong balance sheets as the world has, since then, seen probably the fastest growth in wealth in history. Okay, it may have been faster say in a period pre-1900, so let's say modern history! Fast forward to the 2020’s and this cohort are now retiring and reducing the total workforce in many developed countries. Western economies are seeing increasingly ageing populations.

Secondly, the pandemic. The associated necessity of Work From Home ('WFH') and fear of infection have, for sure, accelerated the rate of retirement, driving more early retirement, and/or withdrawal from the workforce – the latter defined as becoming inactive by economists. A UK Office for National Statistics ('ONS') Report says that the so called rate of economic inactivity (i.e. people who have withdrawn from seeking work) rose by 0.9% in the UK between the end of 2019 and mid-2022. That equates to some 565 thousand people no longer seeking work. The ONS study identifies only 3 countries in the OECD with a higher percentage of dropouts, namely Columbia, Chile and Switzerland. Some countries have seen economic inactivity fall, which is perhaps explained by the rising inflation rate and the need to seek work – which is the more intuitive reaction.

IN SUMMARY

As a result of these two factors, many countries in the developed world now see themselves with shrunken working populations (ss evidenced by the record numbers of job vacancies in, for example, the UK and the USA, as well as many other countries). This combines with the challenges to growth that many of these countries are also seeing. In addition, certain countries have their own specific factors. In China, the previous one child policy means that the population is now moving into contraction. Economic history has shown us that delivering high rates of growth whilst your population is shrinking is hard, if not impossible. In the UK, Brexit has had an influence on the working population.

Central banks are concerned about a potential wage-price spiral and we agree that needs to be nipped in the bud. Those same central banks getting “behind the curve” have not helped that fight, but H2 2022 has seen their fight invigorated. Here we repeat our question as to whether the authorities are focusing on the wrong indicator in jobs? It’s a lagging indicator and it has been significantly distorted by the pandemic. We argue that they should reduce their reliance on job's data as this is not, as it stands today, a measure interest rate policy can influence, due to the factors mentioned. This reminds us of Goodharts’ Law which is that “when a measure becomes a target, it ceases to be a good measure.”

That is not to say that, post-pandemic, the bargaining power between employers and employees has not changed. A smaller workforce combined with secular drivers, such as reshoring and baby boomers retiring, we suspect, may have tilted the playing field back towards employees after a period post the financial crisis when companies share of profits has hit all time highs. We will discuss that further in the "Earnings, Valuation & Equities" section.

Inflation & Interest Rates

Figure 2 below illustrates this. We argue that the spike from goods inflation has, pretty much, now passed through the complex. An important word here is "spike". Oil, as measured by WTI, is -0.5% in 2022; aluminium is -15.9%; copper is -14.4%; steel is -13%; iron ore into China is -5.7%; wheat is -2.6% ; corn is +9%; cotton is -24.9% and so on. Gas is the outlier due to Ukraine, with benchmarks in the US +52%, the UK +47% and Europe +54.6% from the beginning of the year but having, of course, been a lot, lot higher. Ex-gas then whilst they spiked up to much higher levels in 2022, these commodities have fallen back to be almost all down in 2022. Goods inflation has passed.

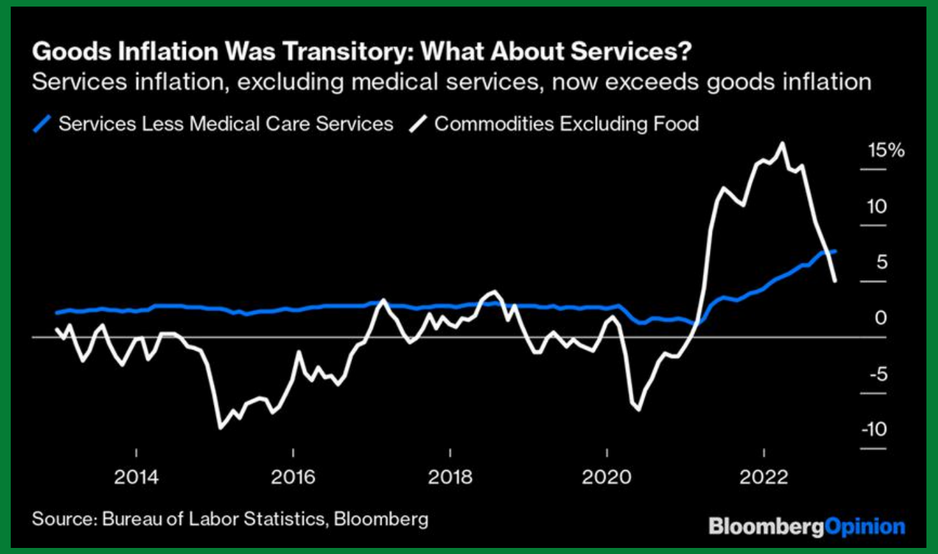

Figure 2. Courtesy of John Authers at Bloomberg. Source: Bloomberg Finance L.P.

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Much has been written of the comparison and similarities of the inflationary period now with the 1970's. We beg to differ. The period in the 1970's was much more one of inflation starting relatively high and moving higher and higher. The 2020's experience is one of inflation, spiking up from low levels when financial markets were more worried about deflation than inflation. As seen in Figure 2, the goods spike is subsiding. The question now is: "Will 2023 see the same move down for services inflation?"

Consumption has been making up the majority of the growth driver in developed economies. In the US, some 60% of growth has been consumer driven – the health of the consumer is key to this question of whether services inflation will follow goods inflation down. Wages have been rising and, as discussed, we are probably seeing a move back in the balance between labour and the employer towards the employee. Wages could continue to rise then. The other side of the equation, though, is the squeeze on consumer disposable income from the rapid rise in inflation but also if we defer to the UK from higher taxes, too – the highest tax take since WWII. Many of the job vacancies are in the services economy but if we are right on a shallow recession, they could disappear quite quickly – jobs a lagging indicator. We would expect businesses to be reluctant to lay of those recently hard-won employees unless the going gets pretty bad.

On balance, the squeeze on the consumer and the growth outlook lead us to believe that services inflation will fall back in 2023. It may well be more sticky on the downside than goods inflation, though.

It would be remiss of us to not mention the difference in the inflation outlooks in the US to the UK/Europe. The US has seen energy mix prices return, pretty much, to pre-Ukraine levels, which is not the case in the UK and Europe, primarily due to the dependence on gas and previously on gas from Russia. Inflation is likely, then, to fall faster in the US than in UK/Europe in the absence of any settlement on Ukraine.

In the US, we argue it's time to pause on interest rate rises. In the UK, we are getting close to peak (so long as the rally in sterling continues). Some may remember the UK's historically strong propensity to import inflation. In Europe, as said recently by Lagarde, then there are more interest rate rises to come.

A final question on inflation (if you will indulge us) – will we be worrying again about deflation in the US this time next year? It seems a faint prospect at present, but look at that sharp fall in goods inflation and the end to free money, and a possible US recession, then it could be more likely than we think – although remaining an outside bet.

Debt

At the risk of repeating ourselves, the era of free money has come to an end. Debt now has a cost, and that cost is rising as central banks raise interest rates. As the world slows from the end of the pandemic activity bounce, we caution against investing in companies with higher levels of indebtedness. If earnings see downgrades, then typically cash generation falls, too. The net debt to EBITDA or interest cover covenant calculation can very quickly turn nasty. It is, then, the equity component of the companies enterprise value that takes the strain – often in a very geared way.

Generally, corporate balance sheets are in a good shape though post the pandemic, as balance sheets that needed to be rebuilt saw that happen in the last couple of years. A factor to bear in mind though, those companies that are going to disappear are the "zombies" who have been hanging on running their businesses for cash, supported by the banks and free money. It was Spring 2022 when the banks attitude to these companies changed.

Consumers who have been big supporters for economic growth, particularly in the US, are

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already turning to credit with balances back rising as pandemic savings have been run down.

Investment

As per last year, we see investment as a key driver of the pick-up in economic growth. This theme has been, somewhat, overshadowed and delayed by the Ukraine conflict, but remains core. Monies have perhaps, for the shorter term, been diverted into defence spending. If anything, reshoring and near shoring have accelerated in the past year, as the geopolitical climate has got hotter. A trade war has effectively been started between the US and China – see the chip bans for a prime example – and a supply chain dependent on China is seen as increasingly risky. That drives investment, as supply chains are re-organised.

Add on the electrifying of the world in order to limit the rise in global temperatures.

Add on the more and more necessary investment in modernising the developed world's ageing infrastructure.

Add on the shrinking workforce, which is likely to drive companies to invest to drive productivity gains as they need to get more efficient.

Add on digitisation investment.

And finally, add the end to free money which had the effect of depressing investment as it supressed the return on capital, not helped by zombie companies run for cash. As mentioned above, they are now disappearing.

We see a period of strong investment in capital looking forward. Companies exposed to this are set to benefit.

Geopolitics

2022 has seen a regrouping of the global power houses. On one side, we have the group led by the US which, under Biden, has moved closer to Europe post the Russian invasion of Ukraine. Include in this: the UK, Japan, most of Asia /Australasia ex-China and North Korea. On the other side we have Russia, which has moved much closer to China and Iran with that group looking to increase their influence in the Middle East. The stance of states like India and Turkey, and much of Africa, is more unsure as they look to take sides according to their own advantage (e.g. India buying Russian oil and, well, who knows where Turkey sits).

These allegiances are similarly having their impact on supply chains as discussed above with reshoring and near shoring accelerating. Another result of the geopolitical changes is the increases we are seeing in defence spending as consortia develop to drive forward projects. Even the likes of Germany and Japan have now announced significant increases in their defence spending. The first big moves by these countries since WW II.

Secular Themes

By definition these shouldn't have changed much from last year. Thus we start with The Singer Growth Economy themes, namely:

- Health & Wellbeing of the Population
- Transition to a Sustainable Economy
- Innovation & Emerging Technologies
- Geopolitcs & Demographics

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Hopefully you can identify these in their many forms throughout this report. To these, add the following :

- Reindustrialisation in developed countries as evidenced by, for example, reshoring with the added driver of a new supply chain revolution;
- An acceleration in the speed of digitisation;
- A secular pick up in capital investment, both in manufacturing and infrastructure.

The UK and a Strategic Plan

Is it too much to ask for the UK leadership and/or establishment to work to come out with a forward looking strategic plan for the UK economy? 2022 culminated with the disaster of Trussonomics, and the UK is now on a path of rebuilding credibility, especially with international investors. A plan as to which areas of the UK economy that are seen as strategically important on a 20 to 30 year view would serve as a part of that rehabilitation.

These areas can then become targets for government pump priming and a, hopeful, move into a reinforcing investment cycle.

Investor inflows into the UK (and in particular into UK equities) are much needed after a number of years of outflows. Will we see a plan?

Earnings, Valuation & Equities

As we look into 2023 and a likely shallow recession, we are thus likely to see downgrades to earnings forecasts. In fact, through Q4 2022 we have already been seeing that. The key question is after the fall in mid and small cap share prices, what has already been discounted in share prices? To the better, one measure of the turn in market sentiment is that when we see an earnings downgrade announced, share prices fall by less than the amount of the downgrade, or even move higher, as investors expected the hit to be even worse. Have we started to see this happen? The answer is yes. It is not widespread, but there are signs. The January Christmas trading updates from consumer-led companies will be a big test of this. They are unlikely to be particularly upbeat given the squeeze on the consumer that will extend into 2023. Much of that must, already, be discounted in share prices.

We discussed previously companies share of profits versus that of labour. There is some pressure there, and the extent of this and how prolonged it is depends on how deep the economic slowdown is. This is thus likely to hit company margins but, on the other side, return on capital employed may grow as the zombie companies are finally shot now free money has ended. "Zombie companies", you question? Those are those companies that have been only just surviving due to free money with them running their businesses for cash and lowering the ROCE for all. The end to free money and these companies disappearing should (hopefully) improve returns for the rest and help offset the renewed bargaining power of labour.

Pricing Power remains a long held attribute held by the most successful companies, and one we have discussed many times before. The return of inflation on the reopening post pandemic has illustrated again why pricing power is so important.

In conclusion, we repeat our belief from our half-year report that as inflation and thus, interest rates, are seen as peaking then bond yields should start to fall. That should be positive for equities and, in particular, those in the UK when combined with what we see as a continued fall in the US dollar in 2023. Remember that the FTSE 100 has significant exposure to the US dollar, which has aided its strong relative performance in 2022 and the

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dollar falling points to mid and small cap outperformance. UK mid cap and small cap stocks have already had a large part of their "recession", as evidenced by index performance. We would again expect "Quality Growth" stocks to lead the indices up. Growth, in what is admittedly likely to be a recessionary environment (at least in H1 2023), we believe will be valued at a premium. Secondly, growth should be valued more highly as the discount rate that is used to discount those future earnings, which is derived from bonds, falls again as the interest rate cycle is seen as peaking.

The risk to our view is that the central banks, buoyed by their inflation attacking zeal, raise interest rates too far and push the world into a deep recession. We would hope that this will not happen and it is not our central case for 2023. Also, we should mention that the move up in bond yields has meant that bonds as an asset class are now too competing more intensely for those investor pounds, dollars and euros.

As equity markets look forward with the interest rate cycle peaking, we see the equity issuance market reopening. History has illustrated that the new issues and equity fund raises, at this stage of the market cycle, can be particularly rewarding.

We finish with saying a (thankful) goodbye to 2022 – what a year – and look forward to a much more buoyant 2023.

All indices and pricing data to 19th December 2022.

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